Trend Monitor

November 2023

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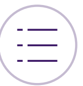
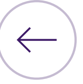
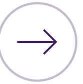

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Introduction

The Trend Monitor lists important trends and related risks in the financial sector. The Trend Monitor provides context and detail and explains the links between relevant subjects of supervision. Early identification and understanding of changes in the sector contributes to a risk-driven, forward-looking and preventive approach to supervision, thus fulfilling the AFM's mission to promote fair and transparent financial markets and contribute to sustainable financial prosperity. Chapters 1 to 4 set out the main trends and risks for our four supervisory areas – Financial services, Capital markets, Asset management and Financial reporting and audit firms. The publication of the Trend Monitor 2024 includes two separate in-depth analyses of (i) factoring climate risks into housing prices and (ii) algorithmic collusion in capital markets.

Trends

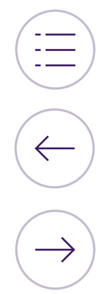
General developments

Economic growth is slowing down, with persistent inflation and rising interest rates as major causes. In 2022, inflation rose sharply due to steep increases in energy prices. Globally, central banks have intervened by tightening monetary policy to moderate inflation, but core inflation, in particular, has not yet been curbed. Inflation is expected to be well above the ECB's inflation target of 2% in 2023 and 2024. Meanwhile, there is a slight recession in the Netherlands, because the growth figures for the first and second quarters of 2023 were just below zero. The Dutch economy is expected to grow by 0.7% over the whole of 2023 and by 1.4% in 2024, while the labour market remains tight.[1] However, this slight economic growth is vulnerable to disappointing economic growth of global economies like the United States and China and geopolitical tensions.

Government intervention has limited the financial consequences of high inflation and interest rate rises for Dutch households for now, but vigilance is required. The vulnerability of the economy is reflected in the financial position of households. Households experience the impact of high inflation on their finances, partly due to more expensive groceries and increased energy costs. The government is taking measures to mitigate the consequences of this, especially for low-income households. This will prevent the expected increase in the number of people in poverty for the time being. However, concern for the vulnerable remains high and this is therefore a focus of attention of supervisors and policymakers. In the credit markets, we have not yet observed significant shifts. Mortgage rates are largely fixed for a longer period of time and house prices are still adjusting to the new interest rates without major shocks. At the moment there are few, if any, indications of increasing payment problems in consumer or mortgage credit. Only a sharp economic downturn would worsen this, but that is not anticipated at present.

Within the financial sector, high inflation and rising interest rates have a strong impact on revenue models and the financial valuation of assets. The rise in central bank policy rates is pushing up government and corporate bond yields. The transition of interest rates to higher levels generally means a healthier revenue model for many financial companies. It also leads to a more robust financial system because it means there are fewer incentives to look for returns through risky activities. However, the transition to higher interest rates also results in a depreciation of the outstanding debt. This particularly affects holders of fixed income. The expected value of companies that float on the promise of their growth potential (such as startups in the tech sector) is decreasing, while financing at very low interest rates is no longer possible. With persistent inflation, rising interest rates, uncertainty in capital markets and high speed of news dissemination, it is conceivable that this will lead to abrupt price fluctuations and liquidity problems in the coming period.

1 'Macro Economic Outlook', CPB, September 2023.



Digitalisation

Developments in artificial intelligence (AI) are moving at lightning speed and create opportunities and risks for the financial sector. The applications of AI (for example Large Language Models, such as ChatGPT) will have an increasing impact on society and the economy and therefore also on the financial sector. In general, AI can contribute to making the financial sector more efficient by taking all kinds of administrative, data processing and risk management tasks off your hands. In addition, AI can be used for direct services in the form of advisory services, devising and executing trading strategies, personalising prices for credit and insurance, conducting targeted marketing campaigns, and so on. The use of AI can also entail risks, for example when it is unclear how an AI model arrives at a certain outcome. Personalisation using AI can also lead to certain consumers being discriminated against or excluded from the market on the basis of the algorithm used. It is important that financial institutions take sufficient control measures to reduce the risks of the use of algorithms and to be able to explain the results of AI models. The European AI Act that is being developed will offer more starting points to manage the potentially large impact of AI but will most likely also lag directly behind the advancing technological possibilities.

The digitalisation and platformisation[2] of the financial sector continue at a steady pace. An important development is the interweaving of the financial sector with (major) tech companies. The interconnectedness of major tech companies often leads to lower costs and greater efficiency, but also leads to more dependence and concentration risks, vulnerabilities such as digital crime and reduced areas of intervention for supervision. The crypto market also continues to move. The arrival of the new Markets in Crypto-Assets Regulation (MiCAR) can have a legitimising effect, falsely giving the impression that cryptos are less risky (cryptowashing), which can lead to renewed interest from consumers (and rogue parties). The development of the underlying technology (distributed ledger technology, DLT) is still trying to deliver on the promise in the form of a shift from the traditionally centralised financial system to a peer-to-peer financial system (decentralised finance, DeFi). For the time being, DeFi also carries several traditional financial risks and these are further reinforced by the international decentralised nature and the increased complexity of the underlying technology.

2 Platformisation is the offering of financial products and services via online platforms.

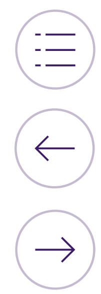
Sustainability

Achieving the climate goals of the Paris Agreement is under pressure.[3] This leads to a further increase in the risks of climate change, including extreme weather, sea level rise and biodiversity loss. In the Netherlands, this means, among other things, increasing financial damage as a result of drought, floods and extreme weather. Much of this type of damage is uninsurable, which can lead to major financial risks for households and businesses. Social awareness of this has yet to take root (see also the in-depth analysis "Factoring climate risks into housing prices").

There is a growing social and political desire for financial markets to accelerate the sustainability transition. The demand for green (investment) products is increasing. This leads to strong incentives in the market to meet this demand. A wave of new sustainability regulations is unfolding. These regulations mainly focus on improving transparency concerning sustainability risks and impact, and aligning financial products with the sustainability wishes of customers. For the transition, trust in the 'green' label is crucial. This includes the risks of net-zero claims from issuers and emerging trends such as voluntary carbon markets.[4] Early intervention and adjustments by policymakers and supervisors prevents ambiguity.[5]

So far, the sustainability transition is failing to achieve the desired pace. In all kinds of areas within the financial sector, the pressure on sustainability is great, but there are also concerns about the speed at which the sustainability transition is continuing. Asset managers are cautious about classifying their funds because there are not yet sufficient clear regulations on sustainability classifications. Issuers and accountants, among others, will have to deal with new European reporting regulations (CSRD), but available sustainability data often still fall short of the reporting requirements. Another issue is finding the optimal balance between financial return and the ESG impact of investments. The way in which sustainable investments are presented is not sufficiently in line with the motivations of consumers to invest sustainably. This makes it challenging for consumers to determine which sustainable investment suits their preferences. When ESG goals are actually prioritised, it requires transparency in informing investors, because expectations may be high, but the real impact on sustainability is often difficult to measure. Also, the continuous growth of

3 See for example: 'AR6 Synthesis Report Climate Change 2023', IPCC, March 2023.
4 See for example: 'Voluntary Carbon Markets', AFM, April 2023.
5 See for example: `Guidelines sustainability claims', AFM, October 2023



passive investing, under pressure of economies of scale and cost savings, does not contribute to a strong focus on polluting companies. All in all, any delay reduces the chances of a swift and orderly transition to a sustainable economy.

Internationalisation

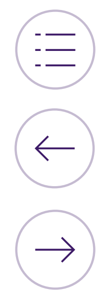
Financial services are increasingly becoming international, entailing cross-border risks. The Dutch financial markets are attractive to foreign parties. Driven by digitalisation, we are seeing an increase in cross-border financial services. In addition to the positive effects of an increase in supply and a greater diversity of providers, the cross-border nature of financial markets leads to cross-border risks, such as rogue foreign providers of risky investment products, an increase in cross-border market abuse in capital markets and the creation of an uneven playing field between domestic and foreign providers of financial products and services. These risks can be less adequately addressed at national level and require an international approach.

In response to the increase in cross-border financial services there is a movement towards further internationalisation of supervision and supervisory convergence. In the short term, many new, extensive, European laws and regulations will be introduced to the financial sector (see Text box 1). Cooperation is also increasingly sought in the area of supervision, for example between the European Internal Market Supervisor for Electricity and Natural Gas (ACER) and ESMA, following the volatile gas market last year. Globally, geopolitical tensions play an important role and European strategic autonomy is in the political spotlight.[6] For a sound financial system, both a robust banking system and resilient and diversified capital markets are important. As a result, there is renewed interest in the European Capital Markets Union (CMU). This is a European project to allow investors' money to move freely across European capital markets. Supervisory convergence is of great importance for this.

Integrity and criminal behaviour

Criminal behaviour affects the integrity of the financial and economic system. Trust in the financial sector can be damaged if financial companies are consciously or unknowingly involved in criminal activities. Among other things, money laundering enables criminals to use illegal income to finance new criminal activities. It also offers the possibility to acquire positions in *bona fide* companies with criminally accumulated assets. Money laundering is a manifestation of the broader social problem of undermining, which refers to all kinds of crime that blur the line between the upper world, including the financial sector, and the underworld. In the accountancy sector, fraud at an audited company that is not detected or disclosed in the statutory audit can lead to material losses to shareholders and a wider loss of confidence in the financial markets.

6 'Council adopts conclusions on strategic autonomy of the European economic and financial sector', European Council, April 2022



Digitalisation and internationalisation increase the possibilities for criminal behaviour. Technological developments and the internationalisation of financial markets are facilitating the entry of many new players into the financial markets. Criminals are also creative in exploiting opportunities offered by technology, digitalisation and cross-border services. This is reflected, among other things, in the increasing reach of foreign rogue providers of investment products. Such malicious activities have a major impact on (groups of) victims who are harmed by them. The AFM is committed to cooperation with national and international chain partners to combat criminal behaviour.

Risks

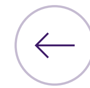
For the different supervision areas, we summarise below the risks that arise or are accelerating due to the above-mentioned trends and developments.

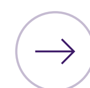
Financial services. The pensions transition is the most obvious notable development in financial services. The transition will lead to a more personal and transparent pension system that better meets the needs of our time. Nevertheless, the system change is complex. It will involve significant and irreversible decisions. This increases the importance of careful guidance. In the field of digitalisation, targeted and aggressive advertising via social media and easily accessible (*embedded*) products and services create risks around consumer protection. The rapid rise of AI entails risks if it is deployed in an uncontrolled manner, for example because of black boxes or the use of incorrect or unreliable data. For the housing market, climate risks are increasingly impactful, which can lead to major financial consequences for (future) homeowners.

Capital markets. In capital markets, information processing accelerated by digitalisation enables market participants to quickly incorporate new data, such as macroeconomic conditions, geopolitical tensions and climate change, into their decision-making. This can lead to sudden price shocks that cause liquidity problems and put pressure on the orderly functioning of markets. In addition, increasing digitalisation places high demands on the controlled business operations of institutions that are active in the capital markets. Insufficient control of algorithms can lead to errors in these algorithms or unexpected interference between different algorithms. Capital markets are cross-border, and so are trading activities. Cross-border market abuse therefore requires extra attention. In order to make informed investment decisions, high-quality information remains essential. Due to fragmentation of European capital markets, there is not enough central market and price information. Finally, market dynamics and complex regulations contribute to concentration in the supply chain through the so-called winner-takes-all effect. The dependence on a few institutions makes markets less robust.

Asset management. Within the asset management supervisory area, attention is paid to the strategic repositioning of parties in the form of (cross-border) mergers and acquisitions, which leads to consolidation and market power. In addition, we see that technological developments are changing the business operations of asset managers and the asset management chain. The increasing outsourcing of business processes to (possibly a few large) service providers – including cloud platforms – makes the asset management sector as a whole vulnerable to cyber incidents at such nodes. The important role that asset management parties play in the sustainability transition is also discussed. For example, it is important that asset managers integrate sustainability into their business operations, manage risks of the sustainability transition and are transparent with investors about how sustainability is implemented. Due to high volatility in capital markets, we pay particular attention to liquidity risks in the asset management sector, as they may affect financial stability.

Financial reporting and audit firms. Audit firms have to deal with changes as a result of digitalisation and sustainability that affect the audited company, the statutory audit and the audit firm, thereby creating new material risks. There are therefore more requirements for both the reporting by the company and the knowledge and expertise of the audit firm. In addition, cyber risks are increasingly important, including for audit firms themselves. Furthermore, sustainability and the economic cycle increase the risk of fraud and discontinuity, which audit firms must be alert to. Finally, we see pressure on the accessibility of statutory audit, partly due to staff shortages. The developments taking place in response to this, such as the inflow of private equity in the segment of organisations with a regular audit licence and supervisory arbitrage at audit firms for public interest entities, have a negative impact on the quality of the statutory audit.





Regulations

Text box 1 Overview of the most important European regulatory pathways

There are various European regulatory pathways that have an impact on the AFM and/or market participants. The most important regulatory processes are highlighted in this box. Some of these regulatory pathways are also discussed in other places in the Trend Monitor.

DORA (Digital Operational Resilience Act). DORA comprises a European directive and regulation with the primary objective of managing systemic risk and thus the resulting consumer and investor risk. DORA sets uniform requirements for financial institutions in the field of, among other things, ICT risk management, ICT-related incident reports and management of ICT risks when outsourcing to third parties and contains a European supervisory framework for critical third-party providers (CTPPs), such as large cloud service providers. DORA will apply to institutions that are regulated in Europe. For example, DORA will apply to trading platforms, central counterparties, credit institutions, and investment firms and institutions. DORA entered into force in January 2023. Market participants have until January 2025 to comply with the relevant provisions.

MiCAR (Markets in Crypto-Assets Regulation). This is the first European legislative package to regulate cryptos and related services. These laws and regulations focus on both issuers of crypto assets and crypto service providers and ensure uniform rules in the EU. MiCAR was published in June 2023 and will enter into force in Q4 2024 after an 18-month implementation phase. The implementation phase gives market participants and regulators the opportunity to prepare.

Revision of MiFID II (Markets in Financial Instruments Directive)/ MiFIR (Markets in Financial Instruments Regulation). The proposal for the revision of MiFIR mainly concerns the adaptation of the rules on trading in financial instruments and transparency provisions relating to this trading. MiFID is largely unmodified. In June 2023, a political agreement was reached in the trilogue negotiations between the European Commission, the European Parliament and the Council of the EU. The agreement includes a consolidated tape (CT) and a European ban on payment-for-order-flow (PFOF). At the moment, only technical points are being developed. The European Parliament is expected to vote on the revision in December 2023 or January 2024.

SFDR (Sustainable Finance Disclosure Regulation). These regulations have been in force since 2021. The lower regulations have been in force since January 2023. Based on those rules, information on the negative sustainability impact of the entity and of products, as well as information on sustainability characteristics and objectives of products, should be provided in a standardised manner. The SFDR aims to give investors more insight into sustainability risks and the sustainability aspects of financial products and to make them more comparable. In addition, it is intended to combat greenwashing. For an unambiguous European definition of which economic activities are sustainable, an EU Taxonomy has been developed. Part of this has been applicable since the beginning of 2022. The SFDR information should also indicate, where applicable, the extent to which investments are in line with this taxonomy. A comprehensive review of the SFDR framework was launched in 2023 to identify any shortcomings.

CSRD (Corporate Sustainability Reporting Directive). To strengthen transparency around sustainability and other non-financial matters, the Non-Financial Reporting Directive (NFRD) has been revised. A new name was chosen for this directive: the Corporate Sustainability Reporting Directive. The CSRD broadens the scope of the NFRD to a large extent by making sustainability reporting mandatory for smaller listed companies and for all large unlisted companies. In addition, the CSRD requires companies to report according to the ESRS, an unambiguous reporting standard for sustainability reporting established in Europe. The obligations (for the larger listed companies that fall under the CSRD) will take effect from the 2024 financial year. From the 2025 financial year, the transparency obligations will apply to all large companies in the EU and from the 2027 financial year also to listed SMEs.

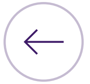
AI Act. The AI Act is a European act that introduces rules at different risk levels for high-risk applications of artificial intelligence. The AI Act oversees applications of artificial intelligence that may pose a risk to fundamental human rights, safety and health. The regulation does not specifically target the financial sector, although it is affected. The AI Act is not yet final and will be negotiated in the near future with the European Parliament, the European Council and the European Commission. An agreement is expected at the end of 2023 or the beginning of 2024, after which Member States will implement the regulation in their own country.

