Views

The EUROFI Magazine

MALTA | APRIL 2017

Edward Scicluna

The questions are more political than technical

The Eurofi High Level Seminar 2017

Malta | 5, 6 & 7 April

Vítor Constâncio

Effectiveness of Monetary Union and the Capital Markets Union

Valdis Dombrovskis

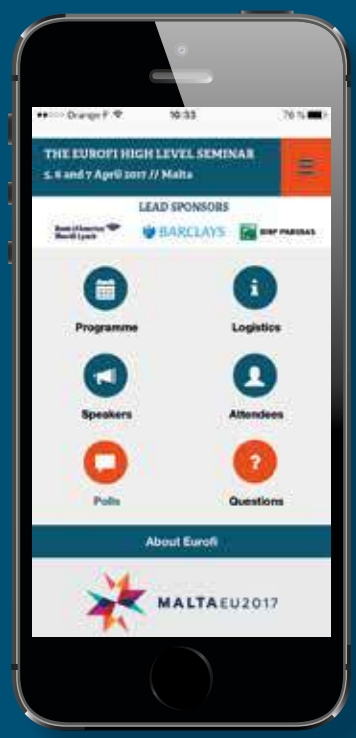
Deepening economic and financial integration

And more than 150 speakers' contributions : J. Muscat, S. Sester, M. Vella, S. Bowen, J. Bannister, P. Callesen, C. da Silva Costa, A. Dombret, E. Nowotny, D. Radev, R. Gualtieri, K. Regling, M. Pradhan, P. Berès, D.M. Hübner, O. Renaud-Basso, A. Wilmot-Sitwell, T. Karpoff, J. Lemierre, X. Musca, A. Simoes, S. O'Connor, J.M. González-Páramo, L. Thompson, M. Madelain, M. Cole-Fontayn ...

Download the Eurofi Malta Seminar App

malta2017.eurofi.net

Answer polls
Post comments and questions during the sessions
Check-out the list of speakers and contact attendees
Detailed programme and logistics information



HOW TO ACCESS THE MALTA SEMINAR APP?

Click on the link contained in the SMS you received after registration.

You can also access directly the App by entering this address (malta2017.eurofi.net) in the browser of your smartphone or by flashing the QR code of the App.

HOW TO BOOKMARK THE APP AND ACCESS IT DIRECTLY FROM YOUR SMARTPHONE SCREEN?
Press on this symbol at the bottom of the App home page (next to About Eurofi) and follow the instructions.

The **Eurofi** High Level Seminar

MALTA | APRIL 2017

STRENGTHENING EU PROSPECTS IN A PERIOD OF MAJOR CHANGE

Content

EDITORIALS &
OPENING INTERVIEWS

Contributors

The Malta Eurofi Seminar is taking place at a crucial moment for the EU and Eurozone

Political events such as Brexit and upcoming domestic EU elections are potentially challenging the cohesion of the Union and of the Eurozone. Economic challenges are also still significant in the EU. Nine years after the 2008 crisis, despite a very substantial degree of monetary accommodation and the implementation of the Juncker Plan, the EU economy is still recovering but at a moderate pace and cross-border capital flows have diminished compared to before the crisis. Major regulatory initiatives such as the Banking Union and the CMU are being implemented to strengthen the EU financial sector and support the financing of the EU economy but they may be hindered by the lack of economic convergence and of political momentum to tackle persistent domestic barriers. Increasing protectionist risks are moreover threatening at the international level the efforts that have been made over the last few decades to leverage the benefits of global trade and regulatory coordination.

At the same time these challenges are all good reasons for relaunching a movement towards more integration of the EU27 and Eurozone supported by a stronger and more diversified financial sector. This indeed seems to be the best way forward for achieving economic growth through increased scale and an improved allocation of resources and for preserving influence in a world dominated by a growing number of super-powers. Many essential building blocks for managing this major undertaking successfully are already in place or underway. An essential condition for progressing towards a more integrated Union and the next stages of an EMU is however to achieve sufficient economic convergence between EU Member States in order to restore trust among political decision-makers and investors across the EU and demonstrate the viability of a common European project.

Over 600 representatives of the EU and global authorities and of the financial industry are gathered in Malta to discuss these challenges, take stock of the significant progress that has been made and discuss the monetary, economic and regulatory actions that are needed to further strengthen the EU economy and its financial sector.

Most of the speakers taking part in the Seminar have accepted to express their views in this magazine, providing a comprehensive overview of these issues. We thank them very warmly for their thoughtful contributions and hope that you will read them with great interest. ●

Didier Cahen, Marc Truchet and Jean-Marie Andrès, EUROFI

David Wright

President, EUROFI

Preparing the new European Union of 27. 2018 will be the vital year

A warm welcome to all participants to EUROFI, Malta.

I would especially like to thank our hosts, Maltas' Presidency of the European Union, for their exceptional support for this event and for their generous hospitality. We are deeply honoured that the Prime Minister of Malta will be joining us at the beginning of our deliberations.

Since the EUROFI Bratislava Forum last September the world looks a much less certain or predictable place.

A new U.S Administration has taken office profoundly challenging some of the long founded pillars of the post-war global order.

Brexit, regrettably, is running its course - the United Kingdom will leave the European Union - what is completely unclear is on what terms, how and when.

North Korea's dangerous sabre rattling is undermining efforts to establish peace in its region.

Parts of Ukraine remain occupied; parts of the Middle East are in flames - and another desperate humanitarian disaster is unfolding in North Africa and Yemen.

Long negotiated near-final trade agreeements have been torn up.

The threats of terrorism and external- EU immigration pressures remain very high.

In short political and security risks are growing and rumbling over financial markets, European and global, which are reacting to this uncertainty and unpredictability with heightened volatility. In this context, where nationalism on its own simply cannot provide the political, social and economic stability and security answers people want, the European Union has a huge role to play and much to do.

To reassure; to strengthen its own solidarity and cooperative mechanisms;to begin to build a common security and defence strategy as the European Commission has wisely proposed; to develop and coordinate operational cross-border crisis management systems to deal with all forms of conceivable emergencies; and, crucially, to steadfastly support and lead multilateralism with global coalitions of the willing.

The European Union, the new EU-27, has to respond more nimbly and assertively to peoples' genuine concerns in the future on the basis of its shared values and ethics. Provide convincing answers to pan-EU problems and communicate better the outcomes.

And take on robustly, continuously, the narrow-minded, self-interested, backward looking nationalistic populists and their simplistic, selfish, empty shell political recipes. Their McCarthyite lies should be exposed and intellectually demolished.

More pro-European political courage and leadership is needed to confront, urgently, these dangerous populist forces. If not their proponents will advance by stealth, by default. So step forward Europeans - those willing to stand up and speak about the evident collective benefits, the rich public goods of the European Union. And there are many, starting with the most important of all, peace in our times.

Most agree the European Union needs more political momentum and a clearer identity. To deliver the essential stability policies, EMU being a key one; imaginative European projects to galvanize public opinion; connecting the peoples of Europe with new ideas and cultures to network its extraordinary diversity; firing up a new pro-EU younger generation.

There are some good signs beginning to appear. The European economy is slowly improving after losing eight years of growth during the financial crisis between 2007-2015 and unemployment is falling although unemployment among young people remains still very high, close to 20%. The European Central Banks' monetary policy is staying the course and helping provide essential economic stimuli. It's courageous leadership has been vital to pull the EU out of the deep financial crisis.

Even so, European economic and financial progress has been too slow and too much today is incomplete. The Eurozone must finish the crucial pillars of banking union; the excellent ideas of capital markets union (CMU) must accelerate and much hangs on its key measure - the third pillar Pan European Pension Product proposal (PEPP) - expected from the European Commission this summer. Structural reforms also are essential - not to wreck and destroy - but to maintain and strengthen European economic welfare and inter-generational solidarity. Gross distributional inequalities and poverty must be addressed by the Member States.

At the heart of EMU are a series of major conflicts to resolve which Marcel Fratzcher, the President of the BDI in Berlin, describes as:

1. Risk sharing v National sovereignty - accepting that some risk sharing is necessary for EMU to work.

2. Regulation v market discipline i.e can governments ensure fiscal discipline - with the precedent of the growth and stability pact being a bad example or should more reliance be placed on stronger market disciplinary forces?

3. Governance of the Eurozone - Federal or National ? The core needs strengthening - eventually one Finance Minister and one budget, not creeping intergovernmentalism.

4. Crisis prevention and crisis resolution - stronger preventive measures and efficient resolution policies.

Most Europeans believe this new political momentum that the EU needs will have to wait until after the German elections later this year. If that is the case so be it. But in which case the rest of this year should be used to define the next phases of European integration - the project - with the Commission, Council and European Parliament acting in concert to determine the main ideas and the modalities for delivery. Early in 2018 there should be a consensual plan. And much of it should be delivered on time before the European Parliament elections in 2019. We will discuss the economic and financial aspects in Malta - EMU, Banking Union, Securities Union, CMU, Fintech, the PEPP.....

If this can succeeed, and it can, the citizens of EUR-27 will see a Union "en mouvement"; a growing economy; a more secure Union; confidence will begin to return and "l'appartenance Europeenne" as well.

The alternative is too awful to contemplate: stasis, "immobilisme", political paralysis and long-term economic decline. ●

Joseph Muscat

Prime Minister of Malta

Economic and Monetary Union: Prospects and challenges

Economic indicators suggest fair prospects for EMU. Following the global financial crisis and the sovereign debt crisis double blow, economic recovery in the euro area has taken hold. Major forecasters project steady but unspectacular growth in the years ahead. Employment is expanding but unacceptably high. Fiscal imbalances are being corrected but outlook risks are on the downside.

Growing protectionism and retreat from international integration pose real threats. Geo-political tensions on Europe's borders have intensified. Brexit is a major source of uncertainty and pressures related to migration are incessant.

Within the euro area there are stresses along various fault lines. One, different euro area member states face divergent economic situations, while sharing the same nominal interest rate and exchange rate. Two, while monetary policy is determined for the euro area as a whole, fiscal policy remains largely national. Three, institutionally there is tension between nation state and supra-national bodies stemming from the fact that the euro area is a monetary union not backed by a common Treasury. Four, the single currency is embedded in an incomplete single market and only a partial banking union.

There are no easy solutions. We need to devise mechanisms to allow for a greater rebalancing of the asymmetries among euro area countries in terms of incomes and employment. Partly, this requires greater economic integration: easier flows of labour within the euro area and greater risk-sharing through financial integration, including the banking and capital markets unions. National structural reforms are needed to recover or enhance competitiveness offering more and better employment opportunities.

On the fiscal front, we clearly need to simplify rules. They have become too complex for ordinary voters to understand. We may need more, rather than less, flexibility in national budgets, as these are economic shock absorbers. We need to enhance the qualitative dimension in our policies. Growth enhancing investment tapping idle labour resources and cheap financing, needs to be executed irrespective of fiscal position. Such investment would enhance rather than complicate long term fiscal sustainability. Simultaneously, we may also need to increase the EU budget's size and re-orient it to allow for more redistribution between member states. Rather than increased member contributions the EU budget can be enhanced through corrective contributions from members enjoying excessive positive disequilibrium.

"It is time for us to declare that we will do whatever it takes to protect the EMU"

- JOSEPH MUSCAT

As we work to resolve these complex issues, it is worth recalling some basic principles. The Treaty calls for constant improvement of living and working conditions, the reduction of disparities across regions and closer union of peoples across Europe. We must admit that in recent years we may have focused too much on stability at the expense of growth. And even when we have promoted growth, we may have given too little weight to the distribution of income and wealth. Europe goes beyond a single market. It must have a social dimension. Our decision-making processes need to be more open and transparent. We need to listen to our citizens, understand their concerns and communicate in ways that everyone understands.

Success is possible. Malta is an example of how to benefit from EMU membership. It is enjoying rapid economic growth, full employment, an external surplus and contained inflation. This reflects welfare reforms that my Government carried out to encourage more people to work, increased public investment and a major energy sector overhaul. This has taken place against a backdrop of a steady improvement in public finances.

As we move forward, we must not forget Europe's advances over the past 60 years. By and large this continent has enjoyed an unprecedented peace and prosperity. Democracy has taken root in those countries that did not have it. We established economic freedoms – to trade, invest and work – that many of our citizens enjoy and value. We have a single currency that has gained popular acceptance in Europe and beyond. It is time for us to declare that we will do whatever it takes to protect the EMU with unifying economic policies bringing prosperity and social justice to all its peoples. ●

Q&A

Edward Scicluna

Minister for Finance, Malta

Some ideas and basic arguments to start you off. The questions are more political than technical

WHAT ARE THE PRIORITIES OF THE EU MALTESE PRESIDENCY IN THE FINANCIAL AREA AND THE KEY CHALLENGES TO BE ADDRESSED DURING THE PRESIDENCY?

Malta takes on the Presidency of the Council at a critical juncture in the EU's 60-year history. Unprecedented waves of migration from Africa and the Middle East are exerting pressures on Europe's Mediterranean neighbourhood, while the rise of populism across the continent is challenging the political status quo. In spite of overall economic improvement, economic stagnation in parts of the Union is adding to rising disenchantment and to a growing disconnect between power elites and ordinary citizens, while the repercussions of the UK's Brexit referendum in June 2016 will be felt for years to come.

In the financial area, the Capital Markets Union (CMU) is a top priority. The Presidency will engage on the remaining elements of the CMU Action Plan, working closely with the Commission to keep up the momentum. We are convinced that a true capital markets union, where savings from one Member State can be invested in an SME in another Member State, will give businesses more options and better prospects. The development of a wider range of funding sources, tailored to the needs of European businesses, is of the essence.

As a matter of priority, agreement with the European Parliament (EP) will be sought on the Simple Transparent Securitisation (STS) Regulation. High quality securitisation will benefit both savers and companies seeking financing and will create more fluid refinancing within the financial system.

Another sector where the EU lags behind other developed capital markets is venture capital. The review of the European Venture

Capital Funds (EuVECA) and the European Social Entrepreneurship Funds (EuSEF) regulation will be prioritised in an attempt to develop a functioning venture capital market in Europe. Once the EP has formulated its position, the Maltese Presidency will engage with the Parliament to reach an agreement on this review before the summer.

In a bid to bolster the financial stability in a CMU, the Presidency will also work on the Commission proposal for the Recovery and Resolution of Central Counterparties (CCPs). These clearing houses perform a very important function and a framework for their orderly recovery and resolution will enhance investor confidence.

HOW TO BETTER PROMOTE THE BENEFITS OF ECONOMIC CONVERGENCE AND DEEPENING THE EMU IN THE CONTEXT OF RISING EUROSCEPTICISM?

Rising Euroscepticism is a concern in the context of an EU which has brought peace and stability to Europe which was unknown for many centuries. The stability on the continent has led to a significant economic well-being. With universal education, universal healthcare and a strong social model in most of Europe, we can look back on the past five decades with pride. The problem we are facing today in Europe and beyond, are the large cohorts of people that are feeling left behind. When people feel alienated by the system, they look elsewhere for new leaders, new ideas. Of course there are exceptions. The current political and economic situation in Malta is stable government with high rates of economic growth and unemployment levels at historical lows. People feel very European and are allowed to feel the benefits of EU membership.

The best way to promote the benefits of the EU is to communicate with the people in a simple way, and national politics is the best forum for these messages. I think that some citizens in Europe feel that Brussels is too far away from them.

WHAT ARE THE SHORT TERM PRIORITIES TO REINFORCE INTEGRATION IN THE ECONOMIC AND FINANCIAL AREAS IN THE EUROZONE?

The short-term priority for the Eurozone is to prevent Greece turning again into another crisis. Despite genuine efforts of the Greek people and the European institutions, the solution still seems to escape us.

Another priority is dealing with the high level of non-performing loans in the Eurozone. We need to have meaningful structural reforms to make insolvency proceedings simpler in our Courts, and provide businesses with a second chance. The difference in bankruptcy proceedings across the Atlantic is considerable and it is clear that the European systems are not geared to provide entrepreneurs with the help that they need when times are hard. In Malta, we are currently overhauling our insolvency legislation to encourage businesses to be given a second chance and continue in business.

SHOULD EMU, BANKING UNION, CAPITAL MARKETS UNION INITIATIVES BE PURSUED IN PARALLEL AND AT THE SAME PACE OR SHOULD SOME PRIORITIES BE PUT FORWARD? DOES BREXIT CHANGE IN ANY WAY THESE ON-GOING PROJECTS?

One can state that the Banking Union and the Capital Markets union all fall under the larger umbrella of the Economic and Monetary Union. I think the EU has made a lot of progress on having a more coherent banking environment, with a single supervisor and the European Stability Mechanism in place. As I already mentioned, Malta is prioritising the capital markets union at this juncture, as it is seen as the best tool to provide financing to our economies today. Banks are under a lot of strain due to the high level of NPLs and there is also much technical work being done in the area of banking concerning risk reduction.

As regards Brexit, I don't think that this should affect the fundamental goals of the EU, which is to create a stable environment on the continent in which our people can thrive economically and culturally on the basis of free, open societies. What Brexit does, is provide that extra impetus to strive harder, to become better and more competitive, especially in the area of financial services and banking, where the UK and the City of London are seen as leaders.

WHAT ARE THE MAIN IMPEDIMENTS TO THE COMPLETION OF THE BANKING UNION? HOW TO FOSTER THE EMERGENCE OF PAN EUROPEAN CROSS-BORDER BANKS?

While the Banking Union has largely succeeded in consolidating banking supervision through the SSM, and in harmonising bank resolution frameworks through the SRM, the ultimate defences are still heavily reliant on national backstops. The final destination must necessarily be a transition to the all important common fiscal backstop to be used in the last resort. This is still proving to be the Holy Grail of the EMU. Pan-European banking would, on the other hand, appear to be more achievable in the medium term if we were prepared to revisit the capital rules that could be discouraging cross-border lending by the larger institutions and to deal with any possible barriers to bank mergers.

WHAT ELEMENTS OF THE CAPITAL MARKETS UNION INITIATIVE ARE MOST CRITICAL TO FOSTERING GREATER PRIVATE RISK SHARING? WHAT ROLE MAY INCREASING PRIVATE RISK SHARING PLAY IN EMU DEEPENING? WHAT ARE THE SHORT TERM PRIORITIES IN THIS RESPECT?

The elimination of differences and inefficiencies that exist in national insolvency regimes across the Union is critical to the success of the CMU. The sooner one can do away with today's complex and opaque legal frameworks the easier it will make it for capital to be deployed and the more liquid and efficient markets can become. Full transparency and access to information must also be ensured before investors can feel they can invest freely in financial products across the single market. This, coupled with efficient, cross-border consumer redress mechanisms would be crucial to the success of the CMU. The immediate priorities would be to resolve any pending issues holding up the new STS securitisation framework and to proceed with the quick implementation of the revised prospectus regime.

SHOULD THE EU INSTITUTIONS FOSTER INVESTMENT IN THE MAGHREB REGION AND WHAT ARE THE OBJECTIVES AND PRIORITIES?

For Malta it has always been clear that there can be no stability in Europe if there is none in the Mediterranean region. The migration crisis which hit the north of Europe in the past year is something that Mediterranean countries have had to contend with for a decade now.

After the Valletta Summit, I think it's clear that this is a shared priority now amongst all Member States. The objective of investing in source and transit countries such as Libya and other African neighbours is to assist these countries better control their vast and porous borders. By having more stability in the southern basin of the Mediterranean, we can expect to have more controlled and economic migration. ●

Valdis Dombrovskis

Vice-President for the Euro and Social Dialogue, also in charge of Financial Stability, Financial Services and Capital Markets Union, European Commission

Deepening economic and financial integration

No economic or governance issue, however technical it may seem at first, can be considered out of its political context. Certainly not in the European Union at this point in time.

Last month marked the 60th anniversary of the Treaties of Rome. It is an occasion to reflect on the achievements of European integration, as well as its shortcomings and challenges.

The White Paper, presented by President Juncker to mark the occasion, set out five scenarios for a European Union of 27 Member States. They range from continuing on the same track to decisively moving forward with EU integration.

It's an invitation for a fundamental reflection as well as a call to action: we need to be clear about what can be delivered by Europe and what cannot. We need a stronger sense of ownership and better management of expectations.

The discussion on the future of the Economic and Monetary Union is entwined with that debate. A lot has been done, since the crisis, to improve our economic governance structures and to prevent and reduce risks in the financial sector. Our economies are more resilient as a result. But we need to keep up the reform efforts in line with the principles underlying the White Paper: each level and actor taking up part of the responsibility and living up to their commitments.

PRIVATE RISK REDUCTION AND RISK SHARING THROUGH BANKING

The sequencing of further efforts is vital: to effectively avoid and limit contagion in future crises, further risk reduction in the EU financial sector must go hand in hand with measures to strengthen risk sharing channels.

The bank credit channel has traditionally been the primary channel of finance in the euro area. Hence, it was also the main channel to absorb shocks due to its role of ex post consumption smoothing. However, consumption smoothing can only address temporary shocks and the credit channel has the tendency to be subject to reversal. This became evident when banks started to adjust to the new market environment and reduce exposures and reduce lending.

Since then the EU, in parallel with other G20 partners, significantly improved banking regulation, in particular to reduce risks in the banking sector. We have set up the Banking Union, with the single supervisory and resolution authorities, and we have adopted a specific bank resolution regime, in particular the bail-in tool, with the Bank Recovery and Resolution Directive (BRRD) and Single Resolution Mechanism Regulation (SRMR). The Single Resolution Fund is gradually being built up and will reach its full size in 2023, and work has started on a common backstop. All these measures do not only focus on strengthening the banking sector resilience in general, but also specifically to tackle the sovereign-bank loop, by overcoming home bias, which has been an essential obstacle to risk sharing. But Banking Union is not yet complete. The Commission proposed a European Deposit Insurance Scheme (EDIS). Such a scheme is essential to reduce the vulnerability of national deposit guarantee schemes and further reduce the link between banks and their home sovereign by gradually pooling funds. We proposed a Banking Package to further reduce risks in the banking sector, including by implementing international standards on Total Loss Absorption Capacity. Work is advancing to decisively tackle non-performing loans, which keep back lending in some parts of Europe.

PRIVATE RISK-SHARING THROUGH FINANCIAL MARKETS

Given the limited size, scope and integration of European financial markets, especially in comparison to the US, there is great stabilising potential in a well-functioning Capital Markets Union. Capital markets, and in particular equity, can absorb losses deriving from more permanent shocks. Also, more developed capital markets would reduce the euro area's very strong dependence on banks, and help companies to achieve a funding profile more conducive to their specific needs.
Since the crisis, the stock of bank loans to non-financials has decreased by 10% and the flow of new loans by 40%. We need to find other funding sources to fill this gap. We have also seen cross-border equity holdings falling significantly during the crisis. They have not yet recovered to pre-crisis levels, and their recovery is slower than for cross-border deposits. Hence the size of the cross-border equity market is several times lower than the cross-border loan and deposit markets.

We are therefore accelerating Capital Markets Union, with a first wave of actions – including a streamlined prospectus regime, our initiative to boost safe and transparent securitisation, and an improved European Venture Capital framework – about to be completed. And we are consulting broadly to prepare a mid-term review of the CMU.

RESTARTING ECONOMIC CONVERGENCE AND REINFORCING STABILISATION VIA THE PUBLIC SECTOR

Strengthening the resilience of the euro area economy depends also on progress towards risk reduction and risk sharing in the public sector, and on restarting economic convergence.