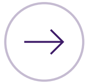
Revision of AIFMD (Alternative Investment Fund Managers Directive) / UCITS (Undertakings for Collective Investment in Transferable Securities Directive). The AIFMD Directive is being revised. Some provisions of the UCITS Directive are also being amended to align them with the amendments to the AIFMD Directive. Both directives contain rules for funds (AIMFD for professional investors and UCITS for retail investors). The revision of the AIFMD is limited to the topics of delegation, liquidity management, supervisory reporting, custody and loan origination by AIFMD funds. A provisional agreement was reached in the trialogue on 19 July 2023. For now, only technical points are being worked out.

ELTIF (European Long-term Investment Fund). The ELTIF regulation is a European framework that allows a label for AIFMD funds that invest in specific (sustainable) long-term investments. The changes relate, among other things, to the strict fund rules (including fewer barriers for retail investors) and to broadening the scope of permitted assets and investments in which an ELTIF may invest. The trilogue negotiations between the European Commission, the European Parliament and the Council of the EU have been concluded. The ELTIF Regulation will enter into force by the beginning of 2024.

RIS (Retail Investment Strategy). The European Commission published the RIS in May 2023. The package of legislation consists of an omnibus directive and a regulation that make changes to MiFID II, the IDD, UCITS and AIFMD. This legislation has multiple purposes. One of these is to make investment services more accessible to Europeans. The Commission wants to achieve this by, among other things, reducing product costs, encouraging independent financial advice and making information easier to understand. Another objective is to reduce sectoral differences and differences between Member States. Sectoral directives such as MiFID II and the IDD will be more harmonised. Council negotiations are currently ongoing.

Listing Act. In December 2022, the European Commission's proposal for the Listing Act was published. The proposal consists of amendments to existing laws and regulations in the field of stock exchange listing. In addition, it contains a new Directive on multiple voting rights for shares in companies seeking access to the growth market for small and medium-sized enterprises (SMEs). At the beginning of June, the mandate of the European Council as a commitment to the trialogue negotiations was announced. Following the announcement of the position of the European Parliament, the trilogue negotiations between the European Commission, the European Parliament and the Council are expected to take place in the autumn of 2023.





Revision of the CCD (Consumer Credit Directive). In 2021, the European Commission's proposal for the revision of the CCD was published. The revision considers, among other things, extending the scope to currently unregulated forms of credit such as buy-now-pay-later (BNPL) products, clearer precontractual information and an obligation to protect consumers from excessive rates. The trilogue negotiations between the European Commission, the European Parliament and the Council of the EU took place in 2022. The European Parliament will vote on the review in the autumn of 2023. The final text is expected to be published in the autumn of 2023.

FIDA (Financial Data Access Regulation). The European Commission's proposal for FIDA was published in June 2023. It is expected to enter into force in 2027. This bill aims to establish a framework for regulating access to and use of customer data in the financial sector. Access to financial data refers to the access to, and processing of, business-to-business and business-to-customer financial data at the request of the customer for a wide range of financial services, such as insurance and pension products. Data on payment accounts are out of scope, as they are regulated under PSD3/PSR.

What trends do we observe?

Trends can form the basis for the emergence of risks and thus largely determine the direction of our **supervision.** Early identification and understanding of changes in the sector contribute to a risk-driven, forward-looking and preventive approach to supervision.

General developments

- Economic growth is slowing down due to persistent inflation and rising interest.
- So far, the consequences for households are limited, but vulnerable households remain a major concern.
- The transition to higher interest rates has an impact on business models and asset valuations.

Digitalisation

- Far-reaching digitalisation, such as the use of AI, creates opportunities and risks to the financial sector.
- Digitalisation and platformisation of the financial sector lead to more efficiency and innovation in financial services.
- The interconnectedness of the financial sector with large technology firms leads to new dependencies and reduced areas of intervention for supervision.

Sustainability

- There is a growing social and political desire for financial markets to accelerate the sustainability transition.
- So far, the sustainability transition is failing to achieve the desired pace.
- A wave of new legislation is intended to increase transparency concerning sustainability.

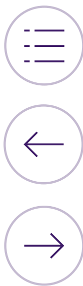
Internationalisation

- Financial services are increasingly becoming international, entailing cross-border risks.
- In the short term a lot of new, substantial European laws and regulations are coming for the financial sector.
- This increases the importance of international supervision and supervisory convergence.

Crime and integrity

- Criminal behaviour impairs the integrity of the financial-economic system
- Digitalisation and internationalisation increase the potential for criminal behaviour.
- Tackling financial crime increasingly requires national and international cooperation with chain partners.

01 **Financial services**

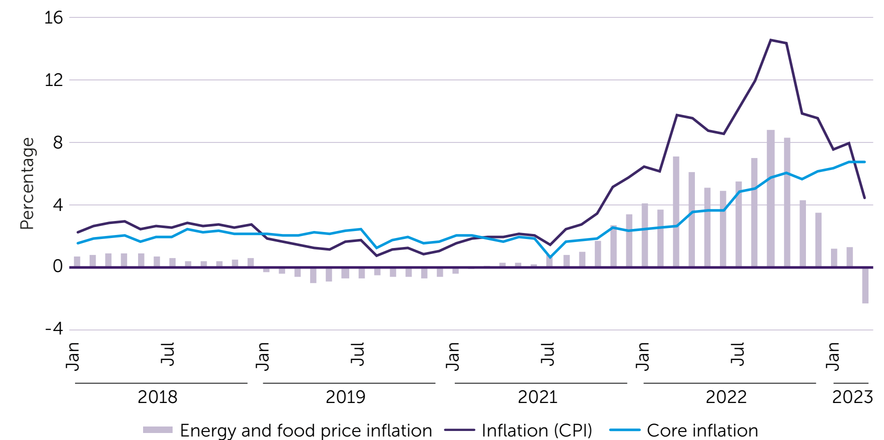


The AFM is committed to fair and transparent financial markets. As an independent conduct supervisor, we contribute to sustainable financial well-being in the Netherlands. In financial services submarket, this means that we assert the protection of consumers. For many consumers, financial decision-making, such as buying a house or saving for later, is difficult. Wrong choices – such as signing an expensive or inappropriate contract or, conversely, waiving a suitable contract, borrowing too much or failing to take the necessary action – have a significant negative impact on the financial well-being of households.

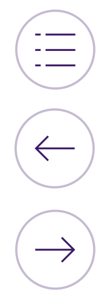
1.1 General developments

Inflation is declining but remains high. After the inflation peak in 2022, inflation has started a gradual reduction this year (see Figure 1). The inflation shock originally stemmed from rising energy and food prices, partly caused by the war in Ukraine. Contrary to previous forecasts, inflation, especially core inflation, will last longer. This has a major effect on the financial position of households.

Figure 1. Strong increase in inflation and core inflation since the end of 2021.



Source: CBS, Macrobond

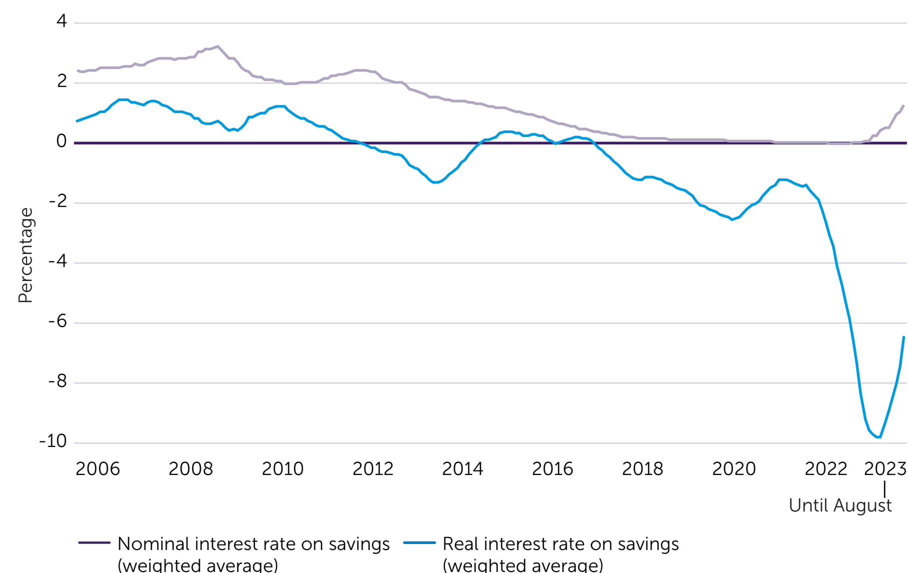


Ultimately, the pain of high inflation is unevenly distributed and some groups are hit harder than others. So far, the tight labour market, higher (minimum) wages and government support have limited a general decline in purchasing power due to the increased cost of living. Despite this, low-income households are generally hit harder by high inflation, as higher energy costs and food prices account for a relatively larger share of spending. In this group, the risk of financial stress is high and can lead to suboptimal behaviour such as accumulation of (consumer) credits, increasing use of buy-now-pay-later services, underinsurance and marginal pension accrual. Despite the (temporary) decrease of average house prices, first-time buyers are still facing difficulties due to rising mortgage interest rates and the structural housing shortage. Homeowners may also get into difficulty due to higher mortgage rates after the fixed-rate period has expired.

Consumers experience savings rates rising to a limited extent. The Netherlands is among the European countries with the highest savings per household. While consumers notice rising capital market interest rates reflected in mortgage interest rates, increases in savings rates are partial and lagging. Moreover, due to high inflation, real savings rates remain negative (see Figure 2), which means that savings become less valuable.

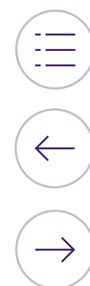
We ensure that the central priority of the customer's interest is sufficiently present in the services banks provide and therefore also in the range of savings products. It is important that banks take a critical look at the range of savings and the variety of savings products they offer. We consider some types of savings to be undesirable, such as teaser rates, where customers are tempted with a high initial interest rate but receive a lower rate afterwards. We also disapprove distinctions between customers whereby selected customers receive higher interest rates. In our opinion, banks can still improve by proactively approaching customers and highlighting alternative, more appropriate savings products. For example, they could encourage customers to switch to (possibly short-term) fixed deposits, which usually offer higher interest rates.

Figure 2. Although the nominal savings rate has risen slightly recently, the real savings rate remains negative.



Source: DNB, CBS, Macrobond

Interest rate rises affect the earnings model of banks and the funding ratios of pension funds. The persistently low interest rates during recent years put pressure on their interest margin, and therefore profitability. Now that interest rates are rising, the interest margin is increasing again, banks and other lenders are seeing their interest income rise. The higher interest rates also lead to a higher funding ratio for pension funds. At the same time, the liabilities of the funds have increased as a result of the indexation granted. In net terms, the funding ratios of pension funds have risen slightly over the past year.



Specifically for neo-brokers, rising capital market rates are detrimental due to declining volumes. Furthermore, the revenue model is under even more pressure due to strong competition and market saturation. Neo-brokers provide investment services for consumers and focus fully on low rates by minimising their costs through more efficient ICT systems, the absence of physical offices, facilitating only online services, etc. For consumers, low costs and ease of use are important considerations when beginning to invest. The influx of new customers and the number of transactions are stagnating and operating costs are therefore increasing proportionally, so neo-brokers have to look for new sources of income. At the same time (domestic and foreign) brokers will maintain the lowest possible costs for as long as possible. In the short term, this could result in mergers driven by thin profit margins and economies of scale. Increasing competition and pressure on profit margins can also increase the risk that brokers (or neo-brokers) will fall short in their services.

Robustness of financial service providers, advisors and intermediaries remains a central theme. Consolidation, changed revenue models and a more professional organisation are some of the adjustments we observe in the financial service providers. These adjustments are partly due to the fact that financial service providers have to comply with increasing legal standards of controlled business operations for financial service providers. AFM studies show that compliance is not always in place. As a result, controlled and ethical business operations are at stake for a subset of these providers. In severe cases, business continuity is jeopardised because financial service providers are not continuously compliant with requirements and have a revenue model that is neither lenient nor future-proof.[7] In addition, part of the sector is struggling to maintain knowledge for specific, new services, such as non-life insurance regarding cybersecurity and climate. We also notice that a part of this heterogeneous sector is anticipating future developments. Firms are choosing to specialise in certain target groups or products, or to merge into larger organisations. We encourage these developments, but urge financial service providers to keep in mind that controlled and ethical business operations must be permanently guaranteed.

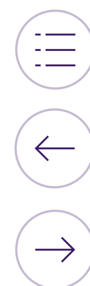
7 For example, a study on compliance with the diploma requirement shows that the legal requirements have been breached on a large scale (40% of the financial service providers audited). See 'Marktindrukken 2022', AFM, November 2022.

Text box 2 The relevance of demographic change for the financial sector

Trends and risks in the financial sector cannot be separated from current and future demographic developments. Various demographic developments are taking place in the Netherlands, such as population ageing, population growth due to migration and an increasing number of households that are simultaneously becoming smaller on average[8,9]. These developments have a major effect on the demand for housing and financial products such as insurance and pension entitlements. Financial institutions and policymakers need to be aware of these demographic trends in order to adapt their products and product distribution to the changing needs of customers and to respond appropriately to the risks this poses.

One of the most striking demographic trends is the ageing of the population in many developed countries, including the Netherlands. Factors such as medical advances and improved living conditions have led to increased life expectancy, while birth rates have declined. The resulting demographic composition leads, among other things, to a shift in financial services (tailored to an older target group) and greater demand for pension benefits. Moreover, the ageing of the population has an impact on the housing market. Elderly people tend not to relocate. The ageing population therefore contributes to congestion in the housing market and makes it more difficult for first-time buyers to enter. The fact that the number of households is increasing – partly due to an ageing population – also makes the housing market tighter.

8 'De Nederlandse economie in historisch perspectief', CPB, July 2023.
9 'Hoe wonen mensen?', CBS.



Not only the ageing population, but also the entry of a new, digitally-driven generation is a development that the financial sector must take into account. This new generation is technology-oriented, has a strong interest in sustainability and is familiar with digital financial innovations. As a result, we observe increasing growth of technology-driven financial services, such as investing apps and digital payment platforms. It is important for financial institutions to respond to these trends, but also to have a sharp focus on the (social) risks, such as normalising purchases through instalment payments, because this contributes to debt habituation.

The growth of the Dutch population, and specifically the increasing diversity as a result of migration, leads to extra pressure on issues related to financial inclusion. Financial inclusion refers to the commitment to provide all individuals and communities with access to a wide range of financial services and products in an affordable, convenient and equal manner, regardless of their socioeconomic status, geographic location, gender, ethnicity or other characteristics. Within the financial sector, this means, among other things, that institutions must take into account the accessibility of financial services for consumers with a different cultural background or a more limited command of the Dutch language and/or digital skills.[10] In addition, certain customers may actually be excluded by means of customer-specific pricing by the insurer (personalised pricing) or by banks as a result of AML/CFT checks. Financial institutions need to balance their role as gatekeepers to prevent the financial system from being misused for financial and economic crime and ensuring accessible financial services for all.

10 'Access to financial services not self-evident', AFM, January 2023.

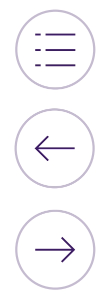
Text box 3 Key regulatory pathways

Pension transition

The *Wet toekomst pensioenen* (Wtp, Future Pension Act) became effective on 1 July 2023. The final version of almost all lower regulations (decrees and ministerial regulations) has been published. As a result, the pension sector has entered a new and challenging implementation phase and within the AFM the focus has shifted from policy to supervision.

During the transition, the AFM will, among other things, pay attention in its supervision to whether information provided by pension providers to participants is correct, timely, balanced, clear and person-specific. This is also of great importance after the transition. The transition from existing agreements to premium schemes, with reserved assets assigned to an individual to facilitate future pension payment, has far-reaching consequences for the provision of information to participants. As pensions are more sensitive to the financial markets, pension outcomes will be more volatile and participants' expectations about the availability of information will also change. Participants will no longer have to be given explanations about the increase in entitlements, but instead about the increase or decrease in their assets and the expected consequences for pension payments due to developments in the share price and interest rate. This brings new challenges. It is important that the pension provider ensures that the participant information is correct.

The pension transition also requires a lot of attention this year, especially with regard to timely and correct information for scheme members and having the pension correctly administered by the pension providers. The new pension system and the resulting new supervisory tasks have important consequences for our supervision. First, the communication plans regarding the transition to the new system in the sector will be verified by the supervisor for the participants. We expect around 200 communication plans. Secondly, the Wtp means a structural extension of the supervisory mandate to include guidance for participants regarding their pension scheme choices, risk preference investigations, order confirmation and complaint handling. In addition, the expected number of communication plans and



follow-up communication to participants will lead to a peak load for the supervisor during the transition phase. Although the transition period has been extended, it remains tight and a risk for the transition. We have been preparing extensively, together with the pension sector, so that we can properly monitor this crucial transition phase in the pension system affecting the majority of the Dutch population.