The Five Presidents' Report of June 2015 laid out the logic, limits and possible sequencing of completing's Europe's Economic and Monetary Union in this area as well. 'Deepening by doing' was the motto of the first phase. And indeed we have seen progress on the four unions – economic, financial, fiscal and political. The longer-term needs focus on upward convergence and fiscal stabilisation.

The Report suggests strengthening the convergence process through a set of binding, commonly agreed benchmarks. 'Significant and consistent progress towards these standards', it reads, 'and continued adherence to them once they are reached, would be among the conditions for each Member State to participate in a shock absorption mechanism.' The areas which have been identified as particularly relevant are labour markets, competitiveness, the business environment and public administrations, as well as certain aspects of tax policy. We now need to make progress on the questions which standards should be picked, which benchmarks are the most tangible, and how they should be operationalised and enforced.

Apart from private risk sharing, the Five Presidents' Report raises the issue of enhanced public risk-sharing through a fiscal stabilisation function for the euro area. I would see scope to reconcile short- and long-term economic benefits by promoting a financial mechanism in support of investment. Concretely, this could be used to support additional investment in countries facing asymmetric shocks. If implemented via loans under favourable conditions, this would not lead to permanent transfers between countries, nor undermine the incentives for sound fiscal policy-making at the national level.

Supporting national unemployment benefit systems, possibly through a reinsurance scheme, is another idea being discussed. This is however more challenging, politically, and would require some prior convergence of labour market institutions.

But the basic principles are vital: risk-sharing and risk-reduction need to go hand in hand, and only by ensuring the credibility of the current framework we can build the consensus needed to go beyond. ●

Vítor Constâncio

Vice-President, European Central Bank (ECB)

Effectiveness of Monetary Union and the Capital Markets Union

The euro area recovery is continuing at a moderate, but firming pace, and is broadening gradually across sectors and countries. The ECB's monetary policy measures have been a key contributor to these positive developments, and the only expansionary macroeconomic policy in support of the recovery.

Real GDP growth has expanded for 15 consecutive quarters, growing by 0.5% during the final quarter of 2016. Dispersion in growth rates across euro area countries has fallen. Economic sentiment is at its highest level in nearly six years. The unemployment rate is back down to single-digit figures and over four million more Europeans are employed now than three years ago.

Since the onset of the crisis, the ECB has put in place a number of conventional and unconventional monetary policy measures to stimulate the economy and rehabilitate the monetary transmission mechanism, which had become impaired at the height of the crisis. This comprehensive range of measures has worked its way through the financial system, leading to a significant easing of financing conditions for consumers and firms. Together with improving financial and non-financial sector balance sheets, this has strengthened credit dynamics and supported domestic demand.

Bank lending rates for both euro area households and non-financial corporations have fallen by over 110 basis points since June 2014. Lending rates for small and medium-sized enterprises, which provide two-thirds of total private sector employment in the euro area, have declined by over 180 basis points.

The sharp reduction in bank lending rates has been accompanied by easier access to funding, as recent ECB surveys on bank lending and access to finance have shown. But it is not just lending rates that are more favourable. Bank lending volumes have also been

gradually recovering since early 2014. Annual growth in credit to euro area households increased in January to 2.2% and growth in credit to businesses remained at 2.3% – the highest growth rates in more than four years. Market-based funding conditions, too, have improved significantly in response to the corporate sector purchase programme launched in June 2016.

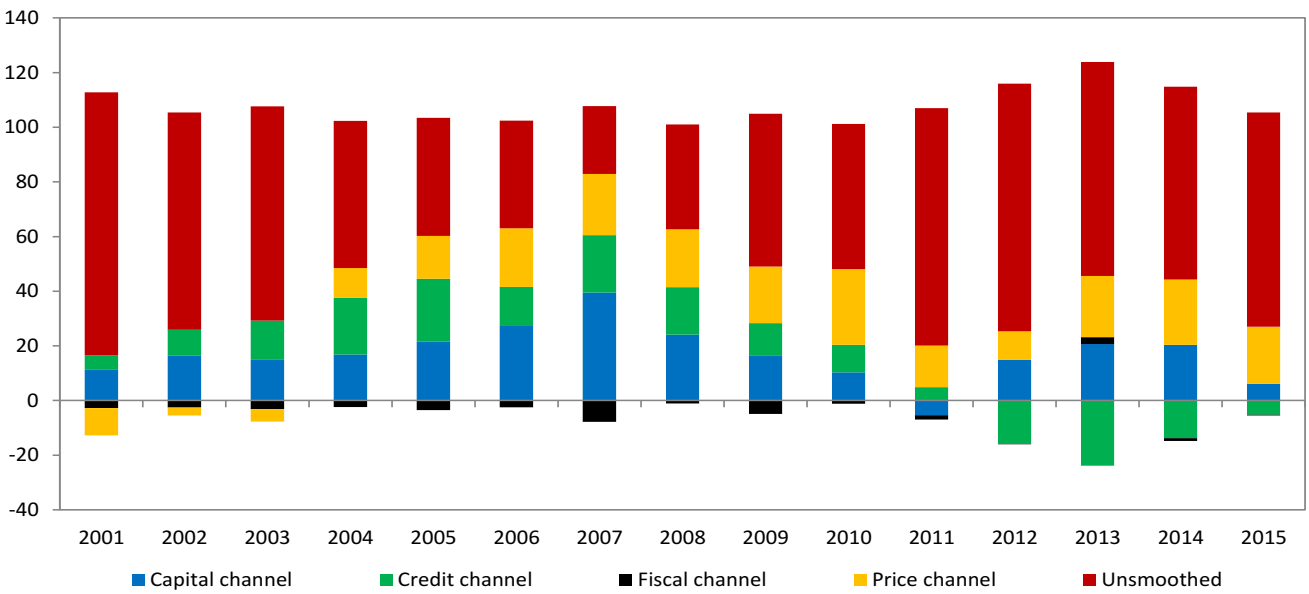
While monetary policy has been the mainstay of the recovery, there are other potential sources of macroeconomic stabilisation. Given the heterogeneity of countries across the euro area, the lack of synchronisation of business cycles, and the absence of fiscal transfers between Member States, capital markets play an important role in mitigating the income effects of region-specific shocks.

For example, evidence suggests that capital markets and credit markets together help smooth around two-thirds of a shock to regional GDP in the United States, dwarfing the 13% contribution of federal transfers. In comparison, the overall contribution of markets to risk sharing in the euro area has, on average, been limited. There was a brief period in the early-to-mid 2000s when capital markets smoothed between 30 and 40 percent of country-specific shocks to GDP, but this declined substantially during the crisis, and region-specific shocks remain mostly unsmoothed (see Chart).

Given the importance of risk-sharing through capital markets for macroeconomic stability and welfare, we need a Capital Markets Union (CMU) that is ambitious. To be truly effective, CMU will require harmonisation in a number of sensitive areas, including key legislation and policies related to financial products, such as investor protection and bankruptcy procedures.

The CMU should come with a roadmap in terms of goals and milestones to be achieved. Broad objectives such as deepening financial integration and achieving risk sharing should be matched with specific proposals such as facilitating funding for corporates in general and for SMEs in particular. ●

CHART: THE CHANNELS OF RISK SHARING IN THE EURO AREA, 1991—2015.



Note: The Chart summarizes the 5-year cumulative contributions of capital markets, credit markets, fiscal tools, and relative prices to the smoothing, in terms of consumption growth, of a 1-standard-deviation shock to GDP growth. Each bar thus measures the parts of the shock to country-specific GDP that are absorbed by the respective channels. The remainder is interpreted as the unsmoothed portion of a GDP shock, i.e., the part of a shock to country-specific GDP growth that is reflected into country-specific consumption growth. Contributions sum up to 100 percent, and a negative contribution corresponds to dis-smoothing of consumption growth. The respective contributions are estimated over rolling ten-year backward-looking windows, based on annual data and applying the Asdrubali and Kim (2004) approach enhanced for relative price adjustments in the spirit of Corsetti, Dedola, and Viani (2011).

Contributors

Sharon Y. Bowen

Commissioner, U.S. Commodity Futures Trading Commission (U.S. CFTC)

All In It together: The importance of global regulatory coordination

As a Commissioner at the U.S. Commodity Futures Trading Commission (CFTC), the agency responsible for the oversight of the bulk of the U.S. derivatives markets, I firmly believe that global regulatory coordination is crucial for me to do my job. The main reason is that the derivatives markets are global markets. Thus, in order for any regulator to properly police them, they need to understand them from a global perspective.

For instance, through global coordination of data sharing, we better understand the markets. Our agency is full of talented, focused staff which engages in robust data analysis. But even with their diligence, they still only see a portion of the market. That is why we need to remove the regulatory barriers to data sharing for the purpose of effective market oversight.

While I certainly understand the concerns about privacy surrounding data sharing, there are other concerns that are equally troubling, namely, the prevention of another crisis like the one we endured in 2008. The actual initiation of the crisis – the collapse of the U.S. housing market – certainly caused a serious economic convulsion, but what greatly magnified the devastation of this crisis was that we did not understand the underlying weaknesses of our markets, particularly the derivatives markets. We did not know the extent of our market participants' exposure to derivatives, or their degree of under-collateralization. We thought we knew our markets, but we had no idea what they were really like. We thought we were in a house made of bricks, when it was actually made of straw; a reality we only understood after the storm came. We cannot afford to make that mistake again. We need a much more realistic picture of the markets we oversee. For that we need data, all of the data; and in order to achieve that, we have to work together.

Sharing data is also essential for analyzing market risk. For example, at the CFTC, we use margin, as one indication of risk. We review the amount of margin outstanding, and analyze the likelihood that market counterparties can meet their margin requirements under a variety of past and hypothetical market movement scenarios.[1] But without a full picture of the global market, we can get a skewed view of the actual risk profile of counterparties. We may think that a counterparty has a lot of one-way risk, when a full picture would reveal a much more balanced portfolio. The opposite is also true; we may have a false sense of security, when in fact there is cause for concern. Thus our ability to mitigate systemic risk is hampered by insufficient data; and so is yours. We need each other to address this.

Another area where harmonization is essential is in enforcement. As regulators, it is in our best interest to share information about potential bad actors that are moving from market to market harming customers, lessening efficiency and bringing otherwise functional markets into disrepute. It is to everyone's benefit that these people are detected and prevented from harming other customers.

With global regulatory coordination we can better achieve our purpose as regulators – to incentivize the formation of efficient, transparent, well-collateralized markets that are safe for counterparties. To do less, it to fail to do our jobs as protectors of our markets and of our citizens who rely upon them.

1. See e.g., "CFTC Staff Issues Results of Supervisory Stress Test of Clearinghouses," (Nov. 16, 2016), available at http://www.cftc.gov/PressRoom/PressReleases/pr7483-16.

The views expressed herein are that of Commissioner Bowen, and do not necessarily reflect the views of the other Commissioners or Commission staff.

Timothy Karpoff

Group Chief of Staff and Head
of Corporate Relations, Barclays

The importance of global capital markets for financing Europe's economies

Society's expectations of banks' role in the economy, and taxpayers' support for those activities, have fundamentally altered since the financial crisis. This has led to major changes in banking regulation and banks' business models.

As a result, as both a policy and prudential matter, we must broaden the means through which businesses and entrepreneurs access capital and financing, reducing their reliance on traditional bank lending. It is no longer desirable, or feasible, for 80% of corporate debt in Europe to be sourced from banks' balance sheets.

Fortunately we have an answer; healthy, diverse capital markets, a centuries old innovation, born in Europe, flourishing in America but requiring further development in Europe, resulting in both challenges and opportunities.

Broad, deep and harmonised capital markets are a positive force. They connect the providers of capital with its users; direct savings towards investments; help economic actors manage their risks; and ultimately power our economies.