DORA

Within the retail domain of the AFM, only a small population of advisors and intermediaries falls within the scope of DORA. In January 2023, the Digital Operational Resilience Act (DORA) came into force, giving companies two years to comply with the regulation. DORA aims to increase the digital resilience of service providers in financial markets, as the risk of cyber attacks becomes more pronounced with the increasing reliance on financial processes. DORA will apply to insurance, reinsurance and ancillary insurance intermediaries with more than 250 FTEs or more than €50 million in turnover.

The advisors and intermediaries covered by DORA still have limited maturity in terms of IT control, which means that relatively large efforts are probably required from this sector to comply with regulations. For the DORA population, the supervision of ethical and controlled business operations is laid down in the Financial Supervision Act and the associated Decree on Conduct of Business Supervision of Financial Undertakings, with only limited obligations related to IT risk management.

MiCAR

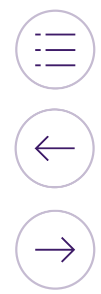
Within MiCAR, there is an important supervisory role for the AFM, which focuses on the protection of (retail) investors against the risks related to crypto assets. These risks are significant. Crypto assets are inherently complex and speculative products with a high degree of volatility. Moreover, the technical and international nature of crypto assets makes investors vulnerable to fraud, deception and scams. The signals we receive from consumers confirm this.[11] In addition, crypto assets and associated services are often actively pushed by providers, *facilitators* and influencers, with investors often receiving unclear and incomplete and – sometimes even – deliberately misleading information. Finally, investors face risks in keeping and holding crypto assets. Due to operational and security problems (e.g. a cyber attack), investors may lose their investment.

With the introduction of MiCAR, some of these risks are addressed, but not completely eliminated. In general, investor protection under MiCAR is less robust than under MiFID. Also, under MiCAR, the possibility remains that customers will lend cryptos to third parties (staking). This increases the risks and losses at one party can be passed on to other institutions. Finally, MiCAR does not have a direct impact on the intrinsic volatility of cryptos and the risks this entails.

11 AFM signals monitor.

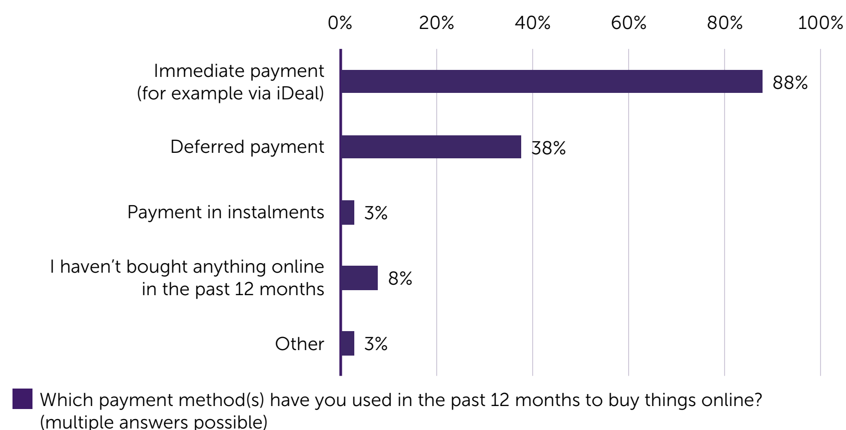
Digitalisation

Sound IT risk management and data quality are becoming increasingly important pillars of controlled business operations to steer digitalisation and automation of processes in the right direction. Due to standardisation and the increasing availability of source data, the underwriting process for mortgages, loans and investments can be further automated. This can provide benefits for customers. Fewer documents need to be shared, which speeds up the turnaround time of the acceptance process. The use of source data can also lead to a more accurate representation of the customer’s financial situation, leading to more suitable lending. However, automation of underwriting processes also entails risks. Errors in automated processes, incorrect use of source data and poor data quality can have adverse consequences for a large group of customers. It can lead to excessive lending or inappropriate products. Customers usually only experience the negative consequences of this later and the impact is often large.



Digitalisation of financial services has a major impact on product (forms), advice and distribution, and will lead to a greater role for technology companies in the financial sector. In the near future, we expect AI and DeFi to have a major impact on financial service providers and their customers. For instance, new product forms, new ways for service providers to give advice to consumers or new ways to offer financial services. Large tech companies are also acquiring an increasingly important role, both within the chain of business operations, but also as financial service providers themselves. This ranges from facilitating the IT infrastructure by offering cloud services or settling payment transactions to offering financial services and products within the ecosystem of these large tech companies, such as buy-now-pay-later (BNPL). Smart software increases the possibilities of seamlessly adding BNPL to a wide range of products, from laundry machines to clothing. We therefore see consumers opting relatively more often for deferred payment (see Figure 3). We see deferred payment as a suboptimal financial decision, because it may encourage consumers to spend more than they can actually bear. It also contributes to debt habituation. At the moment, BNPL providers are not yet subject to AFM supervision, but the revision of the Consumer Credit Directive (CCD) may change this (see also Text box 1).

Figure 3. Consumers relatively often opt for deferred payment for online purchases.



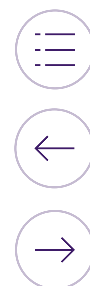
Source: AFM Consumer Monitor spring 2022

Embedded finance makes financial products more accessible, but can also entail risks related to consumer protection. Embedded finance means that financial services are offered through non-financial providers when selling their products or services. Examples are the issuance of proprietary credit cards by non-financial institutions, enabling the monitoring of bank accounts, or offering insurance when purchasing certain products (bicycle, travel, etc.). The latter is also called embedded insurance.[12] Another example is the possibility to take out insurance that is separate from a product, such as term life insurance, via multiple platforms. On the one hand, embedded finance can help increase the accessibility and ease of use of financial services. On the other hand, it can increase consumer protection risks by (i) making the distribution of financial products and services more complex and (ii) not providing clear information about the financial product (e.g. price, conditions, coverage). This may lead to mis-selling, overinsurance, excessive lending, or unsolicited or incorrect financial advice.

At the distribution level, Decentralised Finance (DeFi) is a new development that may have a major impact in the future. The products and services offered on DeFi platforms are not so different from traditional products and services. What differs is the way in which acceptance of consumers takes place and the way these products are offered. Within DeFi platforms, providers offer financial services automatically via so-called 'smart contracts' and conclude them with no or only minor involvement of an intermediary. Where previously this mainly related to more exotic products such as cryptos or CFDs, insurance and credit are now also within reach. This entails risks in terms of consumer protection, governance, mis-selling and integrity.

The distribution of cryptos is often carried out through targeted and aggressive marketing to consumers. For new (digital) financial products and product forms, such as cryptos, providers make the purchase of these products as accessible as possible. In addition, traditional product forms become less popular, because stricter conditions apply to them. As a result, consumers are more likely to purchase these products and services, possibly reinforced by (AI-assisted) targeted and aggressive marketing, without being fully aware of the long-term obligations and corresponding risks. Unlike traditional investment products, cryptos have not been classified as

12 'Opportunities and risks of Digitalisation of the insurance market in the next 10 years', AFM, April 2023.



a financial product until now. As a result, there are no advertising rules for the promotion of cryptos and advertising is still intrusive and frequently present. With the introduction of MiCAR, advertising cryptos will also have to comply with regulations on deception and risk warnings.

For vulnerable consumers, there is a high risk of exclusion from financial services due to digitalisation. A major concern with the far-reaching digitalisation of financial products, advice and distribution concerns the possible exclusion of groups that need physical customer contact.[13] These groups that cannot keep up with the digital world are diverse and extensive. In order to avoid exclusion of everyday or basic matters, such as online payment or opening an account, product coordination with the regulator on matters such as suitability and accessibility is necessary. Both the AFM and De Nederlandsche Bank (DNB) call for cooperation within the sector and the government. In addition, the AFM encourages the introduction of a personal financial overview (PFO) to realise action perspectives and maintain financial health for all Dutch people. Independent financial advisors play an important role in this context and have added value for clients, especially in complex situations or actual or perceived obstacles.[14]

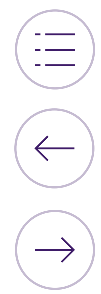
The number of cyber attacks has risen sharply in recent years. Cyber attacks result, among other things, in a temporary interruption of the service due to an attack on the financial infrastructure and theft of (privacy-sensitive) data. The management of cyber risks is crucial and focuses not only on financial service providers, but also on (external) chain parties and intermediaries. Market participants will have to manage cyber risks in a complex ecosystem of external applications and collaborations. Awareness is low and the market for both (small) business and private cyber insurance is still small, but both the awareness and the corresponding insurance market are expected to grow. It is important that insurers continuously assess how they can communicate transparently about the coverage of cyber insurance. Moreover, the sector must jointly consider how – given the growth of this market – it can contribute swiftly to the comparability of the product range. The international character of this market poses an additional challenge.[15]

13 'Access to financial services not self-evident', AFM, January 2023.
14 'Making choices remains essential in the market of financial service providers', AFM, November 2022.
15 'Cyber insurance: comparability requires insurers' attention', AFM, February 2023.

1.2 Sustainability

There is great pressure on the financial sector to speed up the sustainability transition, but the impact of sustainability initiatives is not always clear to consumers. The pressure to speed up is reflected, among other things, in large numbers of new sustainability regulations aimed at the services financial companies provide. The regulations mainly focus on improving transparency about sustainability risks and impact, and the alignment of products with the sustainability wishes of customers. We also see a strong incentive in the market to meet customer sustainability demand. There is a clear push towards sustainable products and many financial institutions are profiling themselves in this area. The risk remains that a discrepancy between the sustainable financial products offered and the wishes of customers will lead to disappointment. This applies specifically to sustainable investments, where greenwashing is an increasing concern for regulators. There is a risk that financial institutions will create false expectations regarding sustainable investments. AFM research shows that investments that are considered sustainable contain various interpretations of sustainability.[16] This can lead to consumers expecting a lot from the contribution of their investment to the sustainability transition, whereas this is not the case for all products. It is therefore important that providers communicate transparently about the objectives of their products and the impact that is achieved.[17] Pension funds must also address this and, in order to avoid disappointment, must keep an eye on transparency regarding sustainable investment choices and the consequences for the participants' pensions.

16 'The retail market for sustainable fund investing', AFM, April 2022.
17 'Impact through sustainable investing', AFM, November 2022.



Climate risks translate into risks for the financial sector. Financial institutions can be affected by physical risks, with climate change leading to damage to the environment, such as natural disasters as floods, prolonged droughts and forest fires. In addition, there are transition risks, where losses are incurred due to increasing regulation and standardisation of sustainability by the government or a change in consumer preferences. Physical and transition risks are reflected in, among other things, the market value of investments, loan portfolios of mortgage lenders and the obligations of insurers.

Climate risks are more likely to affect house prices, but awareness of them and insurance against them are lagging behind. There are several climate risks in the housing market that have an impact on the valuation of homes. The two most prominent risks are foundation damage (subsidence and pile rot) and flooding. Foundation damage is not insurable and flooding is only insurable under certain conditions.[18] Both risks are not yet sufficiently incorporated in the Dutch housing market, which can put both potential homebuyers and homeowners in financial difficulties.[19] Potential buyers of a home are insufficiently informed about possible climate risks and because climate risks are not part of the financing process, there is a risk of overlending. See also the in-depth analysis entitled "Factoring climate risks into housing prices".

Did you know...?
In the Netherlands there are 800,000 homes with an expected cost of foundation damage of €64,000 per home. These costs are borne by the owner, while 40% of homeowners living in high-risk areas rely on financial support from the insurer or government in the event of a flood or subsidence.[20]

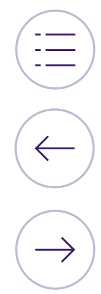
1.3 Internationalisation

International market dynamics do not always lead to outcomes that are in the interest of the customer. The idea behind a European market and international competition is that this improves the financial well-being of households. This idea does not always apply to the financial services industry. Increasing internationalisation, together with digitalisation, makes it easier for providers to offer financial products across national borders. We see this, for example, with internationally operating brokers who, in search of more turnover, encourage retail investors to make numerous transactions or invest in risky products. Rogue providers, with or without a European passport from another EU Member State, are also approaching consumers more effectively through the internet and apps. This is also due to the limitations of national supervision in an international market and the limited focus on cross-border players.

Retail participation in European capital markets is lagging. Household participation in capital markets is relatively small in Europe compared to the US and Asian countries, such as China and Japan. Only 20% of euro area households own shares or investment funds, only a third invest in voluntary pensions and insurance schemes and around 40% of EU household savings are held as bank deposits, compared to 10% in the US.[21] Distribution models vary widely from one Member State to another. As a result of these differences, capital generation products lack scale, resulting in a relatively high cost. To increase retail participation and reduce the high degree of fragmentation, the European Commission has drawn up the Retail Investment Strategy (RIS).[22] This strategy and the accompanying legislative proposal aim to reduce differences in sectoral legislation (such as MiFID II and the IDD), make capital markets more accessible to citizens and reduce costs so that long-term returns improve.

18 See Flood (verzekeraars.nl)
19 'Is flood risk already affecting house prices?', ABN AMRO, February 2022.
20 'Damage caused by climate change increasingly uninsurable', AFM, October 2021, and 'Homeowners insufficiently aware of climate change risks', Vereniging Eigen Huis, February 2023.

21 'A Capital Market Union for Europe', IMF, September 2019.
22 'Retail investment package', European Commission, May 2023.



1.4 Integrity and criminal behaviour

Digitalisation and internationalisation increase the possibilities for criminal behaviour. Technological developments and the internationalisation of financial markets are facilitating the entry of many new players into the financial markets. Criminals are also creative in exploiting opportunities offered by technology, digitalisation and cross-border structures. This is reflected, among other things, in the increasing reach of foreign rogue providers of investment products. Such malicious activities have a major impact on (groups of) victims (see Text box 4).

Text box 4 The AFM tackles criminal behaviour in the financial sector.

Rogue influencers and other new entities in the execution-only chain can mislead consumers. Finfluencers usually promote investments to consumers through various social media channels. Just like other new players in the execution-only market, such as signal traders or providers of trading bots, they present day trading as an accessible way to make money. We see several risks for investors.[23] These new players may be operating without being licensed and without exercising due care in their investment recommendations. Furthermore, they promote risky products or illegal operators, and there may be a conflict of interest. This is due to the fact that they receive inducements for bringing in customers and lack transparency on this issue. There are particular concerns about the risks of influencers and other new entities in the execution-only chain due to the combination of the growing role of social media in the decision-making process, ease of carrying out transactions and the influx of inexperienced investors.

Tackling criminal behaviour in the financial sector is one of the AFM's core objectives. Criminal behaviour includes misleading consumers in investment fraud, advance fraud or abusing the financial sector by laundering money. In addition, criminal behaviour can also consist of self-enrichment as a result of conflicts of interest, market abuse or operating in the financial market without a licence.

The extent of criminal behaviour is difficult to measure because of its hidden nature. Where it is exposed, the damage is major. Both at the individual level, when consumers get into financial difficulty after being scammed, and at the collective level when damage from investment fraud adds up to tens of millions. In addition, criminal behaviour affects the integrity of the financial sector, which in the long run undermines confidence in the financial market.

The AFM receives an increasing number of signals of criminal behaviour regarding crypto. We receive between 4,000 and 5,000 reports per year, of which about 2,000 may relate to criminal behaviour. Half of these reports relate to fraud or scams, 20% are about operating in the financial market without a required licence and 14% concern boiler rooms. In addition, since 2022, crypto has been the most common product in reports of possible criminal behaviour. In 2021, forex (speculative financial instruments (derivatives) based on currency pairs) was still the most common product.

23 'AFM points 'finfluencers' to rules for online posts about investing', AFM, December 2021.

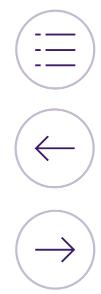
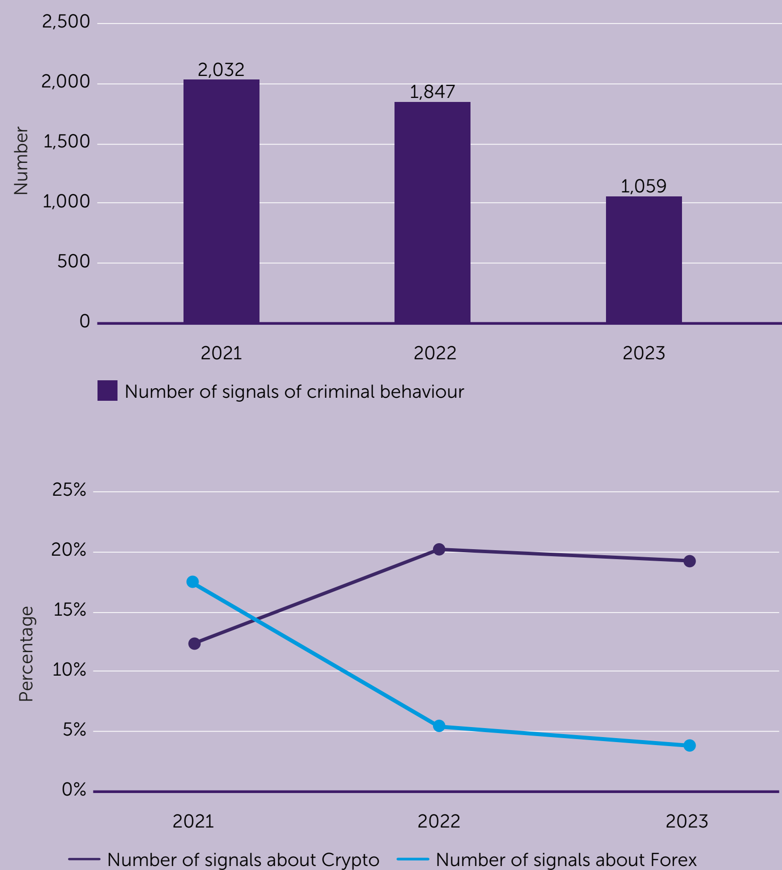


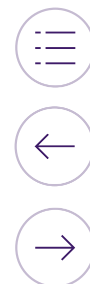
Figure 4. Above: The AFM receives approximately 2,000 reports per year about criminal behaviour in the financial sector. Below: Crypto is the most common product in reports of possible criminal behaviour.



Source: AFM

Digitalisation and internationalisation are creating growing opportunities to expose Dutch consumers and the financial sector to criminal behaviour. Criminals are creative in exploiting opportunities offered by technology, digitalisation and cross-border structures. For example, it is easier for (illegal) operators from abroad to approach Dutch consumers. In addition, digitalisation allows criminals to approach consumers in a more targeted way and, for example, with the help of AI, they can increasingly articulate their misleading messages and disguise their criminal intentions. In order to meet these developments and challenges, we ensure that we have our information position in order, optimise utilisation and assume our role in the chain of tackling crime.

The AFM is committed to cooperation with national and international chain partners to combat criminal behaviour. We do this by proactively responding to developments in the financial sector, also in the field of (possible) criminal behaviour. In this way, we aim to protect consumers against criminal behaviour and to prevent financial companies from knowingly or unknowingly becoming involved in criminal behaviour. We do this by working with chain partners in the Financial Expertise Centre (FEC). We share information and knowledge with partners such as the Police, the Public Prosecution Service (OM), De Nederlandsche Bank (DNB) and the Tax and Customs Administration to gain insight into broader trends and phenomena in the market. In addition, the chain partners also share information and knowledge to tackle specific violations. We also work with international partners to tackle cross-border criminal behaviour in the financial sector. Finally, we monitor transactions in the financial markets. If we discover anomalies that may indicate market manipulation or insider trading, we can independently investigate these or report them to the Public Prosecution Service.



Keywords	Specific risk	Drivers	Importance
Pension transition	The pension transition arouses unrealistic expectations about pensions if the information is not accurate, clear, timely and balanced. The pension scheme does not match with the risks that scheme members are able or willing to bear. Scheme members do not understand the urgency and impact of decisions they make. Due to increased workload and new business operations at pension providers, scheme members do not get sufficient answers to questions and complaints.	• Laws and regulations	Increased ↗
Targeted and aggressive marketing	Targeted and aggressive marketing through social media and parties such as finfluencers and signal providers misrepresent return, risk and costs. As a result, consumers are more likely to purchase complex or misleading products or services without being fully aware of the risks or checkinmg whether it suits their situation. In the crypto market specifically, after the entry into force of MiCAR, rogue providers may wrongly give the impression that cryptos are less risky (cryptowashing).	• Digitalisation • Internationalisation	Increased →
Embedded financial products and services	The accessibility of embedded financial products and services leads to misselling, overinsurance, overlending, or unwanted or incorrect financial advice, because information about the financial product (including price, conditions, coverage) fades into the background. Consumers hardly compare products with each other and do not look critically at premiums and conditions. In addition, the distribution of embedded financial products and services is more complex and less transparent, so there may be less guarantee of consumer protection.	• Digitalisation	High ↗
AI in financial advice and products	The use of AI in financial advice, insurance products and credit approvals lead to risks to customers' interests, from risk selection and premium differentiation to uninsurability and exclusion. Uncontrolled use of AI leads to a black box risk, which, among other things, leads to unsuitable financial advice. Increasing automation, outsourcing and digital (external) access to sources causes errors in decision rules or algorithms with serious consequences for advice and distribution.	• Digitalisation	Increased ↗
Climate risks housing market	Failure to factor in foundation and flood risks into the housing market leads to harmful financial consequences for homebuyers and homeowners. Neither risk is fully insurable, and homeowners are not sufficiently aware of these risks, so they will see unexpected falls in the value of their home or face repair costs.	• Sustainability	Increased ↗
Overlending	Consumers with high loans switch to alternative, riskier methods to finance their purchases, such as cash advances, buy-now-pay-later, types of (private) leases or financing based on a purchase price appraisal. Excessively high loans (mortgages, consumer credit) make consumers vulnerable in the event of a fall in purchasing power, a change of personal circumstances and a rise in interest rates. They consequently look for risky financing options.	• Macroeconomic developments	Increased →
Financial crime	Increasing digitalisation, including new digital communication channels and the rise of AI, creates more opportunities for criminals to defraud consumers, for example by producing credible advertisements for dubious investments. Finfluencers can promote undesirable products to (inexperienced) followers. The limited national supervisory mandate for cross-border players hinders proper supervision.	• Digitalisation • Internationalisation	Increased ↗

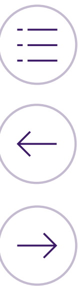
The risk maps translate external developments into specific risks for each of the AFM's supervisory areas.

Assessent risks: High, Increased, Very high

↗ Increase
→ Constant
↘ Reduction

AFM

02 Capital markets

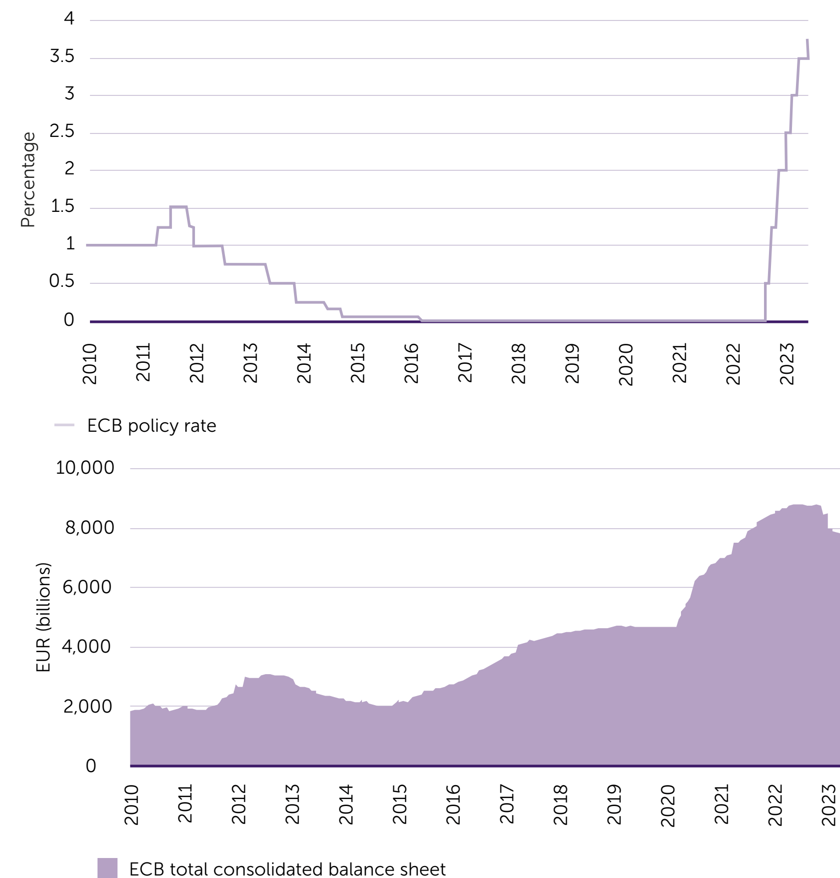


Well-functioning capital markets contribute to the economy and the sustainable financial well-being of the Netherlands. Capital markets play an important role in the allocation of capital for economic activities, the redistribution of financial risks, the financing of sustainability in the economy and facilitating the energy transition. It is crucial that market participants have confidence in the proper functioning of the market. The AFM therefore ensures that all market participants involved in new issuance and from order to settlement take their responsibility to ensure that trading is fair, orderly and transparent.

2.1 General developments

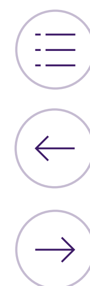
The monetary policy of central banks is an important theme in capital markets. Last year, inflation rose sharply and central bank policy changed from easing to tightening. This initially led to a gradual increase in the policy rate and subsequently also to the tapering of the bond-buying programme (quantitative easing, QE). The ECB now has a policy rate of 4%, up from 0% at the beginning of 2022 (see Figure 5, above). In addition to an increase in the policy rate, the ECB decided not to expand its balance sheet further in 2022 and to discontinue its accommodative monetary policy. As of March 2023, the ECB began quantitative tightening (QT) by selling €15 billion a month in bonds. The effect of this change in policy is clearly visible in the ECB's balance sheet (see Figure 5, below).[24]

Figure 5. The ECB's policy rate at its highest point in years (above) while the ECB's balance sheet is shrinking (below).



Source: Macrobond

24 'Analysis: Traders relaxed as ECB starts running down massive bond holdings', Reuters, March 2023.



Against the background of macroeconomic developments, geopolitical tensions and climate change, new (abrupt) market risks may arise in digitalised capital markets. Capital markets are highly connected and in a digitalised world, lightning-fast information transfer and processing is possible. Against the background of macroeconomic developments, geopolitical tensions or climate change, seemingly isolated events can lead to volatile changes in the valuation of financial instruments. Rapid processing of new information can cause abrupt price shocks, which can cause liquidity problems for market participants. The hyperconnectivity of social media and the provision of news, but also of capital markets themselves, increases these risks. Due to the digitalisation and internationalisation of capital markets, supervisors are increasingly confronted with market risks that are more difficult to mitigate. In the in-depth analysis entitled "Algorithmic collusion in capital markets", we use algorithmic collusion[25] to show how we as a supervisor deal with new risks in a changing world, for example due to far-reaching digitalisation.

In the gas futures market, we see additional volatility due to its sensitivity to (geo-)political developments. Last year a lot of attention was focused on developments in the gas market.[26] Although calm seems to have returned somewhat in 2023, the risks are permanent. The TTF gas futures market is sensitive to fundamental developments in the global gas and related energy markets, such as the war in Ukraine and competition for LNG imports with Southeast Asia and China. This can manifest itself in increased price levels and volatility. For the time being, it remains to be seen what the long-term effect of the Market Correction Mechanism (MCM) will be.[27] If the price moves unexpectedly again towards the agreed maximum price, liquidity may move outside the EU or off-exchange (Over-the-Counter, OTC).

Text box 5 Key regulatory pathways

EMIR review

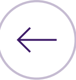
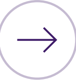
The revision of EMIR should increase the attractiveness of centrally cleared derivatives in the European Union. In December 2022, the European Commission published a proposal to revise the European Market Infrastructure Regulation (EMIR). At the beginning of 2022, a public consultation took place where key stakeholders, such as regulators and market participants, could provide input to improve the European clearing framework. The new proposals aim to increase the amount of centrally cleared derivatives in the EU. One of the aims is to improve and shorten procedures for CCPs. This makes clearing at these European CCPs potentially cheaper, more customer-friendly and more attractive. Changes are also underway with regard to the cross-border supervision of CCPs and clearing by non-financial corporations. The proposal is part of a broader package of measures related to the European Capital (CMU).[28]

MiFID/MiFIR review

The proposal for the MiFIR review mainly concerns adjustments around trading in financial instruments and increasing transparency. For example, the proposed adjustments to MiFIR make a consolidated tape possible. A consolidated tape aims to remove barriers to entry and improve the availability of market data in fragmented European capital markets. In addition, the proposal prohibits payment-for-order-flow (PFOF), a practice in which retail brokers are compensated by market makers or trading platforms for executing their clients' orders. The trialogue started in April 2023.

25 Algorithmic collusion is a form of tacit collusion based on algorithms.
26 The development in the TTF gas futures market is described in more detail in our publication State of the Capital Markets 2023.
27 'Infographic - A market mechanism to limit excessive gas price spikes', European Council.

28 `Capital markets union: clearing, insolvency and listing package', European Commission.

MiCAR

The complex and international nature of crypto asset markets can contribute to the emergence of non-ethical trading behaviour. For example, there is a risk of market abuse, such as orchestrated price increases with the aim of dumping cryptos at a higher price (pump and dump) and insider trading on crypto platforms. For example, crypto assets are purchased just before they can be traded on the platform and then sold again after the introduction. It is also not inconceivable that market participants use crypto assets for money laundering, financing terrorist activities and evading sanctions regulations.

While the Markets in Crypto Assets Regulation (MiCAR) provides the necessary starting points for supervision to address these risks, there are concerns about whether these starting points are sufficiently firm and practically enforceable. For example, identifying and addressing market abuse will be complicated under MiCAR. So-called *tokens* are traded on many different international platforms and market participants are not obliged to report transaction data to the AFM. The supervision of money laundering is also a challenge. After all, private wallets make it possible for parties to trade crypto assets anonymously outside platforms.

DORA

In capital markets, a relatively large number of parties are in scope of DORA regulations. In January 2023, the Digital Operational Resilience Act (DORA) came into force, giving companies two years to comply with the regulation. DORA aims to increase the digital resilience of players in financial markets, as the risk of cyber attacks becomes more pronounced with the increasing reliance on financial processes. In the capital markets, CCPs, CSDs, trading platforms and proprietary traders (*Handelaren voor Eigen Rekening*; HERs) are in scope of DORA. Currently, this population is already covered by various types of legislation that share common ground with DORA in some areas, including MiFID, CSRD and EMIR. Although for some of the parties the difference between the current IT control and the requirements from DORA will be relatively limited, some companies will still have to make significant efforts to be sufficiently resilient to IT risks.

2.2 Digitalisation

Developments in digitalisation, such as artificial intelligence (AI), may increase efficiency, but may also affect the orderly functioning of capital markets and their supervision. For market participants, there are major advantages in the use of AI, such as an information advantage and cost advantages. In addition, AI is used to process large amounts of alternative data (such as satellite images of movements of oil tankers or full parking lots at the DIY store) to build market intelligence and thus make better investment decisions. In theory, this could lead to more efficient pricing, more liquidity and lower costs for end-users. The tension between fairness, orderliness and transparency of capital markets is also increased by advanced technology. Take, for example, a *machine* learning-based algorithm that has taught itself, without human intervention, to manipulate the market with a variant of spoofing or layering[29]. Monitoring this type of development requires a specialised approach, both to maintain the orderly functioning of the market and to promote transparency and fairness.

Did you know...?

On Dutch trading platforms about 75% of all equity orders are executed by means of a trading algorithm?[30]

The use of AI leads to major risks, in particular due to possible lack of transparency and explainability, which can put pressure on the proper functioning of capital markets. Due to the complexity, the use of large amounts of data and new correlations and structures that AI technology can expose, there are concerns about transparency and explainability. If decisions are not explainable, for example, fair trading cannot be guaranteed. Ultimately, this undermines confidence and creates risks to the stability of financial markets. Overseeing AI therefore requires adequate governance that prevents the market from becoming a black box. European legislation to monitor the use of AI is currently being drafted.