To be truly effective and give the greatest support to the economy, these users and providers of capital need to be able to connect across national and regional borders.

This conference therefore comes at an important time. With the future relationship between the UK and Europe far from clear, increasing nationalism in the developed world, and potentially unintended consequences of the past decades' regulatory developments all combining, there is need to articulate the benefits of open, transparent and harmonious relations between states and their financial markets.

Fragmented, disjointed and sometimes conflicting regulatory policy benefits no one. But evidence suggests that liquidity is increasingly locked into regional or national markets. This leaves the market mechanism no longer able to efficiently match supply and demand and distribute risk; financial institutions have smaller balance sheets to offer their customers and clients; firms seeking to expand receive less or more expensive funding, and citizens get lower returns as they save for their home, their children, or their retirement.

It seems that the balance between national and regional interests and the global interests of capital markets is at risk of tipping too far towards the former. Global markets can only be maintained if we continue to work towards harmonised global standards on capital and resolvability, with regulators and resolution authorities working in an atmosphere of trust.

To the extent that national and regional interests lead to fragmentation and dislocation of capital across global bank structures, as well as a deterioration of banks' ability to rely on branch networks and centralised booking models, banks will be inclined to retract further from balance sheet intensive activity.

In this context, Barclays supports the work taking place in international fora to evaluate the cumulative impact of regulatory reforms on market dynamics, such as liquidity. It is critical that reforms do not go so far as to stifle the further development of the markets that we are looking to have increasing reliance on in Europe.

This trend should not continue, in our view. At their core, financial markets exist to support and grow the wider economy. Whilst they must be regulated to ensure that the excesses and crises of the past cannot be repeated, this regulation should be created in a comprehensive and thoughtful manner, ensuring that the individuals and businesses that make up our economies are able to prosper.

As negotiations over transitional and final-state UK-Europe arrangements progress, it is critical that we make the clear and unambiguous argument that open, transparent and harmonious relations between states and their financial markets are a good thing for all concerned. ●

Jean Lemierre

Chairman, BNP Paribas

Europe has ensured financial stability. Regulation must now favor growth and employment

Nearly a decade after the sub-prime crisis, the world economy is now firmly in a post-crisis era. This is particularly evident in the US, where the economy has been growing at a steady pace and unemployment is near record lows. Current economic trends in Europe also point in the right direction and financial stability is strong. Yet Europe is still at a crossroads. Growth remains well below that of other regions and employment is a particularly acute problem in certain Member States.

Europe has made considerable progress since the crisis in strengthening and integrating its financial system. The Single Supervisory Mechanism, the Single Resolution Board and the Single Resolution Fund represent achievements in furthering European integration. Its full rewards are still to be realized by unlocking a number of issues. It is now urgent to address them.

An important priority is the need to consider the Banking Union area as a single jurisdiction. This would address issues that are constraining the free flow of liquidity throughout the Eurozone -- and hinder the ECB's tools for monetary policy, in particular the requirement under BRRD for internal MREL within the zone. A single jurisdiction would also mean that European G-SIBs would not continue to be penalized by an identification methodology for the interconnectedness of systemic banks that considers activities within the Banking Union as cross-border, thus increasing their systemic buffer capital requirements. Moreover, allowing for a true Eurozone domestic market would facilitate the further restructuring and consolidation of the European banking system and enable the industry's full potential to finance the economy and create jobs.

Europe also needs to take into account its specificities in considering the Basel proposals currently under discussion. For this, it must make supporting the European economy the litmus test for adopting any new international standard. It is very encouraging that Vice-President Dombrovskis has recently called for such an approach. This is fully justified because Europe does not have a financial stability issue in the post-crisis period. There remains the separate issue of non-performing loans in certain regions which needs to be dealt with.

But what Europe does have is a low growth and unemployment issue. Thus the balance between these two policy objectives must now clearly be on the side of the economy and jobs. Further, we can certainly expect that the current very low interest rate environment will come to an end, as is already the case in the US. This will present a challenge for the ECB's monetary policy and underlines the need to ensure that regulation will not have a negative impact on the economy at the same time. Incidentally, a recent Commission paper makes these very points, suggesting that the combination of these factors and higher capital ratios requirements risk significantly constraining bank lending, impairing growth and investment in Euro area Member States[1].

The prospects of continued low growth and rising interest rates also reinforce the need to find the right balance between bank disintermediation and market-based financing of the economy. To that end, Europe has to accelerate progress on Capital Markets Union, which has been somewhat measured until now.

The current aspiration for some deregulation in the United States is another reason for a relevant consideration of the Basel proposals not to increase divergence across the Atlantic. These developments also call for vigilance in safeguarding a level playing field. The review of the Capital Requirements Regulation and Directive provides a timely opportunity to make additional progress in this area. EU financial regulation must support Europe's overarching priority, growth and employment, as well as promoting a safe banking sector. ●

1. "Bank Lending Constraints in the Euro Area", European Commission, DG Economic and Financial Affairs, Discussion Paper 043, February 2017

Alexander Wilmot-Sitwell

President, Europe, the Middle East and Africa, Bank of America Merrill Lynch

What is the outlook for global financial regulation?

At the 2009 G20 summit, following the global financial crisis, governments agreed to support a vision of greater regulatory harmonisation and co-operation across the world's financial sector.

Eight years later, most of the regulation intended to prevent similar financial turmoil occurring again is now either in place or close to implementation. There is also now clearly increased awareness of risks within the financial system, there are numerous forums designed to address those risks and we have seen the benefit of greater information sharing by firms and regulators.

These positive initiatives have undoubtedly helped financial stability, notwithstanding that there could have been greater efficiencies in their delivery. Unfortunately, however, we are still some way short of a globally harmonised framework. Given recent political developments in the UK, the EU and the US, the question we now need to ask is: have we reached the high water mark of global regulatory convergence?

Maintaining confidence

Political developments in both the UK and the US means that there may be some reconsideration of financial services regulation in both those jurisdictions. While it of course makes sense to keep the balance of financial services regulation under regular review, policymakers around the world should ensure that any regulatory changes do not put at risk hard-won financial stability and trust in the system. In any changes, continued information-sharing and co-operation between supervisors will be important.

Regulatory consistency

Global regulatory consistency is crucial for global institutions. Creating inconsistencies between US, UK and EU legislation could have the potential to decrease the ability of global banks consistently to support clients globally and would also inevitably drive up costs. One important example where regulation risks creating inconsistencies with US law is in the Intermediate Holding Company proposal contained within the recent CRD V package. This would see non-EU headquartered banks having to create a single holding company in the EU above their local operations which, as well as increasing capital requirements and adding operational complexity, could also complicate resolution strategies in the EU.

Brexit

Global financial markets are highly interconnected and London represents a complex ecosystem for financial and related professional services, where the proximity of multiple market participants brings cost savings and efficiency gains. In the future mutual market access, supported by regulatory co-operation arrangements, should help ensure that customers of all sizes across the EU continue to benefit from integrated financial markets. In the shorter term, the UK's departure from the EU must avoid a cliff-edge and allow enough time for financial services firms to make the necessary adjustments to be able to continue to serve their clients. A stable and orderly exit, with a well-considered implementation or transition period, is therefore vital.

In conclusion, the outlook for financial services regulation is currently an uncertain one and there may be further changes ahead. The temptation to move further from 2009's agreed goal of global convergence needs to be resisted where possible. Policymakers and regulators should remember that regulatory change has real economy impacts and therefore changes need to be considered carefully and in light of international developments. ●

Olivier Guersent

Director General, Financial Stability,
Financial Services and Capital Markets Union,
European Commission

Making Basel rules work for Europe

Banking is a global business that needs global rules. The financial crisis illustrated that our financial system is inherently international and that financial stability cannot be achieved within national borders. Global rules make the financial system safer, and they underpin the level playing field that is needed for free trade, competition and growth. For these reasons, Europe champions the ongoing work on international agreements in response to the financial crisis.

In particular, Europe is very actively engaged in the Basel Committee to further develop the international prudential standards for internationally active banks. In parallel, we are proceeding to implement key prudential standards that have been agreed by the Basel Committee over the past years. Notably, the Commission's banking reform package proposed in November 2016 paves the way for the EU implementation of the leverage ratio, the Net Stable Funding Ratio and revised market risk rules based on the respective Basel standards.

That said, finding an agreement in the Basel Committee that works for all jurisdictions is not always an easy task. A key dilemma we are faced with is how to achieve consistency in implementation across the world while making sure that the agreement reflects certain unique characteristics of regional financial markets and institutions in their particular diversity. The increasing complexity of the framework over time has arguably also increased the challenge of how best to simultaneously achieve consistency and "customisation". The EU strongly believes that rigorous and consistent implementation of risk sensitive prudential requirements by supervisors is crucial to reconcile this trade-off. Risks sensitivity allows the same risks to be treated alike across jurisdictions, but it also allows idiosyncratic risks to one jurisdiction to be appropriately dealt with and provides adequate incentives for banks to efficiently manage their risks.

During the current negotiations on the finalisation of Basel III, the importance of this issue from a European perspective has often been illustrated by reference to residential mortgages. Compared to many other jurisdictions, banks in Europe hold a large amount of low-risk mortgages on their balance sheets, which can attract relatively low risk weights in particular if internal models are used – and they often are – to determine these risk weights. In principle, these low risk weights are justified by the low underlying risks.

As the current discussions are driven by concerns about unjustifiably low risk weights that may result from internal models, and proposals evolve around putting in place constraints around the use of such models, there is a high risk that these constraints will prevent banks with low-risk mortgages from reflecting this low risk in the capital charges they apply. Such an outcome would clearly be undesirable, as it would limit the risk sensitivity of the framework, creating the wrong incentives and resulting in increased capital requirements, all of which to a larger extent for European banks than for many others. In other words we would miss the initial target of the whole exercise that was to treat similar risks in the same way across jurisdictions, and would instead end up treating similarly very different risks across jurisdictions. A key objective from a European perspective is thus to ensure that the Basel framework remains risk-sensitive enough to accommodate this key concern.

Additional complexity in the European implementation of Basel standards arises from the fact that Europe applies the same single rule book to all banks, while the Basel Committee members formally commit only to applying them to internationally active banks and their basic design reflects this narrower scope of application. In Europe, a wider scope of the single rule book is however necessary in particular as banks of different sizes and business profiles compete with each other and because banks authorised in one Member State can provide their services across the EU's single market. Applying the single rule book only to a subset of European banks would have created competitive distortions and potential for regulatory arbitrage within Europe. At the same time, this widened scope means that our single rule book must be appropriate for a potentially much wider range of business models, yet be consistent with international standards. Ideally, European concerns will anyway be sufficiently reflected by the final outcome at Basel level. Nevertheless, as has been done in the past, the European single rule book should develop in parallel with the Basel standards but taking European specificities into account further where this is not sufficiently the case at international level. ●

EU growth and stability challenges

Content

Issues at stake

Nine years after the crisis economic recovery is continuing at a moderate pace in the EU and the mobility of capital between Member States has not yet been restored, despite a very substantial degree of monetary accommodation and the implementation of the Juncker Plan. Brexit is a further challenge due to the importance of the City for the financing of the EU economy.

Strengthening the EU financial sector and developing private risk sharing in the Union through the completion of the Banking Union and an acceleration of the Capital Markets Union seem essential for fostering growth in the EU. A pre-requisite however is for all euro Member States to strengthen their fiscal positions and competitiveness, which requires significant domestic structural reforms in some cases.

Priorities for the EU27 and Eurozone

Contributors

Klaus Regling

Managing Director, European Stability Mechanism (ESM)

Economic governance for a more stable EMU

Countries can successfully function in a monetary union if they avoid excessive macroeconomic imbalances and divergences. Imbalances can arise if a country loses its competitiveness, for example due to wage growth above productivity gains, labour and product market rigidities, or an unsustainable accumulation of private and government debt. Preventing such imbalances is more important for the good functioning of monetary union than ensuring nominal or real income convergence, even though these are desirable in general. A successful monetary union also needs mechanisms to address asymmetric shocks.