29 Spoofing and layering are trading strategies in which (many) orders are placed with the aim of deceiving the market with regard to true trading intentions.
30 'State of the Capital Markets', AFM, October 2023

Among other things, this AI legislation will guarantee certain ethical principles that reliable AI must comply with, for example in terms of safety, transparency and human accountability and responsibility.[31]

AI involves high costs, for both knowledge and capital, and these potentially create an uneven playing field within the capital market infrastructure. Even without AI, there are concerns about concentration risks around key parties that support the capital market infrastructure, such as banks, trading platforms and market makers. For example, being active as a market maker requires high investments (technology, capital and specialised personnel) that not every small player can afford. This leaves only a few, wealthy players. AI can further exacerbate this, because the application of AI also requires high investments, in both knowledge and capital. Small, new or niche parties – which are important for the health of the financial ecosystem – are no longer profitable due to these higher implicit barriers to entry. If only large, wealthy market participants can afford to enter, this will contribute to an uneven playing field within the capital market infrastructure. Concentration around a few parties may harm financial stability.

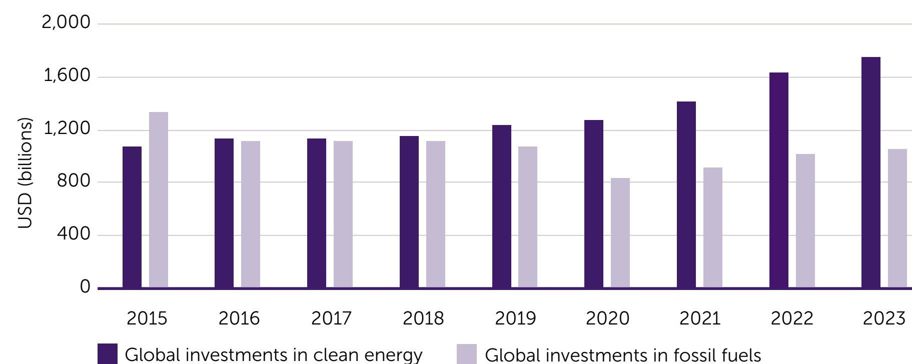
Cyber risks will continue to be relevant, even with the arrival of DORA. The capital market infrastructure has been highly digitalised. Both the trading platforms and the largest liquidity providers rely on advanced technology. This technology can be developed by these operators themselves as well as by (large) technology companies. In addition, capital markets are interconnected worldwide, which benefits efficiency and liquidity in capital markets. However, this connectivity is also vulnerable, as evidenced by a cyber attack on a relatively unknown financial service provider in January of this year. This company makes crucial software that reconciles derivative transactions. As a result of the attack, no transaction reports could be produced by trading platforms and regulators for several weeks.[32] The aim of the new DORA regulation is to strengthen the capital market infrastructure by, among other things, requiring financial institutions to implement certain best practices. Research by the AFM shows that not all trading platforms and proprietary traders (*Handelaren voor Eigen Rekening*; HERs) in the Netherlands are fully DORA-proof.[33]

31 These principles already largely apply in existing legislation on (algorithmic) trading, such as MiFID and MAR.
32 'Derivatives market still hit by fallout from Ion Markets cyber attack', Financial Times, February 2023.
33 'IT Incident Management Capital Markets', AFM, March 2023.

2.3 Sustainability

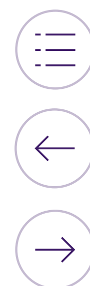
Capital markets play an important role in financing the sustainability transition. The primary function of capital markets is efficient price discovery and risk and capital allocation. This also makes the sustainability transition possible. Capital markets facilitate capital flows from banks and asset managers to sustainable projects and enable the allocation of capital to green investment opportunities. Meeting the EU's sustainability goals requires large amounts of capital. The International Energy Agency (IEA) predicts that global investment in green energy will be greater than fossil energy by 2023, but investment in fossil fuels will remain high. The $2,800 billion of investments in energy by 2023 is estimated to include $1,700 billion in green technology such as renewable energy, storage technologies and electric vehicles. The other $1,100 billion will go to fossil and emission-intensive sectors (see Figure 6).[34] Net investments in green energy are therefore lagging behind the targets. Sustainable financing activity will have to double or even triple to achieve these targets by 2050.[35]

Figure 6. Green investments are increasing, but investments in fossil fuels remain high.



Source: International Energy Agency (IEA)

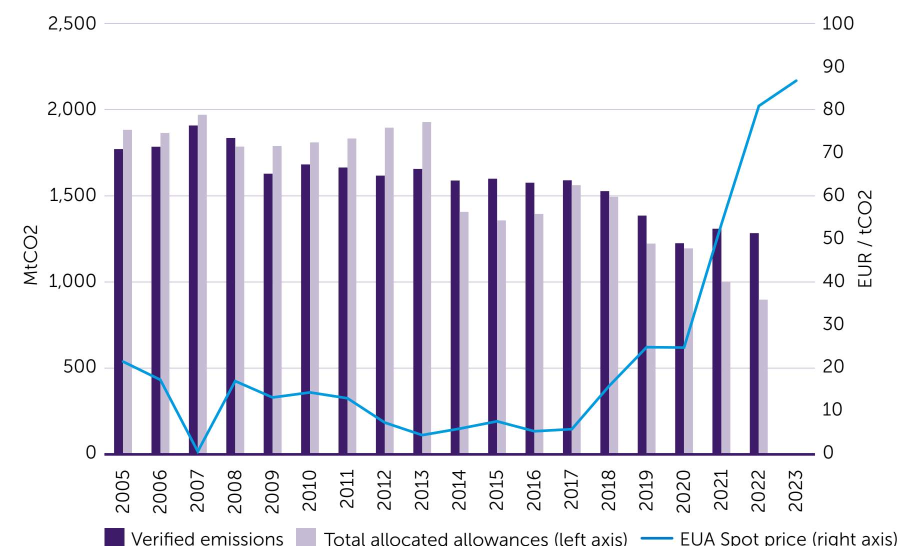
34 'World Energy Investment 2023', IEA, June 2023.
35 'A reality check on Green Finance', New Finance, June 2022.



Developments in the gas futures market have a material impact on the energy transition. The gas futures market plays an important role in pricing energy and therefore the energy transition. High prices can result in both more and less investment in the energy transition. On the one hand, high fossil fuel prices can make renewable alternatives more attractive. On the other hand, energy companies have fewer incentives to invest in renewable alternatives if a lot of profit is made on fossil fuels. Ultimately, it is important that the price of gas is established in a transparent and fair manner in the gas futures and underlying markets, so that market participants can make investment decisions that support the sustainability transition.

The European Emissions Trading System (ETS) and the Amsterdam-based futures market also contribute to the energy transition. Industries covered by ETS are obliged to offset CO_2 emissions by buying sufficient carbon emission allowances (European Union Allowance, EUAs). They are faced with the choice of buying emission rights or investing in emission savings. Investments in emission savings become more attractive as emission allowances become more expensive. Fewer and fewer emission allowances are becoming available, which means that companies have to compete for increasingly scarce emission rights, which increases the price (see Figure 7). The futures market with EUAs as an underlying asset plays an important role in the price discovery process. This Amsterdam-based market, like the gas futures market, is vulnerable to political developments. Unexpected (political) intervention in the market can cause volatility in the EUA (futures) market with possible consequences for market participants such as immediate liquidity problems due to margin calls.

Figure 7. Lower supply of emission allowances pushes up the EUA price.



Source: European Environment Agency (EEA), EEX, AFM

2.4 Internationalisation

Geopolitical tensions and deglobalisation affect the returns of publicly listed companies operating globally. For decades, the consensus has focused on globalisation of trade and investment. Publicly listed companies (and other companies) that operate globally benefit from globalisation and free markets, which they saw reflected in higher returns. At present, signs of deglobalisation, or *slowbalisation*, are becoming visible (see Figure 8).[36] In addition to the war in Ukraine, tensions between the US and China are increasing. These rising tensions may affect the returns of global companies. Investors are not always aware of geopolitical risks of the companies in which they invest. Transparency around these risks, such as chain dependencies, is therefore important.

36 'The High Cost of Global Economic Fragmentation', IMF, August 2023.

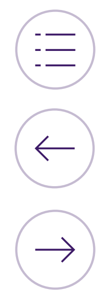
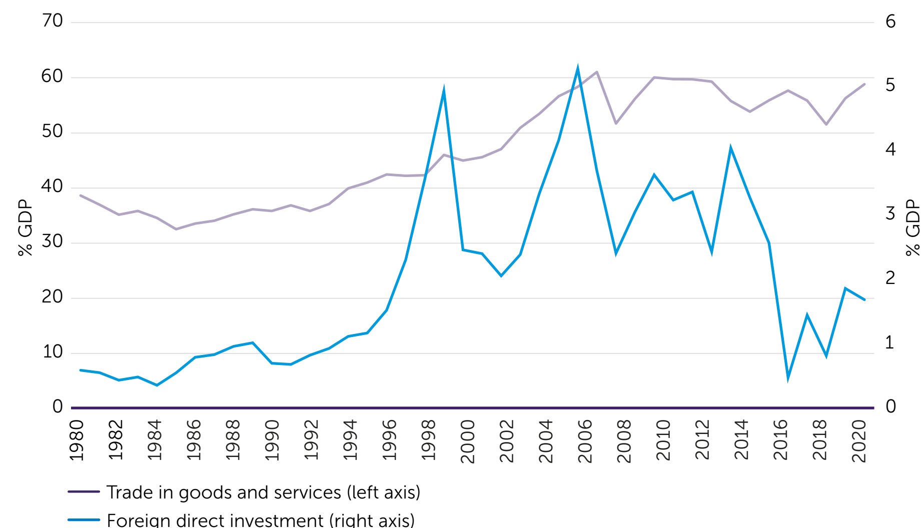


Figure 8. Signs of slowbalisation: stabilising world trade and declining Foreign Direct Investment (FDI).



Source: IMF WEO[37]

Liquidity in EU equity markets lags behind Asia and the US. This is partly due to the dominance of bank financing within the EU as the main source of financing for companies.[38] European capital markets are also segmented along national lines and the contribution of alternative sources of financing, such as venture capital and private equity, is limited. In the US and Asia, corporate finance is a lot more diversified. This makes an economy more resilient, for example in the face of increasing stability risks in the banking system. EU equity markets are therefore experiencing slow progress, reflected in the EU's declining share of the global stock market capitalisation of listed shares. This makes it more difficult for European companies, among other things, to attract financing in the European capital markets.

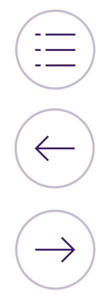
37 'World Economic Outlook: A Rocky Recovery', IMF, April 2023.
38 'State of the Capital Markets', AFM, October 2023.

While progress has been made on integrated capital markets, European capital markets remain fragmented. With dozens of (national) exchanges and trading platforms in different countries, the European capital market is fragmented. Reducing fragmentation in European capital markets is important to strengthen Europe's competitiveness, attract investment and facilitate the financing of companies. The European Commission has drawn up several action plans for this under the name of the Capital Markets Union (CMU). A Capital Markets Union should – through efficient market infrastructure and intermediaries – increase the flow of capital from investors to European investment projects, improve the allocation of risk and capital in the EU and ultimately make Europe more resilient to future shocks.

Text box 6 European capital markets post-Brexit

As a result of Brexit, the Netherlands has become an important financial trading centre in the European Union (EU), especially for equity and bond trading. After Brexit, seven new trading platforms relocated to the Netherlands, two of which focus on equity trading (Cboe and Turquoise) and four on bond trading (Tradeweb, Bloomberg, MarketAxess and CME). The related ecosystem has also grown, with more proprietary traders, asset managers and data service providers relocating operations to the Netherlands.

The degree of regulatory divergence between the UK and the EU in the area of capital markets remains limited for now. In the run-up to Brexit, there was a lot of uncertainty about an increase in regulatory divergence between the UK and the EU. Increasing divergence can lead to market distortions and higher costs for the participants involved. To reform its financial sector and services, the UK has introduced new rules, such as abolishing the Double Volume Cap (DVC) and the Share Trading Obligations (STOs) and changing the definition of Systematic Internalisers (SIs). In short, this increases the freedom of trade for market participants in the UK. The coming period will show more how the EU will adapt its regulations to the new situation, such as the revision of rules on derivatives clearing (EMIR). Discrepancies are most likely to arise in areas with new regulations, such as around crypto and Fintech, as there was limited regulation for these areas pre-Brexit.

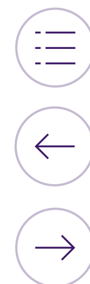


Cooperation between the UK and the EU on legislation and regulations is essential. In June 2023, a Memorandum of Understanding (MoU) was signed between the UK and the EU to strengthen cooperation and dialogue in the field of financial services, with an emphasis on voluntary regulatory cooperation. This is also important in relation to the European Capital Markets Union (CMU). With the UK's departure from the EU, the challenges concerning the European Capital Markets Union have increased further. After all, London, as a leading financial centre, is no longer part of the EU.

2.5 Integrity and criminal behaviour

Digitalisation and AI are facilitating new forms of market abuse in capital markets. Developments in the field of digitalisation create new risks for capital markets. An example concerns dynamics on social media, which, stimulated by automated content, can lead to significant fluctuations in the price of financial instruments. We have seen this, among other things, in the GameStop case.[39] These dynamics can also be used in a malicious way, by deliberately manipulating the market with false reports or 'investment tips' from finfluencers.[40] AI models create new, even more far-reaching opportunities for this, for example by enabling criminals to generate credible news reports or images about listed institutions that can be distributed on social media to manipulate the market. The trading of crypto assets, which with MiCAR will come under the supervision of the AFM, is also susceptible to various (new) forms of market abuse. These types of risks are relatively new, potentially have a major impact on capital markets and require new and more developed ways of monitoring and tackling market abuse.

39 'AFM Market Watch 'Investing and social media in light of GameStop', AFM, June 2021.
40 See for example: `SEC Charges Eight Social Media Influencers in $100 Million Stock Manipulation Scheme Promoted on Discord and Twitter', SEC, December 2022.



Keywords	Specific risk	Drivers	Importance
Event risk	Events can cause abrupt price fluctuations and liquidity problems. In the digitalised world with global communication lines, social media and fast trading algorithms, lightning-fast information transfer and processing is possible. New information is priced in very quickly, resulting in rapid and magnified market movements. Underlying causes of events include macroeconomic conditions, geopolitical tensions and climate change.	• Digitalisation • Geopolitical developments • Internationalisation • Macroeconomic developments	Increased ↗
Control of algorithms	Uncontrolled use of AI in trading algorithms puts pressure on the orderly functioning of capital markets, for example through the use of black box trading algorithms. Poor control leads to errors in individual algorithms, such as coding or data errors, and may lead to unwanted interference between algorithms. This can lead to financial instability.	• Digitalisation	Increased ↗
Cross-market and cross-border market abuse	Internationalisation and fragmentation of capital markets provide opportunities for forms of insider trading and market manipulation that are difficult to detect and tackle. Examples include cross-product insider trading or price manipulation in correlated cross-border products. In these cases money is earned unfairly at the expense of other investors.	• Digitalisation • Internationalisation	Very high →
Deficient data for investor decisions	Insufficient (central) sustainability, market and price information weakens investors' information position and thus reduces the efficiency of investment decisions. With dozens of trading platforms in different countries, the European financial market is highly fragmented and there is currently too little central market and price information.	• Digitalisation • Internationalisation • Sustainability	High →
Digital operational resilience	Market participants' controlled business operation is failing to keep pace with the demands of far-reaching digitalisation. The controlled business operation of high-technology operators in capital markets is crucial for the proper functioning of the market as a whole. There are concerns surrounding operational control and resilience with regard to failures of infrastructure, cybersecurity and control of algorithms.	• Digitalisation	High →
Chain dependency	Capital markets are sensitive to failures of a single player in the infrastructure that could halt trading and impede the price discovery process. Increasing laws and regulations raise barriers to entry, leaving only a few players in the trading chain. This puts pressure on the robustness of markets and may lead to financial instability.	• Digitalisation • Internationalisation • Laws and regulations	Increased ↗
Consolidation and market power	In some parts of the market and trading chain, the few remaining players have significant market power, so customers and end-users do not always have the best outcome. Market structure, such as market fragmentation and high barriers to entry, leads to winner- takes-all outcomes. This applies, for example, to proprietary traders, trading platforms or other operators that are crucial for the capital market infrastructure.	• Digitalisation • Internationalisation • Laws and regulations	High →

Risk map for Trend Monitor 2024
Capital markets

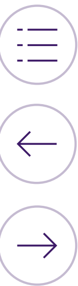
The risk maps translate external developments into specific risks for each of the AFM's supervisory areas.

Assessent risks: High, Increased, Very high

↗ Increase
→ Constant
↘ Reduction

AFM

03 Asset management

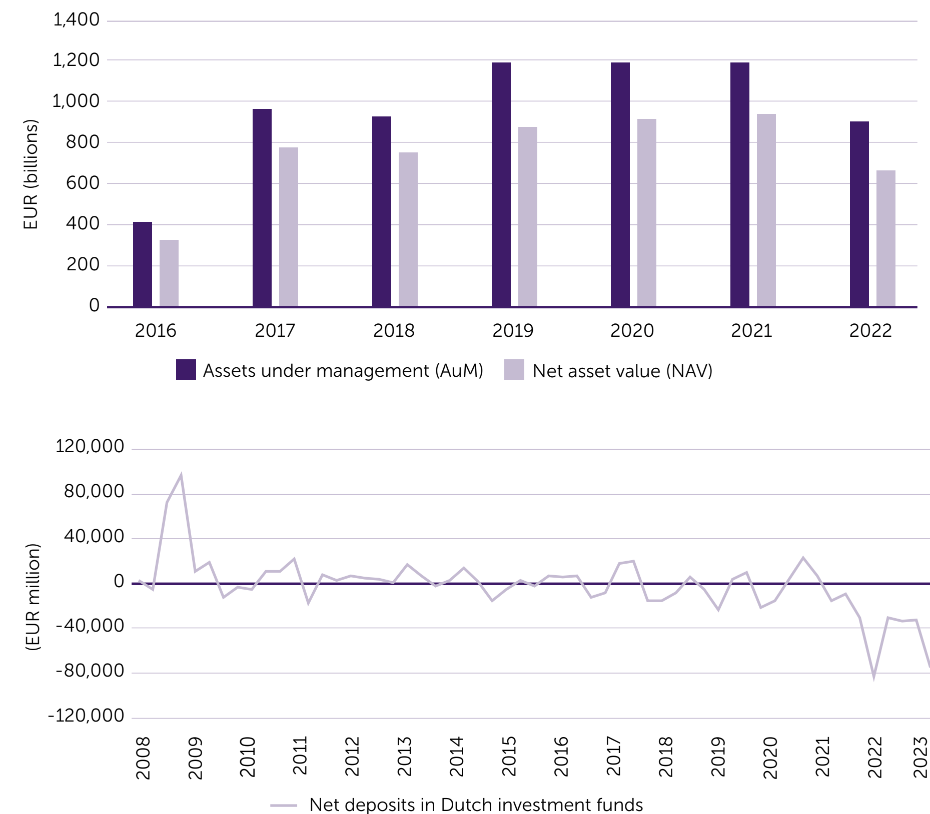


The AFM's mission with respect to asset management concerns supervision to ensure a robust and agile asset management sector for the benefit of investors. With our supervision, we contribute to the protection of investors and consumers who have directly or indirectly placed money with asset managers. They invest in the capital markets the assets of private individuals and large institutional investors such as pension funds and insurers.

3.1 General developments

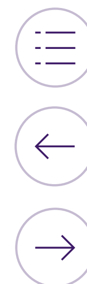
Total assets under management of Dutch investment funds decreased significantly in 2022, mainly due to the worldwide decline in share and bond prices. After several good investment years, 2022 was marked by high volatility and falling stock and bond prices. Whereas bonds normally serve as a safe haven for investors during periods of falling stock prices, investors now had to deal with the rare situation of stocks and bonds falling simultaneously. This resulted in negative returns for Dutch investment funds and therefore lower net assets (see Figure 9, above). In 2022, for example, pension funds achieved an investment return of -21% on average after deduction of costs.[41] In addition, there was also a net outflow from Dutch investment funds (see Figure 9, below). This was mainly because pension funds sold a relatively large number of assets in order to meet margin calls that they faced as a result of the rise in interest rates.

Figure 9. Above: Lower assets under management (AuM) and net asset value (NAV) of Dutch investment funds in 2022. Below: Decrease in net deposits at Dutch investment funds.



Source: AFM, DNB

41 Data on individual pension funds (quarterly), DNB.



Rapidly rising interest rates and periods of acute market stress increase the risk of liquidity problems. As a result, open-end mutual funds may face liquidity pressures if many, or a few large, investors want to exit at the same time. This can lead to asset managers having to sell assets quickly and at a loss (fire sales). This risk is particularly relevant for funds that invest in asset classes that are inherently illiquid, such as direct real estate or (high-yield) corporate bonds. Asset managers with large derivatives portfolios can also run into liquidity problems when they are confronted with high margin calls due to increased volatility in underlying assets and the (illiquid) assets of the fund cannot be liquidated in time. Finally, the money market plays an important role in enabling asset managers to attract and place liquidity. When money market interest rates rise sharply in a short period of time and market participants cannot attract liquidity for a short period and against collateral as usual in the money markets, this contributes to liquidity problems. How the risk of liquidity problems develops in the future will also depend on the interest rate policy of central banks.

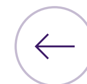
Liquidity management is a critical part of controlled management by fund managers and is the first line of defence against stability risks. The increased volatility in markets creates increased liquidity risks for asset managers and highlights the importance of adequate liquidity risk management. Part of this is the availability of liquidity management tools (LMTs) with which fund managers can, for example, temporarily suspend withdrawals. It is also important to properly align the conditions for withdrawals from funds and the liquidity of the underlying assets so that there is no liquidity mismatch. In extreme cases, the AFM has the option of suspending additions and withdrawals from funds.

Cyclical and structural developments in the commercial real estate sector can have a systemic impact on the financial system and the real economy. Cyclical risks relate to increased inflation, tightening financial conditions and a deterioration in the growth outlook. Vulnerabilities related to structural changes in the commercial real estate sector include sustainability and the shift to e-commerce. Unfavourable developments have an impact on, among other things, credit risks of banks and liquidity risks in open-end investment funds. In December 2022, the European Systemic Risk Board (ESRB) called on the EU and national authorities to improve the monitoring of these risks arising from the commercial real estate sector.[42]

The increasing pressure on assets under management is a catalyst for consolidation in the asset management sector. Margin pressure, growth of (online) passive (index) investing and increasing laws and regulations force asset managers to strategically reposition themselves. The wave of acquisitions and consolidation is occurring in all segments of the market. The poor stock market year of 2022 has significantly affected the assets managed by asset managers. In the first place this is due to falling prices for certain asset classes, such as stocks, and secondly the rise in interest rates has led to lower bond valuations. Together, this results in declining income due to lower assets under management. In addition, the minimum amount of assets under management needed to recoup the costs of complying with laws and regulations increases. This makes it increasingly difficult for asset management parties to guarantee their solidity.

In addition to acquisitions, we see that outsourcing is becoming increasingly important in the asset management sector, which leads to concentration risks. Within the asset management sector, the importance of outsourcing has been increasing for several years. In addition to outsourcing investment administration and IT, activities such as portfolio and asset management are increasingly being outsourced. If asset managers outsource activities to third parties, they remain responsible for this themselves. This requires strict agreements and control measures, so that the service to customers is not jeopardised. In addition, concentration risks arise when many asset managers become dependent on a limited number of third parties for certain activities. Interruption of service from such a party can then cause problems for many asset managers.

42 'ESRB issues a recommendation on vulnerabilities in the commercial real estate sector in the European Economic Area', ESRB, January 2023.



Text box 7 Key regulatory pathways

DORA

Within the asset management sector, the implementation of DORA has a major impact. In January 2023, the Digital Operational Resilience Act (DORA) came into force, giving companies two years to comply with the regulation. DORA aims to increase the digital resilience of players in financial markets, as the risk of cyber attacks becomes more pronounced with the increasing reliance on financial processes. In the asset management sector, managers of investment funds (UCITS and AIFM), investment firms, trading venues, crowdfunding service providers, data reporting service providers, crypto asset service providers and certain custodians are in scope of DORA.[43] The mandatory task for financial participants is, among other things, a more extensive 'framework' for the management of IT risks, an analysis of the security of each system and IT supplier and guaranteeing continuity. Within the population, we see differences in IT maturity levels, which highlights the relevance of investing in IT risk mitigation. Because asset managers are increasingly outsourcing business processes – including IT – it is important that the implementation of DORA is embarked on and handled in a timely and careful manner.

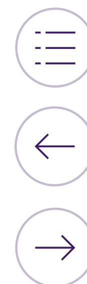
SFDR level 2

Since the beginning of this year, the additional obligations from the Sustainable Finance Disclosure Regulation (SFDR level 2) have applied to, among others, asset managers and pension funds. By 1 January 2023, additional sustainability information was required to be published, including (i) the statement on the main adverse effects of investment decisions and (ii) information on the sustainability characteristics of financial products. The implementation of these additional transparency obligations has once again required a major effort from market participants. The available sustainability information should provide insight into the degree of sustainability of financial products and the way in which companies deal with sustainability. **Signals from the market show that parties are still struggling with uncertainties surrounding these regulations.** After the entry into force of the additional requirements of the SFDR at the beginning of 2023, market participants are still struggling with the execution. They have particular difficulty in obtaining the data needed to meet the SFDR requirements, such as reporting on the main adverse effects. In addition, market participants encounter practical ambiguities when complying with the SFDR requirements, including the use of the mandatory information template. The regulations are also still being developed. For example, an adjustment of the SFDR level 2 requirements is on the way and the European Commission has announced a review of the SFDR level 1.

Pension transition

Especially for asset managers who perform a fiduciary role for pension funds, the pension transition in the Netherlands poses considerable challenges. These challenges include strategic and tactical portfolio management. The introduction of cohorts under the solidarity variant and/or a possibly partial introduction of the flexible contract leads to pension funds making an additional call on managers to reanalyse adapted variants of the investment portfolio. They must also calculate scenarios and look specifically at, for example, interest rate hedging, the use of derivatives and the justification of returns. In addition, the transition requires adjustments to business operations and related adjustments to data, IT applications and the administrative organisation (policy, SIRA, process and work descriptions). Finally, the *Wet toekomst pensioenen* (Wtp) requires even more cooperation and coordination within the chain. There is a long tradition of outsourcing in the pension sector, especially in the field of asset management and pension administration. The interaction between these chains is limited in the current situation. It can be expected that cooperation and coordination within the chain of pension administration, asset management and investment

43 Currently, investment funds and investment firms already have different types of legislation (MiFID, UCITS, AIFMD) that already affect certain parts of DORA (such as risk management, incident reports and outsourcing). In addition, the crowdfunding platforms are subject to the ECSPR, where DORA topics are included to a lesser extent.



administration will increase significantly. This intensification of exchange and coordination between pension and asset management chains requires additional attention to be paid to the control of this (outsourcing) chain and efforts in the field of IT and data. Finally, the timing of the transition of individual pension funds must match the capacity of managers.

3.2 Digitalisation

The use of artificial intelligence (AI) applications by asset managers in both portfolio management and operational processes is expected to increase. Worldwide, we see that AI systems are increasingly integrated into all kinds of business processes, partly due to the rise of Large Language Models (LLM) such as ChatGPT. In the asset management industry, AI can be used for process optimisation to reduce operational costs for asset managers. AI systems are used in both portfolio management and operational processes, for example in first- and second-line applications, risk management and compliance. In addition, they can be used in the customer acceptance process (AML/CFT Act) and the enforcement of the Sanctions Act.

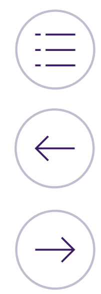
In addition to the use of AI for business processes, asset managers can use AI models to determine their investment policy. The investment policy of asset managers has traditionally been based on available data relevant to the expected risk and return of asset classes. The use of AI builds on the quality and quantity of available data by uncovering connections that cannot be easily distilled by humans. Academic literature shows that, for example, machine learning can actually help to uncover non-linear patterns with the aid of large amounts of data and thus contribute to making optimal investment decisions. This is applicable not only in predicting investment returns but also other metrics such as risk or the sustainability/ESG score of an investment. Nevertheless, AI investment models also remain subject to the fundamental uncertainty of financial markets (it is not certain that past relationships will exist in the future) and human decisions are needed to make methodological choices.

One of the main risks arising from the use of AI models by asset management parties is the lack of explainability. In short, explainability means that the AI model is explainable and understandable to humans. Humans must have a technical and objective understanding of the behaviour of an algorithm, for example, to understand the contribution of the different variables of the model to the output. Applications that provide insight into the operation of an algorithm and the process that leads to the output are therefore becoming increasingly popular (also known as explainable AI, XAI). Nevertheless, some AI models – for example, models used to identify patterns (such as neural networks) – will generate predictions that are inherently difficult for humans to explain and interpret. These models therefore have the character of a black box. This lack of interpretability makes it difficult to discern whether an AI model is revealing a meaningful pattern or merely creating noise.[44]

AI models are also prone to quality errors, potentially leading to financial instability. With regard to AI models and algorithms, two types of quality errors are possible: errors within the AI model or algorithm itself and/or errors within the outcome of the AI model or algorithm. In the case of errors within the AI model or algorithm itself, there can be several reasons. This may be caused by poor control of algorithms by humans themselves, such as a programming error, but biases in an algorithm can also lead to quality errors. In addition, errors in the outcome of an AI model or algorithm can be caused, among other things, by poor data quality (e.g. incomplete or unrepresentative input). The quality and accuracy of the training and test data is also of great importance for a correctly working AI model. Both programming errors and data errors have an impact on risk management by individual asset managers and in extreme cases – for example when large asset managers are involved – can pose a threat to financial stability. For asset managers, this means that these types of factors must be considered in their risk management process. The question arises of the extent to which asset managers have the knowledge to properly assess these risks. It is essential that the data quality is in order and the underlying AI models and algorithms are understood.

Far-reaching digitalisation makes the asset management sector vulnerable to cyber attacks. The strong dependence on IT entails risks for asset management parties in the field of digital resilience. The asset management sector appears – in general – vulnerable to cyber incidents, partly due to 'legacy' IT systems. Moreover,

44 The current EU regime for investment funds already contains transparency provisions that should prevent the creation of a black box, including by making management responsible for supervising the funds' overall investment policies, specific investment strategies and individual limits, as well as monitoring risk management.



the increasing outsourcing of business processes to possibly a few large service providers – including cloud platforms – makes the asset management sector as a whole vulnerable to cyber incidents at such 'nodes'. We therefore see that cyber incidents are increasing in number and severity. A cyber incident can damage the trust in and continuity of an asset management party. It is therefore important that both asset management parties and the AFM understand and manage the management of cyber risks. TIBER tests[45] and the DORA regulations contribute to this.

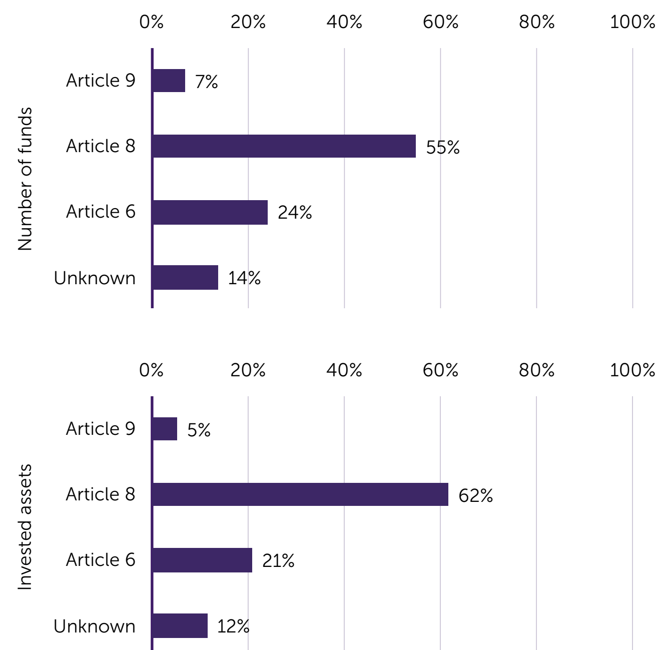
3.3 Sustainability

The asset management sector plays an important role in meeting the rapidly growing demand for sustainable investments. Asset managers mobilise capital for sustainable investments and focus on sustainability aspects in the business operations of companies in which they invest. There is high demand for these sustainable investments from investors and unsustainable companies are increasingly excluded from investment portfolios. It is important for asset managers to integrate sustainability into their business operations and to manage the risks of the sustainability transition. The number of funds and invested capital in SFDR Article 9 funds is still limited (see Figure 10).

Did you know...?
31% of pension providers stated in their policies that they do consider the principal adverse impacts of their investment decisions on sustainability factors? This group includes the largest pension providers who provide the pensions of more than 80% of all scheme members.[46]

It is very important that timely, correct and complete data on ESG factors is available. A lack of reliable data to measure sustainability performance can contribute to greenwashing and misjudging sustainability risks. In addition, asset managers have difficulty obtaining the data needed to meet SFDR requirements, such as reporting on the main adverse effects. This makes asset managers reluctant to disclose their sustainability, partly out of fear of reputational risks if the ESG objectives are not achieved (also known as green hushing).