Europe has made significant progress in reducing macroeconomic imbalances since the financial crisis. More specifically, reform implementation led to a successful programme conclusion in four out of five countries benefiting from EFSF and ESM support. Reforms of the European governance framework such as with the European Semester and the Macroeconomic Imbalance Procedure have also supported progress. These reforms added a regime of ex-ante coordination and strengthened the system of ex-post monitoring and sanctioning.

At the same time, the current framework is not equipped to sufficiently cushion asymmetric shocks affecting one of its Members when, for example, national buffers are depleted and fiscal space is limited. The euro area created the EFSF and ESM, which reduced contagion across the currency union. To address asymmetric shocks and make economies more resilient, EMU governance should be further strengthened through increased risk-sharing between countries. A new fiscal capacity, which could take the form of a stabilisation fund or an insurance scheme, could provide for enhanced risk-sharing without creating permanent transfers or debt mutualisation.

Another route to enhance risk sharing would be through financial markets and the completion of Banking Union and Capital Markets Union (CMU). Banking Union should be completed through a common backstop for the Single Resolution Fund, and eventually a common deposit insurance after legacy issues have been reduced. Further development in the area of the CMU is needed, starting by harmonising legal frameworks affecting cross-border EU businesses. This would diversify funding sources for corporates, facilitate cross-border equity investment, and reduce firms' dependence on bank loans. In aggregate terms, it would substitute a part of the shock-amplifying debt flows for shock-absorbing equity flows.

Creating a common European 'safe asset' would in principle be another step to facilitate cross-border risk sharing. Different models for creating a safe asset have been debated, with ample liquidity comparable to that of the U.S. Treasury market being a common characteristic. However, the economic and fiscal fundamentals in euro area countries are currently not strong enough to avoid the risk that disproportionate support by euro area sovereigns could be needed. Therefore, the specifics of how to introduce and develop a market for euro area safe assets requires further thought.

Increased risk-sharing should be accompanied by incentives to comply with common rules and with stronger monitoring of national fiscal policies. When setting up new frameworks and policies, Europe needs to move towards mechanisms that provide strong incentives to comply with the rules and implement structural reforms. Participation in risk-sharing arrangements could be made subject to compliance with commonly agreed rules. To this end, European policy makers could also create a central coordinating authority to oversee national fiscal policies. ●

Sven Sester

Minister of Finance, Estonia

Strong Economic and Monetary Union needs solid foundation built on mutual trust and confidence

European Union and Euro area in particular have remarkable economic governance toolbox at their disposal. The full potential of it has not been used yet. We have consistently backed the rules-based approach to the Stability and Growth Pact. For us it has been the cornerstone of the euro area economic and budgetary policy co-ordination at equal footing with the monetary policy pillar.

We may be biased, because Estonia is used to rely on the responsible fiscal policy. In the currency board arrangement before joining the euro area there was no other way. At the same time the rest of the economy has been flexible enough to adopt to new circumstances in the crisis situations.

For us and I guess for number of Member States, the deepening of EMU is very much dependent on how we can jointly demonstrate the ability to follow the rules based approach. I am not talking about blindfolded automatic following of the rules. There is considerable flexibility inscribed in the stability and growth pact already. Still, we are too often trying to bend the rules.

It is indeed important to remember that we have the debt criterion alongside the deficit threshold in our fiscal governance rules. The high debt levels have to be taken seriously as the low interest era will not last forever and population ageing will put additional pressures on long-term fiscal sustainability. The Commission has to fulfil its task in policing how the debt reduction target is met and whether this is persistent. This would contribute significantly into strengthening financial stability in the Union.

We have to recognise the benefits the euro and EMU has already brought us. The euro has time and again proven itself as a robust currency fostering a stable monetary climate. With euro have lower transaction costs, easier price comparison leading to increased cross border trade, long term investments and economic growth. The single currency has given the euro area members a global voice, and together we can build a dynamic monetary union.

What we must avoid, is trying to promote the deepening of EMU on false pretences. The deepening in itself does not do the trick. There has to be clear political will to follow the rules-based approach and to implement the structural reforms, which is inevitable in more integrated EMU. ●

Xavier Musca

Deputy Chief Executive Officer, Crédit Agricole S.A.

The European banking model and banking union should mutually benefit one another

Following the 2008 financial crisis, banks refocused on their core activities and main domestic markets. This necessary massive deleveraging was particularly pronounced and sustained in Europe and contributed to fragmenting the European banking market. In Europe, what has been accomplished so far to reduce fragmentation is impressive. For financial services alone, European integration has progressed significantly in a very short time, fostered by political will: the Banking Union and the single rulebook represent formidable transfers of sovereignty. Yet, while the banking union has introduced a single supervisory approach, regulation continues to allow different or additional requirements at national level. We now need to think about what remains to be done to address that inconsistency and make the regulatory framework fit for our European specificities of bank-based economy financing and universal banks. The universal banking model, with its well-diversified risk and funding structure, has proven to be more resilient and has less probability to fail than smaller specialised financial institutions. Those specificities are Europe's strength and as such deserve to be given their due place. This means at least two things:

First, the EU regulatory framework should be made consistent with the economic ambitions of the EU and should make the banking union a reality, thereby also strengthening the Single Market. Although much has been done already for the banking union, its completion faces structural impediments: liquidity remains a national prerogative and is hindering effective ECB monetary policy transmission; the Banking Union is still not recognised as a single jurisdiction which penalises banks operating across the Eurozone and impedes greater risk diversification. As a cross-border banking group operating across the banking union we could face local requirements (liquidity, internal MREL…) for our subsidiaries despite our centralised capital and liquidity management and our single point of entry resolution strategy. Other impediments include addressing the high levels of NPLs, which is still work in progress for banks and supervisors in some countries and at EU level, and work on EDIS, the third pillar of the Banking Union, cannot progress while a number of prerequisites in terms of risk reduction have not been implemented. In any event, the establishment of EDIS must be cost-neutral for banks which are already members of national deposit guarantee schemes.

Second, at the Basel Committee level, European members should speak with one voice and ensure standards are adapted to our specificities rather than uniformly impose a model that is at odds with Europe's economic reality.

Financial stability has been strengthened and we are on the right path towards restoring confidence. The context of Brexit should be used as an opportunity to sit back and define what kind of European banking sector we want to promote to "build a Union of jobs, growth and competitiveness"[1]. A new strategy is needed to foster the competitiveness of the EU financial sector which is essential to the EU economy and to increase the positive effects of market integration on growth. This includes a consistent and stable single rulebook, and a banking union backed by enhanced cooperation amongst supervisory and resolution authorities. It also involves putting forward the benefits of Europe's bank intermediation model. Finally, beyond financial stability, the banking union will naturally create the conditions for further consolidation of the banking sector; one might then ask whether regulators and supervisors will ease that trend or mistrust the increase of larger domestic players and pan-EU institutions. ●

1. One of the priorities for the EU until 2020 adopted by the European Council in June 2014

Peter Praet

Member of the Executive Board, European Central Bank (ECB)

It is urgent to agree on an ambitious timetable for completing the Banking Union

In less than half a decade, the EU moved from decentralized banking supervision and resolution to the Single Supervisory Mechanism and the Single Resolution Mechanism, based on the Single Rulebook. This is part of an overarching effort to create a sound institutional framework for financial integration in Europe. There still are a number of legal, institutional and political problems to overcome before a European bank can operate in the Banking Union as it operates in its domestic market.

Several dimensions need to be taken into account in institutional design. First, private risk-sharing. The financial system is a private risk sharing device, but we have learned the lessons from the financial crisis in terms of budgetary costs, when excessive risk-taking by the private sector was eventually borne by the public sector. Not to revert to the old world of implicit government guarantees for risky behaviour of financial institutions entails making banks equally liable across countries for the amount of risk they want to take into their respective balance sheet. The general principle of the new European rules such as the Bank Recovery and Resolution Directive is to absorb bank losses by bailing-in shareholders and uninsured creditors. The new rules contain sufficient flexibility to deal with exceptional situations where public money may be required to ensure financial stability. Second, public risk sharing. A certain level of public risk sharing is necessary to create confidence in the overall financial system. Even well-capitalised banks can fall victim to runs and contagion. This is why central banks act as lender of last resort and fiscal backstops should be in place to ensure trust in the stability of the financial sector.

In the Banking Union, both supervisory responsibility and the fiscal backstop need to be at European level, to underpin durably confidence in the area-wide financial system. Just as necessary is the establishment of a European Deposit Insurance System (EDIS). The current situation, where supervision is common, but the consequences of potential bank failures are still predominantly national, should not last. In such an incomplete framework, national considerations inevitably continue to affect supervisory decisions. This is not without consequences for the incentives for banks to become more European. Concrete examples include a lack of fungibility of liquidity or capital. The fact that the euro area is not considered as a single jurisdiction may result in applying higher capital buffers to euro area G-SIBs.

While the institutional underpinnings of the Banking Union do not yet meet the requirements of a genuine single financial market, the creation of the SSM has been a leap forward in the establishment of a coherent regulatory framework. One of the first priorities of the Supervisory Board has been to promote integration through harmonized implementation of Options and National Discretions (ONDs), thereby evening the level playing field in the euro area. Regarding liquidity requirements, the Single Supervisory Board can grant waivers at national as well as cross-border level on a case-by-case basis. In the current institutional context, where the free flow of liquidity within the same banking group but across border could be impeded, a prudent supervisory approach has led the ECB's Supervisory Board to still maintain a floor on the liquidity requirements of significant subsidiaries.

Overall, the banking landscape still resembles too much a collection of banking systems highly exposed to their domestic economies, with limited cross-border private risk-sharing. At the same time, one should recognise that the Banking Union is both an objective and a process of fundamental structural changes in the euro area's financial architecture. The next steps are clearly set out in the ECOFIN roadmap to complete the Banking Union. It is now urgent to agree on an ambitious timetable for its implementation. ●

Vincenzo La Via

Director General of Treasury, Ministry of Economy and Finance, Italy & Chairman, Financial Services Committee (FSC)

A well designed Financial Union in the EU as a key underpinning for a successful EMU?

Two major concepts stand out in the economic theory of integration: (i) integration allows to reap higher gains in social welfare over the medium term, (ii) if not properly governed and regulated, integration can fail where a few pre requisites are not satisfied.

Against this background, the cost of non Europe in banking and financial markets is sizeable. Beyond damages to the political intent of the EU, a failure to further advance in financial integration would be dramatic in economic terms: disintegrated financial markets would hinder better outcomes for the welfare of firms and citizens since the range of financing and investment opportunities would be restricted; by cutting down on efficiency, this reverberates negatively both on the cost of capital and on the potential risk adjusted returns. In addition, taking a broader perspective, the cost of non Europe in financial markets also encompasses the reduced ability to absorb asymmetric shocks in view of lower private risk sharing across the EU and possible disruptions in the banking and financial system serving the European real economy.

All in all, failure to progress towards the completion of the Financial Union in the EU would exacerbate weaknesses in underlying conditions, which are prerequisites for the optimal functioning of an economic union. This would lead to greater disintegrating forces of an economic, financial and political nature, with obvious repercussions over the project of the European Union and its promise of stability and prosperity. Banking Union and Capital Markets Union should therefore be carried forward with renewed determination to complete the Single Market after taking note that one important European player has decided to leave our community.

At the technical level, there are several short term priorities, which can be pursued only if trust amongst member states is reinforced.

Within the Banking Union, a political agreement is already in place to complete this key project in accordance with a roadmap calling for progressing in parallel in risk reduction and risk sharing. The priority is to proceed swiftly on this path, recognizing that important progress has been made and is being made to enhance the resilience of European banks and that risk sharing through EDIS and a common EU backstop must be secured quickly if we want to reap the economic, financial and political benefits of a Banking Union.