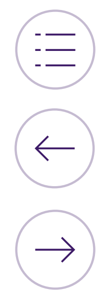
Figure 10. The number of funds (above) and invested capital (below) in SFDR Article 9 funds is still limited.



Source: Morningstar[47]

45 Since 2021, as part of the TIBER programme, the AFM has been conducting advanced *red teaming tests* in collaboration with large companies under its supervision to help manage cyber risk at institutional level. TIBER tests are also carried out at a number of AM parties.
46 'Key points of AFM report on pension funds and premium pension institutions', November 2022.

47 The data are not a complete representation of all mutual funds, but comprise a subset of funds that report to Morningstar.



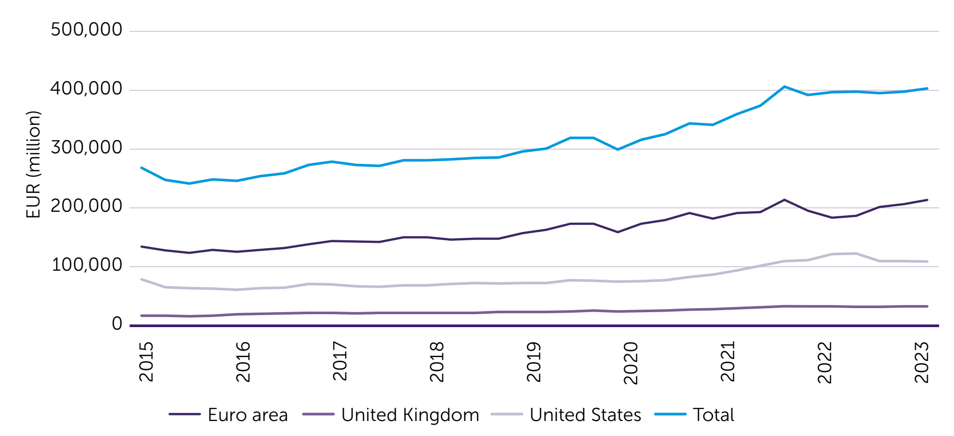
Taking sustainability ambitions into account is an extra dimension for asset managers in their investment decisions. Taking sustainability into account in investment decisions turns a 2D issue (optimisation of risk-return) into a 3D issue (optimisation of risk-return-sustainability). As described above, asset managers play an important role in the sustainability transition and society is increasingly asking them to invest more in shares of 'green' companies and less in those of 'brown' companies. However, this means that asset managers no longer base their investment decisions solely on a trade-off between risk and return (2D), but that sustainability performance will play an increasingly important role (3D). This leads to both practical and legal objections. On the practical side, asset managers must consider topics such as classification (what is sustainable?) and effectiveness (what exactly is the impact on the sustainability transition?). Legal objections may concern the fiduciary duty of asset managers to achieve optimal returns at acceptable risk. It is important that asset managers are transparent with their clients about the choices they make in the field of sustainability and what the impact is on risk and return.

If investors do not sufficiently integrate sustainability risks in their risk and portfolio management in the short term, this may harm the sustainability transition and financial stability in the longer term. An ESG circumstance that has a negative impact on the value of an investment is referred to as ESG risk.[48] If ESG risks are not taken into account in the (investment) strategy in the short term, this can cause problems in the longer term, for example when investing in stranded assets, if a CO_2 tax is introduced, if fraud or corruption is found, etc. This poses a threat to financial stability, because it can lead to forced asset sales, overlooking counterparty risk in derivative contracts, the drying up of credit intermediation or contagion to other funds and asset classes due to a loss of confidence by investors. Of course, the sustainability transition may also be jeopardised if investors continue to invest in 'brown' companies at the expense of 'green' companies. An orderly transition to a green economy reduces climate risks to the economy and the financial system in the long term. Asset managers play a crucial role in this, both in the implementation and in the associated communication.

3.4 Internationalisation

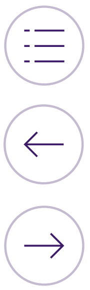
Mergers and acquisitions by foreign parties put pressure on the control of Dutch pension funds, making sustainability ambitions, for example, more difficult to achieve. Large foreign asset managers manage an increasing share of Dutch assets (see Figure 11). For example, Dutch pension capital is largely managed by foreign investors. On the one hand, this can be positive, because these large asset managers can invest more cost-efficiently due to economies of scale, resulting in higher net returns. On the other hand, it entails risks, including autonomy and the achievement of European sustainability ambitions. Many of these large, foreign asset managers invest largely passively, which means they may pursue less active policies to influence the results and behaviour of the individual companies in which they invest. This may put pressure on the autonomy of pension funds because they have little or no say at a shareholders' meeting and cannot simply withdraw their money. This can become a problem when pension funds actively want to exclude certain ('brown') companies from their investments.

Figure 11. Dutch invested capital in foreign investment funds is steadily increasing.



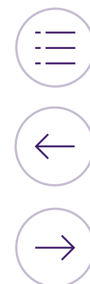
Source: DNB

48 See Sustainable Finance Disclosures Regulation (SFDR).



3.5 Integrity and criminal behaviour

When combating money laundering, terrorist financing and violations of the Sanctions Act, a waterbed effect can arise. Financial institutions act as gatekeepers in combating money laundering, terrorist financing and sanctions. The sanctions introduced in response to the Russian invasion of Ukraine, combined with the continued political and social attention paid to money laundering and terrorist financing, put greater pressure on the implementation of this gatekeeper function. When countering criminal behaviour, a waterbed effect can occur: addressing one channel where these transactions take place can lead to greater pressure on other channels. For example, there is a chance that the risk of money laundering will shift to asset management parties now that the banks are further defining their role as gatekeepers. The legislation requires these institutions to properly fulfil their gatekeeper function, including a systematic assessment of integrity risks and the monitoring of transactions in line with the applicable AML/CFT Act, the Financial Supervision Act and the Sanctions Act.



Keywords	Specific risk	Drivers	Importance
Consolidation and market power	The changing environment – including scale and margin pressure, the rise of (online) passive investment and increasing laws and regulations – is leading to a strategic repositioning of asset managers in the form of (cross-border) mergers and acquisitions. As a result, a few players with a dominant market position remain in both the market and the trading chain. This may not lead to the best outcome for investors.	• Digitalisation • Internationalisation • Laws and regulations	→
Liquidity risk	Substantial outflows of assets or the use of excessive leverage cause liquidity problems for investment funds. This risk is particularly relevant in times of market stress for open-end funds that invest in illiquid assets or for funds that make extensive use of derivatives. For some types of funds, a discrepancy between book value and market value of investments can amplify liquidity risk. This is particularly the case with commercial real estate or privacy equity funds, where valuation is hampered by insufficient market transactions.	• Geopolitical developments • Macroeconomic developments	↗
Chain dependency	Outsourcing of activities such as portfolio management, investment administration and IT to third parties leads to chain dependency. If many asset managers become dependent on a limited number of third parties, the result is concentration and/or systemic risks (domino effect). Asset managers remain responsible for the activities they outsource to third parties and must therefore take sufficient control measures to guarantee services for clients.	• Digitalisation • Internationalisation	→
Digital operational resilience	Increasing use of and dependence on IT systems makes asset managers vulnerable to cyber-attacks and other IT incidents. Moreover, the increasing outsourcing of business processes to large service providers (such as cloud platforms) makes the entire asset management sector vulnerable to cyber incidents at such 'nodes'. Asset managers must take sufficient measures to ensure strong digital operational resilience, even when they outsource IT.	• Digitalisation	↗
ESG integration, control and communication	Insufficient integration of ESG factors in risk and portfolio management and insufficient control of ESG risks leads to disappointments among investors. Furthermore, there is a risk of greenwashing if asset managers are not transparent in their communication to investors on the integration of ESG in the investment policy and the impact on sustainability. Both risks are increased when accurate, timely, and complete ESG data is lacking.	• Sustainability • Laws and regulations	↗
AI in investment policy and operational management	Uncontrolled use of AI in both portfolio management and internal operational processes leads to reduced transparency with regard to the investment policy towards investors (black box) and insufficient risk management by asset managers. In extreme cases, errors in algorithms or poor control of algorithms lead to financial instability.	• Digitalisation	↗
Combating money laundering	Money laundering increasingly takes place through investment firms and institutions because other financial institutions with a gatekeeper function erect higher barriers (waterbed effect). This gatekeeper function is under greater pressure due to extensive (or more extensive) sanctions legislation and the political focus on terrorist financing and money laundering. This can lead to insufficient compliance and increased risk of money laundering, terrorist financing and sanctions violations.	• Undermining • Laws and regulations	→

The risk maps translate external developments into specific risks for each of the AFM's supervisory areas.

Assessent risks: High, Increased, Very high

↗ Increase
→ Constant
↘ Reduction

04 **Financial reporting and audit firms**

Relevant and reliable information for end-users of reporting and statutory audits is a crucial precondition for fair and transparent financial markets. That is why we supervise reporting and the auditing of such reporting by audit firms. The functioning of this chain is essential for the availability of correct information in the market. The issuer reports on its financial and non-financial performance and the audit firm provides assurance with its audit opinion. If the chain does not function properly, this can lead to a lack of information, incorrect information or a lack of confidence in that information among end-users, who use it as a basis for investment decisions. This can lead to poor investment decisions or, in an extreme case, to financial losses due to fraud.

Did you know...?
In 2022, 252 licence holders carried out around 20,000 statutory audits? The number of licence holders has been falling for several years, while the number of checks is expected to increase.[49]

4.1 General developments

The accounting profession is strongly influenced by the growing digital society, more supply chain dependencies and therefore rapid changes in the nature of the audited company. The scope of the statutory audit is increasing and with it the expertise that the auditor must possess. Especially in the field of sustainability, supply chain dependencies and digitalisation, developments are occurring rapidly. These changes are in line with the shift already underway from traditionally shareholder-oriented financial information to a broader (non-financial) provision of information for a growing group of stakeholders. The interaction of companies with all of its relevant stakeholders and environmental factors is also receiving increasing attention.

49 'Sector in Beeld 2022', AFM, November 2022.

The consequences of the sustainability transition are the most visible. In addition to the physical consequences of this transition for companies, there are new reporting requirements that oblige companies to report on much more than traditional financial information. In addition, digitalisation, more recently including ¬¬AI models in particular, is developing rapidly. This may have major consequences for business operations, revenue models and associated material risks. It is the responsibility of the auditor to keep up with these developments and to have the knowledge and expertise to audit these changing companies. Providing assurance on an increasing number of topics on which companies report is essential.

The staff shortage in the accountancy sector is becoming more acute, while the number of institutions subject to statutory audits is increasing. Two-thirds of audit firms indicate that a shortage of staff is an obstacle to carrying out activities, compared to less than half a year ago (see Figure 12). There are a number of factors underlying this growing deficit.[50] The supply of personnel is decreasing because interest in studying accountancy is decreasing compared to other studies. Besides, the sector is facing staff outflows due to an ageing population and a work-life balance that is under pressure. In addition, the demand for audits is increasing; an increasing number of companies meet the staff criterion[51] for a statutory audit[52] and inflation is a contributory factor in more companies meeting the turnover and/or balance sheet criterion, although these criteria will soon be revised.[53] The scope of the statutory audit is also increasing and an auditor is being requested more often, for example in the context of the expiry of temporary Covid-related support packages. In the light of macroeconomic tightness in the labour market, staff shortages are expected to persist for the time being and may even increase further.

50 'Nieuwe data-analyse geeft inzicht in marktontwikkelingen accountantsorganisaties', AFM, November 2022.
51 A statutory audit is mandatory if a company meets two of the following three criteria: €12 million turnover, €6 million balance sheet total, 50 employees.
52 'Sector in Beeld 2022', AFM, November 2022
53 'Adjusting SME size criteria for inflation', European Commission, Oktober 2023.

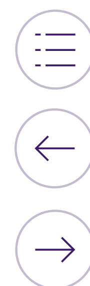


Figure 12. Two-thirds of accounting firms suffer from a shortage of staff (percentage of firms in the accountancy sector experiencing a shortage of labour as an obstacle to their activities).

Source: CBS

The risk resulting from a shortage of staff combined with increasing demand for audits is that an audit becomes less accessible. Firms with staff shortages may become more selective when taking on new clients, making it harder for higher-risk clients to find an accountant. For example, Euronext plans to end the listing of six smaller funds because they cannot find an accountant to audit their financial statements. This is not solely due to the shortage of staff at audit firms. Organisational risks also play a role. There is a risk that more companies will be confronted with the consequences of lower accessibility of audits in the future. This mainly concerns companies with a non-standard risk profile.

Due to ageing in the accountancy sector and increasing requirements from legislation, consolidation is taking place, in which private equity parties play a role. Due the ageing in the accountancy sector and the increasing requirements resulting from regulations, an increase in the scale of audit firms is needed. As a result, consolidation is taking place, especially among smaller firms. This consolidation wave is expected to continue in the coming years. We observe growing interest from private equity parties in audit firms. Private equity firms would be interested in accounting firms because of the recession-proof and predictable nature of the sector. Private equity involvement would, in its own words, also be better able to make the profession more attractive to young people compared to the traditional partner model. However, we are still at the beginning of this trend and therefore we still have limited insight into the possible effects and the associated risks. The AFM views this development against the background of the long-running discussion about the structure of the accountancy sector and possible disincentives for safeguarding audit quality. It is important that the involvement of private equity parties does not introduce (additional) commercial incentives that are at the expense of improving audit quality.[54]

Partly due to the sharp rise in energy prices, higher wage costs and the termination of Covid-related support packages, a focus on continuity risks in reporting and control remains important. The number of bankruptcies in the Netherlands was at a record low in 2021 and 2022 (see Figure 13).[55] Inflation is expected to remain at a high level in the coming years.[56] This may create continuity risks for companies that are heavily dependent on energy or labour costs and those that are less able to pass on these changes to customers. As a result, market participants expect the number of bankruptcies to rise.[57] The importance of these risks in reporting and audit is therefore increasing.

54 'Private-equity-investeringen in accountancysector: houd oog voor het risico', AFM, April 2023.
55 'Historically few bankruptcies in 2022 as well', CBS, January 2023.
56 'Macro Economic Outlook 2024', CPB, September 2023.
57 'Allianz voorziet faillissementsgolf door coronaschulden', accountant.nl, April 2023.

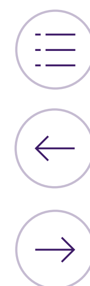
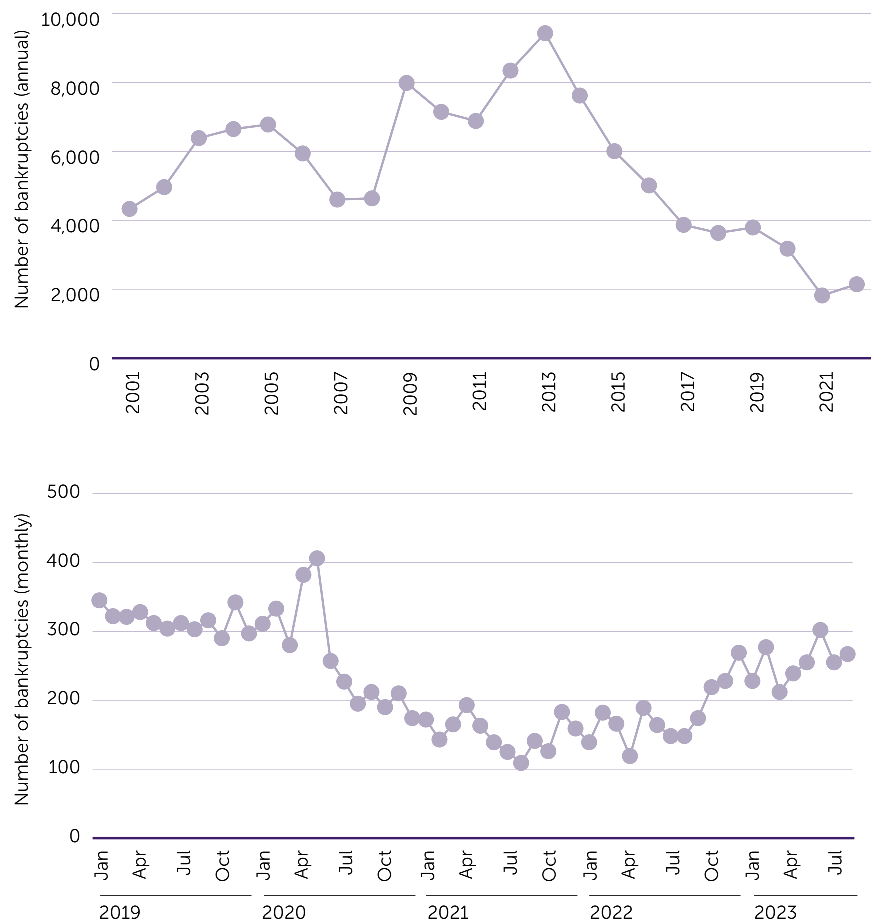


Figure 13. Although the annual number of bankruptcies is at a record low (above), the number of bankruptcies in the monthly figures has recently appeared to be rising (below).



Source: CBS

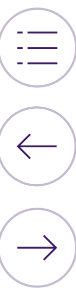
Text box 8 Key regulatory pathways

The outgoing Minister of Finance intends to submit the Bill on the Future of the Accountancy Sector (*Wet Toekomst Accountancysector*) to the House of Representatives before the end of 2023. This bill, which follows the recommendations of the Committee on the Future of the Accountancy Sector, was put out for public consultation in 2021. The bill proposes, among other things: the introduction of audit quality indicators, a power of designation, governance requirements for the largest regular (non-PIE) audit firms (internal supervisory body and suitability requirement for policymakers) and an increase in the responsibility of audit firms for the quality of their statutory audits. This bill was submitted in 2022 to the Council of State, which made critical comments on some aspects of the bill.[58] It remains to be seen how the Minister of Finance will incorporate the comments of the Council of State into the bill that will eventually be submitted to the House of Representatives. This law is expected to enter into force in 2025.

CSRD

The legal requirements for sustainability reporting are increasing. The most important development is the introduction of the Corporate Sustainability Reporting Directive (CSRD). This is the first regulation to introduce sustainability reporting obligations for large issuers for fiscal years starting on or after 1 January 2024. Step by step, sustainability reporting obligations will become applicable to more companies. The CSRD requires companies to report on more and more specific non-financial information (NFI) based on the European Sustainability Reporting Standards (ESRS). Important changes include reporting CO_2 emissions and more attention paid to the effects of the entire value chain of a company. Among other things, the ESRS-G(2) requires companies to report much more and in greater depth on their governance, including possible involvement in fraud and corruption. Companies must describe incidents and report how often they occur. The CSRD also requires an external auditor/assurance provider to provide limited assurance on the non-financial

58 'Wet toekomst accountancysector', Raad van State, November 2022.



information prepared on the basis of the ESRS.[59] A first exploration by the AFM shows that many steps still need to be taken before the CSRD enters into force in the areas of reporting, audit, underlying systems, data and building up expertise.[60]

4.2 Digitalisation

Digitalisation affects the accountancy sector along three axes: the audited company, the statutory audit and the audit firm itself.

Digitalisation changes the processes, services and products of the audited company. Organisations are adopting new technologies in their processes, services and products. In addition to automation, new business models are emerging that are often highly dependent on digitalisation. The leap that AI models have made in the past period gives digitalisation a further impulse with new automation possibilities and the emergence of new revenue models. For the auditor, this means that the audit must adapt to this in a timely manner.

Cyber risks are growing in importance. IT systems play an important role in managing business operations and broader business risks. It is important that companies are aware of the cyber risks to which these IT systems are exposed. In the first instance, it is up to the company itself to manage these risks. There are a number of concerns here. Firstly, the Netherlands seems to invest relatively little in cyber resilience compared to neighbouring countries.[61] Secondly, corporate governance does not seem sufficiently equipped to manage cyber risks. Responsibility for digitalisation is usually decentralised within organisations and the concern is that the bodies responsible for governance (such as supervisory boards) do not have sufficient knowledge to be able to critically question management about this.[62] Although large companies are more likely to deal with cyber incidents (see Figure 14), there are concerns about lower awareness of cyber risk in SMEs.[63] The reporting and governance of these companies should be adapted to adequately manage these risks.

59 'Big steps needed to ensure compliant reporting of sustainability information in annual reports from 2024', AFM, March 2023.
60 'CSRD report: no time to lose!', AFM, March 2023.
61 'CSR Adviesrapport 'integrale aanpak cyberweerbaarheid'', CSR, April 2021.
62 'Reactie AFM op consultatievoorstel actualisatie Corporate Governance Code 2022', AFM, April 2022.
63 'Preventie cybercrime voor het midden- en kleinbedrijf', Ministry of Justice & Security, July 2022.

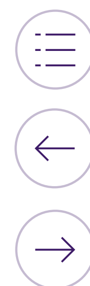
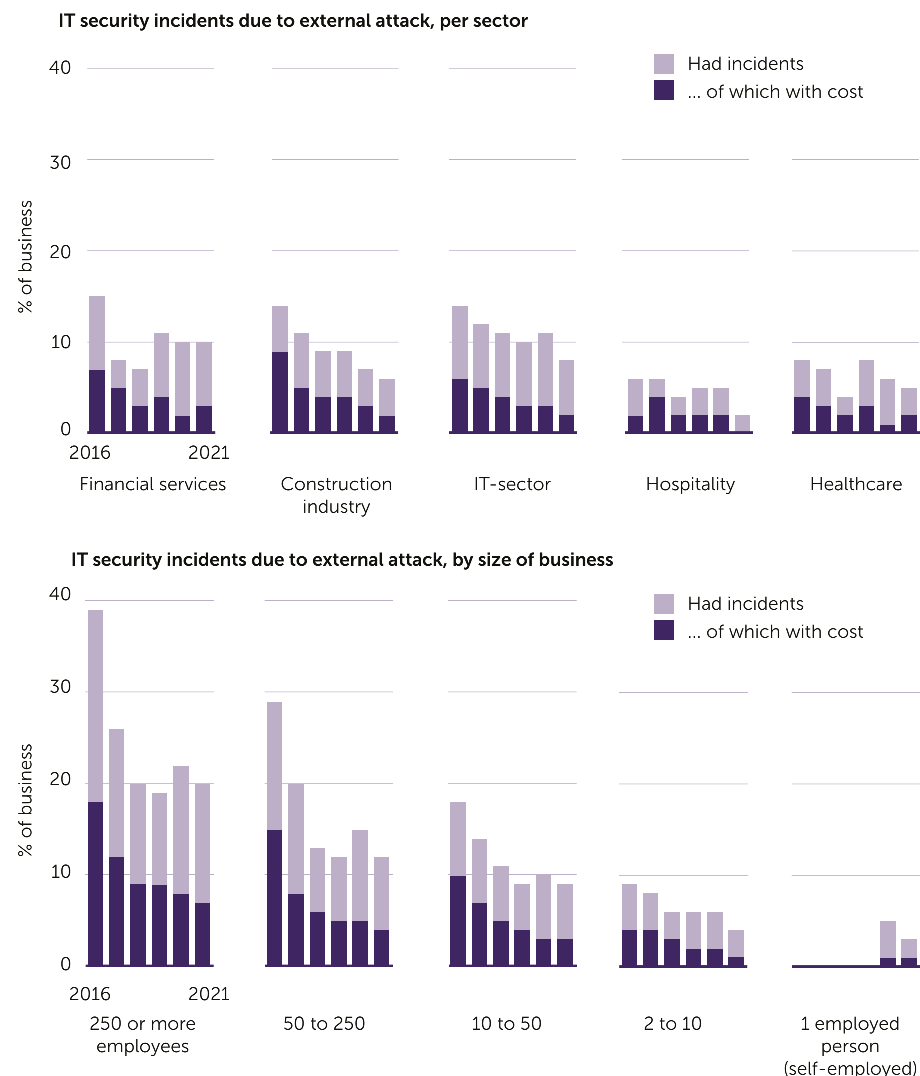


Figure 14. Large companies (>250 employees) and financial services companies are the most frequent victims of cyber attacks.



Source: CBS Cybersecurity Monitor 2022

Digitalisation requires more knowledge of IT risks and IT audit at audit firms. The changes brought about by the rise of the digital society and economy and the associated material risks have an impact on auditing. Relevant risks for the auditor include the valuation of intangible assets (e.g. intellectual property) and an integrated value chain. The accountant must understand how IT systems work, what dependencies they create, how they contribute to controlling business operations and what risks they introduce and give an opinion on them. In particular, the rapid development of AI models also appears to introduce new risks for the auditor. With these new models, the photographs and texts that accountants typically use in the audit can be artificially generated and are difficult to distinguish from the real thing.

Digitalisation offers opportunities for innovation in the statutory audit, but the use of data-driven techniques appears to be lagging. Increasing digitalisation of the audited company leads to more available data on which to base the audit. Data-driven analysis techniques therefore seem suitable for increasing the quality of control and/or reducing the time required. New AI techniques increase these possibilities even further. However, the use of data-driven techniques in statutory auditing seems difficult to implement. One possible reason is that such innovation requires an investment of time and resources that is not made spontaneously by audit teams but has to be managed by the audit firm. The sector is then not sufficiently able to reap the benefits while managing the risks.

Finally, digitalisation affects the business operations of the audit firms themselves. Digitalisation helps to automate or improve various business processes at the accounting firm. Internal control of these systems is therefore also important for the audit firms themselves. In addition, audit firms have large amounts of sensitive data resulting from the audit work, making cyber risk management particularly relevant. In this light, it is striking that audit firms are currently outside the scope of DORA regulations.

4.3 Sustainability

The impact of the sustainability transition on companies and vice versa is becoming increasingly important in reporting. Companies are increasingly committed to ESG targets and their efforts need to be adequately reported. This leads to new material risks for companies, such as direct consequences of climate change, but also of sustainability policy (such as the effect of a carbon tax). There is a growing need among end-users for better information on the sustainability risks and performance of companies and financial products. The importance of this in governance, reporting and audit is increasing. This requires that both companies and auditors have sufficient knowledge and expertise to adjust the reporting and the associated audit and that this is supervised by the AFM.[64] The AFM has previously expressed concern that the management and supervisory boards of issuers need to catch up with regard to knowledge of sustainability.[65]

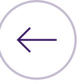
The availability of sustainability data is not yet sufficiently in line with the reporting requirements. The quality and availability of sustainability data are key issues throughout the reporting chain. Partly because standards and definitions are still being developed, companies need time to set up systems, processes and governance to be able to deliver the necessary data. In addition, external data suppliers are used, whose thematic coverage, quality and level of detail can vary greatly. We see that the availability of data on CO_2 emissions is getting better, but that data on broader sustainability topics such as biodiversity and social and governance-related topics are still developing. Especially where there is dependence on other parties in the value chain, such as when reporting scope 3 CO_2 emissions (the CO_2 emissions of upstream and downstream value chain parties), there are major challenges in establishing proper reporting. Companies have to deal with the sum of challenges faced by their partners in the value chain, such as the lack of uniformity, limited data availability and lack of expertise to arrive at a reliable estimate. The limited availability of data also poses challenges for the audit, because the auditor has no or limited alternative data sources on which to base the audit.

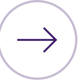
Companies make net-zero claims as part of their voluntary climate plans. Net-zero claims are commitments to be climate-neutral at some point in the future. This usually relates to CO_2 emissions and means that the CO_2 emissions that the company has are offset with voluntary carbon credits. While a voluntary climate contribution is to be welcomed, there are a number of risks related to the net-zero claims that are currently being made. For example, companies are insufficiently clear about the interpretation of these claims. As a result, it is unclear how they achieve climate neutrality and what ratio between actual emission reduction and purchases of carbon credits they use. Some companies seem to consciously choose not to publish these details, possibly for fear of reputational damage if the objectives are not achieved (also known as greenhushing). This may not only cause confusion among end-users about the path to net zero, but may also raise concerns about greenwashing.

4.4 Internationalisation

Cross-border services provided by audit firms require attention. Dutch companies can use audit firms from other Member States. The number of organisations doing this is expected to increase in the near future. We see Dutch audit firms also bringing in accountants from abroad or using the capacity of audit firms from other Member States. To the extent that this is done to overcome capacity problems, this may help with the accessibility of an audit. However, a key issue is that the AFM cannot supervise the quality control system and the integrity of business operations of audit firms from another Member State. This leads to risks in terms of the quality of the audit. Moreover, for these foreign PIE audit firms, the suitability regulations for policymakers do not apply and they do not have to establish a supervisory board. Although the use of an audit firm from another Member State is consistent with a European integrated capital market, it is also a way to avoid specific requirements in Dutch legislation.

64 'Big steps needed to ensure compliant reporting of sustainability information in annual reports from 2024', AFM, March 2023.
65 'Reactie AFM op consultatievoorstel actualisatie Corporate Governance Code 2022', AFM, April 2022.





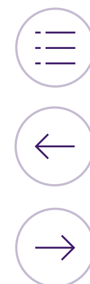
4.5 Integrity and criminal behaviour

Fraud in audited companies is becoming a more important issue in statutory audits. Fraud at an audited company that is not detected or disclosed in the statutory audit can lead to material losses to shareholders and a wider loss of confidence in the financial markets. Fraud is understood here in a broad sense. It is not only about financial fraud, but also about greenwashing, for example. Fraud and integrity risks among audit clients are exacerbated by internationalisation, the tax conditions in the Netherlands and undermining.

Integrity incidents at audit firms, such as involvement in corruption or fraud among clients or in the audit firm itself, damage confidence in the sector. This risk is partly caused by the favourable tax conditions in the Netherlands. These attract companies from abroad with limited substance and increased integrity risks. Due to these increased integrity risks, these companies are more often refused by large accounting firms and consequently resort to a smaller audit firm, which is less prominent on the AFM's radar at this time. The risk is that these organisations have less fraud expertise and capacity, which means that these risks are less well detected at the system level. In addition, integrity incidents at audit firms themselves, such as exam fraud, damage confidence in audit firms. These types of incidents underscore the importance of the efforts made to improve behaviour and culture in the accountancy sector.[66]

66 'AFM response to KPMG exam fraud', AFM, July 2023.

Keywords	Specific risk	Drivers	Importance
Changing nature of audited companies due to sustainability	Audited companies commit to ESG objectives, leading to new material risks such as physical damage and the consequences of sustainability policy. Audited companies must report adequately on this and audit firms must check this information. End-users have insufficient sustainability information due to a lack of sustainability data, inconsistency between financial and non-financial reporting and insufficient sustainability expertise at issuing companies and auditing firms.	• Sustainability • Laws and regulations	→
Changing nature of audited companies due to digitalisation	Audited companies are adopting new technologies in their processes, services and products, which leads to new material risks, such as failing systems or chain partners and new valuation issues. Audit firms may not have sufficient knowledge and expertise available about these developments among their audit clients and how to adapt their audit approach accordingly.	• Digitalisation	↗
Fraud and discontinuity in audited companies	Fraud (including greenwashing, money laundering, selective outscoping of non-financial information and corruption) and discontinuity that have not been detected or whose risk has not been identified in the statutory audit lead to material losses for end-users and to a broader loss of confidence in the financial market. Partly due to the loss of corona support, discontinuity is a growing risk.	• Internationalisation • Macroeconomic developments • Undermining	↗
Cyber risks	Audit firms do not sufficiently control the use of technology and data in their business operations, including as a tool for performing statutory audits. They also have a lot of sensitive data at their disposal and thus are vulnerable to cyber incidents. They are currently exempted from the DORA regulation and are not specified as an essential entity in NIS2. Poor control of cyber risks impairs the quality of the statutory audit and leads to operational risks, including outsourcing risks.	• Digitalisation	↗
Accessibility of audit	The accessibility of audits is under pressure due to increasing demand for audits (increasing scope and more entities subject to mandatory audit), while the supply is constrained (staff shortages, reduced popularity of training). This is particularly evident to audited companies with a divergent risk profile. Consequent developments, such as the inflow of private equity in the segment of regularly licensed entities and regulatory arbitrage in the Public Interest Entities (PIE), have a negative impact on the quality of the statutory audit.	• Macroeconomic developments • Laws and regulations	↗
Integrity risks	Integrity incidents at audit firms, involvement in corruption, or fraud by audit clients undermine trust in the industry. These risks are exacerbated by increasing internationalisation, the fiscal business climate in the Netherlands and undermining. Integrity incidents at audit firms themselves, such as examination fraud, damage trust in audit firms and underline the importance of a healthy culture in the industry.	• Internationalisation • Undermining	→



The risk maps translate external developments into specific risks for each of the AFM's supervisory areas.

Assessent risks: High · Increased · Very high

↗ Increase · → Constant · ↘ Reduction

Any questions or comments about this publication?

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As an independent market conduct authority, we contribute to a sustainable financial system and prosperity in the Netherlands.

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