Within the Capital Markets Union, the political commitment of the EU-27 must be reaffirmed. The upcoming mid term review will provide this opportunity along with the possibility to better calibrate the various priorities and measures, also taking into account new developments such as Fintech. The need of European firms, in particular SMEs, to diversify and strengthen their funding bases remains pressing: regulating uniformly various segments of private and public EU financial markets is key to enhance the availability and cost of credit to boost the investment needed to unleash the European growth potential. Institutional and retail investors increasingly need to better manage their wealth, in order to diversify risks and extract higher risk adjusted returns. Bearing in mind that a successful CMU is a single undertaking, there are two key short term priorities: first, implementing swiftly the newly approved Prospectus Regulation, in particular the simplified regime for SMEs (the so called EU Growth Prospectus) and second, forcefully preserving investor confidence through a coherent and uniform regulatory and supervisory EU framework.

>>>

>>> The Banking Union and the Capital Markets Union can deliver important results for European firms, intermediaries and citizens, also strengthening investment and enhancing private risk sharing; at the same time member states cannot shy away from responding constructively to divergences in civil and insolvency laws as well as from addressing selected fiscal barriers to financial integration.

In addition to maintaining political momentum for such projects, governments have wider responsibilities to complement Financial Union with further progress on the front of Fiscal and Economic Union. Persisting fragmentations and a rapidly evolving international scenario require a urgent collective response based on credible reforms and effective private and public risk sharing to address economic imbalances, smooth asymmetric shocks and foster convergence among member states. ●

Odile Renaud-Basso

Director General of Treasury, Ministry of Economy and Finance, France

The Economic and Monetary Union needs a fresh collective impetus

Over the last 17 years, the euro has acquired a strong credibility worldwide and protected its Member States from external shocks. Its first existential crisis in 2010-2012 showed nevertheless that the EMU remains a work in progress. Very important steps have been taken to address the weaknesses revealed by the crisis. However, some way to go on financial, fiscal and political integration remains. Thus, a far-reaching reflection on the short- and medium-term priorities for the EMU is critical to progress towards a resilient architecture.

Despite critical steps towards the reinforcement of the EMU, the euro area still faces vulnerabilities hampering its long-term growth potential and resilience. Financial markets remain fragmented because of persistent barriers within the euro area to capital and liquidity mobility and to the development of cross-border financial services. Moreover, current coordination of national fiscal policies does not necessarily lead to an optimal policy mix at the euro area aggregate level, while asymmetric adjustment of current account imbalances creates disinflationary pressure across the euro area. Finally, the legacy of the crisis could make it harder for the periphery to catch up with the core countries.

"In order to ensure stability and unleash the full potential of the EMU, its architecture must be significantly fleshed out with new common tools and democratic institutions."

- ODILE RENAUD-BASSO

In order to ensure stability and unleash the full potential of the EMU, its architecture must be significantly fleshed out with new common tools and democratic institutions.

In the short term, the level of integration of the European financial sector can be strengthened without treaty change so as to develop private risk-sharing across >>>

>>> the euro area. In this perspective, the Banking Union must be completed to definitely rule out the possibility that a bank failure leads to a sovereign crisis. A common fiscal backstop to the Single Resolution Fund should be implemented as soon as possible to ensure the last resort credibility of the Fund in the case of a systemic crisis. A common European deposit insurance scheme should also be agreed on as soon as possible in order to break the negative feedback loop between banks and their sovereigns and give the same degree of protection to small deposits across the whole euro area. This also means removing border-sensitive banking regulations while ensuring a more homogenous supervision across the Banking Union so that national practices are aligned on the best supervisory standards, especially for small banks, to eliminate remaining domestic bias : this is a matter of both financial stability and level playing field. Finally, the creation of a genuine Capital Markets Union is warranted ; notably by expanding equity financing and shoring up bankruptcy procedures, the CMU would indeed give businesses - notably SMEs and mid-tier companies - easier access to financial markets and cross-border investment, reduce their reliance on the banking sector and financial markets fragmentation within the EU, and boost resilience by extending the scope of private sector risk-sharing. A more unified Capital Market Union could also benefit from a reinforced approach to EU supervision.

Looking further ahead, a more deep-seated evolution is needed. In particular, a fiscal pillar leant against the already integrated monetary pillar seems essential. Hence, a euro area budget, financed by own resources, with both stabilization and investment functions should be established in the long run. In parallel, legally binding fiscal rules at the national level would be required to eliminate moral hazard and ensure sustainability of public debts. The implementation of a convergence process would allow member States to gradually access such a budget.

These reforms would imply much closer integration within the currency bloc. The euro area's governance needs therefore to be overhauled by creating specific institutions, such as a euro area "finance ministry", which would be accountable to a euro area Parliament – something that requires a treaty change.

Some decisive decisions are needed to address challenges the euro area will face in coming decades. It behoves us to imagine and implement these further steps. ●

Servaas Deroose

Deputy Director-General, Directorate General Economic and Financial Affairs, European Commission

Strengthening Convergence Towards - More Resilient Economic Structures

Just a decade after its inception, the euro area cohesion was severely tested by the crisis. While the process of nominal convergence was a resounding success, structural divergences persisted after the launch of the euro. The initial assumption that the single currency would foster a process of structural convergence, thereby increasing economic resilience across euro area countries, proved too optimistic. Real interest rate differentials fuelled capital flows from 'North' to 'South' and created the impression that reforms were no longer necessary under the euro. However, the persisting structural rigidities and barriers in the Single Market hindered >>>

>>> the efficient allocation of the abundant capital flows, channelled it to less productive uses and created harmful imbalances. When capital flows reversed suddenly, the same rigidities hampered adjustment, led to long spells of high unemployment with high social costs and eventually questioned the viability of the euro area.

Convergence towards more resilient economic structures is both an economic and political prerequisite for the proper functioning of EMU. Structural divergence increases the risks of asymmetric shocks, impedes adjustment and can lead to long-lasting differences in potential growth. Diverging economic structures also lead to differences in the monetary transmission mechanism and reduce the effectiveness of the single monetary policy.

Various EU policies, such as regional policy or the Single Market, have over the years aimed at strengthening structural convergence. The latter in particular is a powerful tool for convergence via increasing market integration. However, the depth of the Single Market is still curbed by remaining barriers and transposition deficits.

"Convergence towards more resilient economic structures is both an economic and political prerequisite for the proper functioning of EMU."

- SERVAAS DEROOSE

Most of the competences for structural policies lie with the Member States and this is where action is necessary. The EU has been encouraging better reform uptake by providing guidance, facilitating coordination and disseminating best practices. Most prominent examples are the strengthened coordination within the so-called European Semester or the third pillar of the Investment Plan for Europe, which aims at identifying and removing investment barriers. Moreover, for euro-area countries the reforms have to be even more targeted towards the ability to adjust to shocks and strengthen resilience.

Since the crisis, some Member States, in particular programme countries, have initiated considerable structural reforms. Nevertheless, the progress has remained modest. Completing EMU requires therefore further steps towards resilient economic structures. The Five Presidents Report (5PR) proposes the creation of binding convergence standards which would grant access to an area-wide stabilisation mechanism. These common high-level standards should primarily focus on labour markets, competitiveness, business environment and public administrations, as well as certain aspects of tax policy (e.g. corporate tax base). Social resilience needs also to be taken into account. This implies that convergence standards should be consistent with the European Pillar of Social Rights. Finally, desynchronised financial cycles in the euro area highlight the role of macroprudential policies in avoiding the build-up of excessive leverage and credit booms and the need for common mechanisms to insure against severe downturns. ●

Eurofi would like to thank very warmly
the **lead sponsors** of this event

Future prospects of Eurozone monetary policy

Contributors

Mario Vella

Governor, Central Bank of Malta

Investment and jobs: the keys to sustainable euro area growth

The European Commission's latest economic forecasts note that real GDP in the euro area has grown for 15 consecutive quarters, employment is growing robustly and unemployment continues to fall. However, economic growth, at 1.7% in 2016, remains well below the 2.2% observed between 2003 and 2007. While private consumption growth has recovered, investment growth remains below historical averages. This is mainly due to investment in equipment and public investment. The latter is projected at 2.6% of GDP, as against 3.2% in the pre-crisis years. Investment in equipment is growing at 3.4%, against nearly 5% in the pre-crisis period. Lack of investment, combined with high unemployment – especially amongst youths – limit the euro area's potential output growth recovery.

While the ECB's monetary policy stance has helped to alleviate financing costs, the pass-through from policy rates to lending rates declined after the crisis. Financial constraints increased, partly due to financial fragmentation, weak bank and corporate balance sheets and subsequent pressure to decrease leverage. Uncertainty dampens investment.

It is important to continue working to improve firms' access to capital, particularly in stressed euro area countries. The required deleveraging must not result in reduced credit for all firms. These efforts need to combine both national and supranational initiatives. The European Fund for Strategic Investments (EFSI), and the broader Investment Plan, are vital. By end 2016, less than one and a half years into its operations, EFSI raised nearly €154 billion and almost 400,000 small firms and start-ups across Europe got fresh finance as a result. National governments have to supplement this initiative by promoting access to finance. This requires facilitating small firms' access to capital markets not just traditional bank finance. Europe lags behind the rest of the developed world in the use of non-bank finance. Now is the time to try to leverage the high level of savings more directly to finance investment.

Besides helping firms find new ways of raising capital, I emphasise the role of development and promotional banks. Although they should not impinge in an uncompetitive way on commercial banks, important synergies are possible.

Strengthening European banks remains key. National and supranational regulators need to put in place plans so that non-performing loans are tackled successfully. This could include swift recognition of loan losses, and more conservative provisioning and collateral valuation. Improving the efficiency of the judicial system and overhauling insolvency legislation may also be needed in many euro area countries. Active markets in distressed loans need to be developed. Reducing the fragmentation of the European banking sector could also help improve the flow of finance.

At the same time, while governments face significantly reduced interest rate burdens, they have not used this fiscal space to boost investment. In fact, in 14 euro area countries public investment in 2017 is projected to be below the 2003-2007 ratio to GDP. A significant part of the improvement in the fiscal stance across the euro area appears to have resulted from a reduction in government investment. This >>>

>>> poses clear risks to sustainable growth, particularly as public investment in education, research and development and infrastructure are vital to enhance competitiveness and growth of new sectors.

Treating all government expenditure in the same way is clearly a risky strategy. Fiscal consolidation should not rely on limiting public investment. This needs to be emphatically stressed both at EU and national levels, also through oversight by national fiscal councils.

Governments also need to be innovative, involving the private sector in key areas such as infrastructure and education. The use of EU funds needs to become more effective. Appropriate national mechanisms must evaluate this dimension and the contribution of EU funds to bolstering economic growth.

Tackling the investment gap is critical but addressing unemployment is imperative. The euro area's long-term unemployment rate remains very high at 5.5%, with youth unemployment above 20% since 2009. We need to enhance the employment prospects and the employability of millions of individuals if we are to succeed. ●

Ewald Nowotny

Governor, Oesterreichische Nationalbank

The Eurosystem's accommodative monetary policy: effects and side effects

For me as a central banker, the balance of positive and negative aspects of the Eurosystem's current expansionary monetary policy stance is clearly tilted to the positive side. Of course, a long period of ultra-low interest rates bears risks. These risks are mainly associated with financial stability concerns, as low interest rates may induce households and businesses to invest in more risky assets. Moreover, cheap interest rates on loans may tempt economic agents to take up higher loans than they will be able to pay back once the interest rate level normalises again. Low interest rates are of course also challenging for banks and insurance companies, as their profitability might suffer. As monetary policy makers, we aim for macroeconomic stability and, consequently, we are concerned with these risks and monitor them closely.

The economic and financial crisis highlighted the importance of financial stability, which is a necessary precondition for macroeconomic stability. Consequently, policy makers around the globe concluded that we need more policy instruments to safeguard financial stability. Thanks to this learning process, we now have more such instruments at hand than before the crisis, for example micro- and macroprudential regulation. These new tools are designed to mitigate the risks mentioned above, and we are optimistic that they will help to deal with these risks.

Now let me turn to the positive effects of the Eurosystem's accommodative monetary policy, which – in my view – clearly prevail over possible risks. Unfortunately, it is difficult to argue with counterfactuals. However, the argument that the European economy would be in a much worse state without the Eurosystem's ultra-accommodative monetary policy stance is still valid. The global economic and financial crisis made real euro area GDP contract by about 5% and drove unemployment >>>

>>> up dramatically. It was of utmost importance to counteract these disruptive forces. The Eurosystem's monetary policy lowered interest rates to unprecedented levels, generously provided banks with central bank liquidity and targeted different financial market segments with asset purchase programmes in order to broadly reduce the interest rate level. Now, in 2017, ten years after the outbreak of the crisis, we observe that monetary policy measures have been working. Interest rates are very low, and financial frictions have been reduced. Confidence has returned, GDP growth rebounded – bringing aggregate real euro area GDP back to its pre-crisis level in 2015 – and unemployment started to recede. In fact, euro area unemployment has been steadily declining. More than four million jobs have been created since 2013, when the unemployment situation was at its worst. And finally, HICP inflation has left the deflationary danger zone and has started to increase toward 2%. The quantitative impact of our policy measures is difficult to estimate. However, we are confident that their cumulative impact exceeds 1 pp for GDP growth and is around 1½ pp for HICP inflation over a three-year horizon.

Nevertheless, we must keep in mind that the longer low interest rates remain in place, the more pronounced the side effects will become. However, the Eurosystem's monetary policy stance has to stay accommodative until economic recovery in the euro area has gained sufficient momentum to bring inflation back into line with the Eurosystem's definition of price stability, namely an inflation rate of below, but close to, 2%. That this process has been taking longer than anticipated has to do with the severity of the crisis on the one hand and, on the other, with the time lag of the structural reforms necessary to make our economies more competitive and flexible. The sooner these reforms are implemented, the stronger and more sustainable the recovery will be. For the sake of future generations, we have to boost potential economic growth in the euro area. Unfortunately, this is nothing monetary policy can deliver. This requires policies that set the right incentives for investment. To push forward economic recovery and raise potential economic growth, structural reforms are indispensable. ●

Mahmood Pradhan

Deputy Director, European Department, International Monetary Fund (IMF)

ECB's monetary accommodation should be used to strengthen public sector balance sheets

The ECB's accommodative monetary policy has buoyed financial and credit conditions through various channels. But at the same time, countries with high debt should use the space created by accommodative ECB policies to consolidate so that they can continue to access markets at favorable rates when the ECB eventually starts raising rates.

The combined ammunition provided by the asset purchase program, negative interest rate policy and long-term refinancing operations has improved the funding and income conditions of various players in the economy. Public sector asset purchases compressed sovereign risk premia and supported portfolio rebalancing. Sovereign yields have fallen substantially since the announcement of QE in January 2015. Corporate issuances also picked up significantly after the announcement of the corporate bond purchase >>>

>>> program in March 2016. SME lending rates have fallen, while credit standards and conditions have eased. The ECB's Bank Lending Survey suggests that most banks used long-term refinancing operations to increase corporate and household lending, as intended.

More recently, the negative interest rate policy has helped provide further accommodation. Negative policy rates were quickly transmitted to various key rates. Money-market rates have closely tracked the policy rate due to excess liquidity pushing interbank trading towards the deposit rate. Moreover, expectations of future money market rates decreased, in response to the ECB's forward guidance. Lending rates for both corporates and households also decreased, and as a result, credit has expanded modestly. Initially, a flatter yield curve due to the QE hurt bank profitability. However, the ECB's flexibility in purchasing assets at yields below the (negative) deposit rate floor, announced in December 2016 helped steepen the yield curve by lowering the short-end.

However, economies with lingering crisis legacies need to act to reap real benefits from ECB's accommodative policies. The high stock of nonperforming loans, especially in high-debt countries, need systematic resolution to reduce sovereign-bank linkages and to enable banks to lend again. Supervisory monitoring of NPL targets have to go hand in hand with encouraging the creation of distressed debt markets.

Finally, banks need to restructure and consolidate to ensure viability. More mergers and acquisitions would help the system navigate the testing profitability environment, where factors include still under-provisioned NPLs and high operating costs. Credit losses have been a significant drag, as have rigid cost structures, reducing aggregate returns on assets to levels well below the cost of new equity. There is a need for further consolidation and restructuring, including to rationalize branch networks. In addition to many of these legacy issues, banks globally are facing competition from new (and disruptive) technologies, which will force, possibly very substantial structural change. ●

Lorenzo Bini Smaghi

Chairman, Société Générale

The Pros and the Cons of the ECB policy stance

Central Banks around the world - and the ECB more than others - are increasingly criticized for the ultra-accommodative stance of their policies. Indeed, since the early stage of the global financial crisis, the ECB has been actively using both standard and non-standard tools. It has offered banks unlimited liquidity, cut its deposit facility interest rate into negative territory and implemented large-scale asset purchases. With the benefit of hindsight, what have been so far the benefits and costs of this policy?

First, both CPI inflation data and inflation expectations have recently picked-up. This is a very positive outcome, as both were decreasing dangerously since 2012, leading to a resurgence of deflation fears. The turn-up in energy prices is obviously part of the explanation, but monetary actions have also played their role. Indeed, ECB policy has successfully contained long term interest rates and narrowed sovereign yield spreads, thus allowing a better transmission of monetary policy. Indeed, credit conditions for both households and corporates have >>>

>>> significantly improved, including in periphery economies.

Second, the real trade-weighted exchange rate of the euro exchange rate has depreciated by more than 15% since the crisis. This has also facilitated the adjustment of the euro area economy as a whole. It is worth noting that the record-wide current account surplus of Germany (close to 9% of GDP in 2016) primarily reflects a structural excess of domestic savings over investment, rather than an under-valued exchange rate.

Having said that, it is likely that the marginal benefits of ECB ultra-accommodative policy measures will decline over time, while their marginal undesirable side-effects may grow. This is especially true for the negative interest rate policy. This measure has initially facilitated the transmission of ECB policy to asset prices and the exchange rate. However, over time, it will increasingly hurt bank profitability and thus the credit channel. The good news is that the expected higher pace of interest rate hikes in the US may eventually allow the ECB to exit from its negative rate policy.

So what should the ECB do? The widespread view, shared by the ECB itself, is that without the contribution of other policies – in particular structural reforms and fiscal expansion in countries where there is room - the effects of monetary policy are waning. Yet, against the current political backdrop in Europe, it would be naïve and dangerous to bet that governments would have no alternative but to take the baton if the central bank decided to stop playing its part. The risk for the ECB would rather be to lose its credibility and ultimately its independence and legitimacy.

The fact that monetary policy is the only game in town is problematic. But at this critical political juncture in Europe, it is reassuring to know that there is at least one credible player in town. ●

Stimulating productive investment

Contributors

Benjamin Angel

Director, Treasury and Financial Operations,
Directorate-General for Economic and Financial Affairs,
European Commission

Juncker Plan: closing the investment gap in Europe

In July 2014, Jean-Claude Juncker announced, in a speech at the European Parliament, his intention to put forward an "ambitious package for growth, investment, competitiveness and jobs". This marked the beginning of a flagship initiative of the current Commission, aiming to mobilise public and private investments in key sectors of the European economy. Today, the Investment Plan for Europe is delivering. It is well on track to mobilise more than EUR 300bn of additional investments within its initial three-year timeframe.

Building on its achievements, the Commission has proposed to extend its duration and increase its firepower to mobilise at least EUR 500bn by end-2020. The negotiations of the terms of the extension with the European Parliament and the Council provide for an opportunity to reflect on what has been done and what can still be done to help close the post-crisis investment gap in Europe.

At the heart of the Investment Plan, the European Fund for Strategic Investments (EFSI) enables the European Investment Bank Group – thanks to a risk-bearing capacity provided by the EU budget – to support riskier operations which would not have been financed otherwise. More than 400 transactions in all 28 Member States have already been approved under the EFSI, mobilising around EUR 170bn in investments and expected to benefit around 400,000 SMEs and mid-caps in Europe. The European Investment Bank has provided support to projects in energy, transport, research, digital, social infrastructure or environment and resource efficiency. The European Investment Fund has significantly increased its volume of operations in support of SMEs and mid-caps, delivering well beyond expectations.

An extended and enhanced EFSI 2.0 will build on the successes and lessons learnt so far – accelerating Europe's full recovery from the crisis. First, the geographic coverage of projects supported under the EFSI ought to be improved - not by changing the market-driven nature of the EFSI but by making it work for everyone. In particular, the capacity of project promoters across Europe to structure viable projects and to combine different sources of financing will be supported. Second, additionality and transparency of EFSI projects will be further reinforced. By making sure that projects under the EFSI address sub-optimal investment situations and market gaps, we send a clear signal to European citizens that public funds are used in a meaningful way – to address investment gaps in tandem with private investors. Third, support to strategic infrastructure and innovative projects, start-ups, SMEs and mid-caps should be further increased in order drive the European economy forward.

Achieving the above, the Investment Plan for Europe could prove to be a game changer – not only in closing the EU's investment gap but also in shaping a more unified, inclusive and competitive Europe. ●

Xavier Larnaudie-Eiffel

Deputy General Manager, CNP Assurances

European and French market position: conditions of the future success of the pan-EU pension product

Europe faces a major challenge in ensuring adequate retirement income. Europe's pension gap represents more than €2 trillion a year, which is equivalent to 13% of Europe's GDP. Individuals will need to take responsibility for their retirement income and insurers have a key role to play. Most European member states have planned to reform their pensions systems. While considering pension products, we must always take into account that their purpose is to secure an income in retirement and cover against longevity risk. The current policy measures across the UE won't be enough to assure the sustainability of the pension system, as the demographics and increasing old related risks will demand deeper reforms.

The Eurogroup commented officially on this topic in June 2016. Currently EY France is in charge of a study on the feasibility of the pan-EU pension product. This study aims to give some solutions to the potential impediments to the success of a personal pension's initiative, such as the PEPP. Since this initiative is intended within the mid-term review of the Capital Markets Union, the EC has expressed its firm will on launching a legislative proposal for mid-2017.

The creation of a personal pension product is a way to reduce the pension gap. However, some important obstacles have not been covered yet by the European Commission:

- The potential impediment that the different tax treatment and legislation constitutes for a pan-European personal pension product. This obstacle might pose a significant limitation to the success of the personal pension's project. Therefore, it is crucial that tax treatment of personal pension products remains a competence of the Member States.
- The level playing field between different types of insurance providers. Without an adequate framework, there is a risk of switching between both pension products and pensions providers. This would have a detrimental prudential impact on the financial management. The personal pension product will create an uneven playing field and will foster insurance industry out of the classical core business. Life insurers are in favour of a European initiative aiming to protect retirement savers. Pension products are designed to reduce certain risks while taking account of savers' specific need. Nonetheless, policy measures should always be designed to be proportionate and a long-term engagement. This is why the PEPP must be long-term pension product with a decumulation phase, and also represent a long-term engagement for pension holders.
- Consumers should be aware of the risks they bear. From a consumer protection perspective, the PEPP should entail an appropriate level of security for policyholders.
- Furthermore, future PEPP providers should be subject to an appropriate prudential treatment taking into account the pension products' long-term horizon and specific features. "Same risks, same rules" principle should apply to ensure a level-playing field between all providers. The Commission's priority should be to remove constraints on long-term guarantees. The current Solvency II framework constrains insurers' asset allocation, by penalising equity investment. In France, the adopted Sapin II law foresees a convergence between pillar II and pillar III with the 2003 Institutions for Occupational Retirement Provision (IORPs) Directive, since this Directive does not impose capital requirements.

Fausto Parente

Executive Director, European Insurance and Occupational Pensions Authority (EIOPA)

Providers of PPPs are long-term investors and can play a key role in enabling efficient financial markets in the CMU

The aim of the Capital Markets Union (CMU) is to create opportunities for investors, efficiently link financial institutions with the wider economy, and foster a more resilient financial system in the EU. In order to enable much needed long-term financing, institutional investors, such as insurers and pension funds, with typically less liquid, long duration liabilities, could play a major role. EIOPA's most recent actions to promote sound long-term investments include:

Firstly, EIOPA has worked on measures to reflect the evidenced lower risk of investments in qualifying infrastructure projects and corporates by proposing a risk-based enhancement in the Solvency II asset class. With proper risk management, this will help institutional investors to better match long-term liabilities and to increase portfolio diversification, for the >>>

>>> benefit of policyholders while, at the same time, delivering strong support for the CMU.

Secondly, EIOPA advised the creation of a Pan-European Personal Pension product (PEPP). Only a prudentially sound, second regime product that is demonstrably trustworthy, transparent and cost effective can successfully overcome hurdles and inefficiencies of cross-border business and offerings.

EIOPA stands ready to continue to work on PEPP, namely in the design of „product pilots". We intend to explore pure individual Defined Contribution Schemes but also collective Profit Sharing Products that match efficient investment portfolios and mirror long-term retirement objectives. Consumers need to be supported by a strong default investment option and optional, fair, protective risk sharing mechanisms. This would also provide stable capital inflows for key CMU assets, such as equities, infrastructure and green investments. Scalability and simplicity will drive better returns, transparent investment strategies and cost-effective asset management.

While an appropriate, reliable, regulatory framework for a PEPP is key, strong EU-wide oversight is equally essential, including for instance a centralised database with transparent information about charges, risks, and returns of PEPPs. In addition, enhanced supervisory convergence within a Single Market for personal pensions, enabled through efficient European-led supervision, is decisive for the PEPP to fully benefit European citizens. ●

Sophie Barbier

Director of the European Affairs Department, Caisse des Dépôts

Looking for EU growth... long-term investors needed!

A persistent European paradox: liquidity is abundant, but productive investments remain too low...Due to high economic and regulatory uncertainties brought about by the financial crisis, institutional investors are still reluctant to take on long-term risks in their balance-sheets. On the other hand, European capital markets are not yet mature enough to take

them over. So productive investments needs – in infrastructure, venture capital, research and development...– are not fully satisfied.

But what is even more worrying is that, as a consequence, productive investments needs are not as high as they should be in a growing and ageing economy. In the current environment, the pipeline of risky but sound projects is not strong enough because economic agents – be they SMEs, bigger companies or local governments – are deterred from implementing long-term development plans. As a consequence, investment in the EU is still well below its pre-crisis average: measured as a share of GDP, the investment gap is about 1.7% of GDP for the EU (Eurostat data).

It is therefore essential that institutional investors get involve in maintaining and developing long-term financing. In this context, their mission is threefold: to contribute directly to long-term financing of the economy, to act as catalysts vis-à-vis other economic agents and thereby to contribute to the emergence of vibrant markets for long term financing. ... In order to overcome the investment gap and restore growth and job creation in the EU, institutional investors must be put in capacity to invest in projects that are beneficial to the real European economy.

Since 2015, the Juncker Plan is supporting the financing of projects in infrastructure and SMEs. Already, the European Fund for Strategic Investments (EFSI), the functional keystone of the Plan, committed nearly half of the € 315 billion of targeted investments at its launch.

EFSI provides risk-sharing through public funds at a time when low investor confidence is key to understanding the low investment activity. This encouraging stimulus owes much to the strong involvement of so-called National and Promotional Banks and Institutions (NPBIs) who have clearly positioned themselves as "facilitators" for the deployment of the Plan in their respective countries. Close to the project developers and able to mobilize the private actors, the NPBIs co-financed more than a third of all EFSI operations.

To send a strong signal to investors, the European Commission decided in 2016 to extend the duration of the EFSI until 2021 and to increase its amount. However, the dynamics of investment remain fragile and further initiatives are needed to improve the contribution of Investors.In this respect, more "investment platforms" should be set up in the coming months. It is crucial to further facilitate the implication of NPBIs and the emergence of "investment platforms" as a tool to pool smaller investment projects with a thematic or geographic focus. The establishment of such investment platforms meets the growing demand for financing of smaller scale and higher-risk projects across Europe. Platforms are a practical way to increase the pipeline of projects which can be financed by long-term investors.

Setting up platforms which benefit from the guarantee of the EFSI allows for an increased implication of investors (leverage effect) in risky projects. So they are key for the development of a stronger project pipeline and for the increase in productive investment in the EU! ●

Michael Hennig

Deputy Head of Institutional Sales and Relationship DC, Fidelity International

PEPP - a vital complement to our existing pension systems

The European Union (EU) has not yet fully recovered from the impact of the financial crisis. It is faced by the unhelpful interaction of low growth and an ageing population, which will bring further strain as public sector pensions become increasingly unaffordable. The banking system is also still constrained and may be unable to finance growth if and when it returns.

Against this background, a proposal for a Pan-European Personal Pension (PEPP) could not arrive at >>>

>>> a better time. A well-considered and structured PEPP could have an immediate and significant impact on retirement provision. PEPP could over time create substantial pools of investible capital outside the banking channels. It could thereby in the future become an important source of finance for industry and government.

"PEPP could over time create substantial pools of investible capital."

- MICHAEL HENNIG

Pension fund contributions are often directed through the more liquid markets. However, much of this investment is genuinely for the long term. It should thus be possible to direct substantial capital flow into medium- to long-term investments, including infrastructure. While financial measures stand-alone may not suffice to create growth and jobs, such measures can when combined with other initiatives provide important support.

We are of the firm view that the size of the capital pool created by the PEPP could be substantial. As an example and source of inspiration, it can be noted that the first UCITS Directive came into force in 1985, and 30 years later some € 8 trillion has been invested through such funds. We would say that with the right design, there is no reason why PEPP should not be in a position to take off on a similar trajectory.

Besides providing a steady flow of investment capital, furthering growth and creation of jobs, the PEPP could also support free movement of labour in the EU. Individuals who work in different EU countries may in the world of today find that they have pockets of pension contributions in multiple places. Depending on national requirements, such contributions can become trapped in multiple places, and may in a worst case scenario not meet applicable minimum requirements in any single country.

Many technical and other challenges lay ahead of us, before we can say that PEPP has become a natural part of our life. We will for example have to analyse and find workable solutions relating to distribution, marketing and taxes, and we have to make sure that the PEPP system works on a national as well as on a pan-European basis.

However, challenges are there to be overcome, and we are convinced that with the right design and appropriate regulatory framework, the PEPP could turn out to be not just an important building block and part of the Capital Markets Union, but also an excellent complement to existing national pension schemes, contributing to investments, growth and new jobs in Europe. ●

Fernando Navarrete

Chief Financial Officer, Instituto de Crédito Oficial (ICO)

Deepening an Investment Plan for Europe

A successful implementation of the Investment Plan for Europe is based on three pillars: the additionality of the plan, a broader investment base and a bigger range of eligible products.

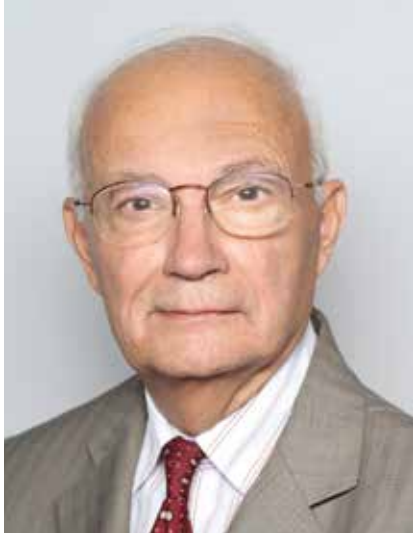
The success of the Investment Plan for Europe relies firstly upon its additionality. This means its ability to enable valuable but risky projects that would otherwise be unable to secure funding. The European Investment Bank (EIB) must use its European Fund for Strategic Investments (EFSI) guarantee to fund projects that under different circumstances could not have been carried out or not to the same extent. This complies with EFSI regulation and its willingness to address market failures or sub-optimal investment situations. So, additionality means to assume higher risk operations than the previously funded EIB operations. But additionality is not only about assuming higher risks, it also means EFSI to adopt a junior position in relation with its co-financiers to reduce the risks of said co-financiers. This junior position may also boost the entrance of private investors in projects that otherwise may not be feasible or that at least would not have the presence of private investors. If the assumption of higher risks and the junior position do not come together, there is a risk of creating market and competitive distortions. Additionality may also be achieved through longer terms as commercial banks are more reluctant to intervene when the term is longer.

"A catalytic effect of the Investment Plan for Europe may be reached by widening the investors' base."

- FERNANDO NAVARRETE

A catalytic effect of the Investment Plan for Europe may be reached by widening the investors' base. This widening is possible through the definition of a standardized asset referred to infrastructure investment. This would make it easier for more market agents, currently inactive in this market, such as insurance companies or pension funds, to invest in these EFSI projects.

The third dimension to deepen into a good performance is to widen the framework of feasible projects. This means to make the PPP projects or project finance structures easier, as well as to introduce best practices such as TFIA or the Project bond initiative. The introduction of such schemes allows a better risk sharing, whereas they assign risks depending on the characteristics of each agent. ●



Jean-Jacques Bonnaud

Independent Director, Eurofi

Addressing all the challenges SMEs are facing

What are the financing needs of EU SMEs which are not yet covered (capital risk, access to equity resources, development capital…), which weigh on the level of their productive investment?

One of the difficulties in the development of SMEs is the lack of sufficient profitable perspectives. This is of course largely due in many countries to a weak economic growth and related lack of confidence on the future. But is also due to some more specific problems.

The strengthening of the financial structure of their balance sheets cannot just result from further piling up bank loans since SMEs are too often already too indebted. However, often financial market repel small innovative companies, since they oblige them to comply with strict publication demands, which actually unveil to their competitors the specificities of their strategies. Consequently they prefer private equity and private placements, which they acknowledged as more friendly capital providers. There the problem to address in order to improve their access to finance is the availability of private investors and the level of risk they are able to take. The scarcity of such investors still lead innovative entrepreneurs to accept - often too early - to be absorbed by large multinationals.

In addition, to be up to rapid technologic changes, both innovative or more classic small companies are increasingly confronted to recruitment challenges when it comes to hire adequately trained personnel. The level of wages is one of the root causes, which weighs on their development. Consequently, notably when they evolve in classical economic sectors, SMEs are prevented from increasing the level of their production and have to limit the range of products they propose, in a context where competition mostly demands differentiation and economies of scale. Their capability to export is also particularly affected.

These observations raise one question: how to ensure in the EU, that the bulk of these small firms contribute to the creation of positive economic externalities, which are required by the economic competition between the countries globally? Indeed such competitive context stems not only from free-trade but also from permanent waves of automation opportunities or the emergence of digital developments such as connected things…

Clearly a great deal of those externalities should be catalysed by public programmes.

Infrastructure, transport, energy, telecoms equipment as well as the availability of high-level trainings or sufficient social housing, are clearly important SME enablers, since SMEs cannot directly compensate for the lack of them as bigger corporates would .

In such a context, given the restrictions suffered by public budgets, the Juncker plan should be enlarged in size and scope. The stake is to ensure that sufficient inflow of private savings is ready to join this EU initiative. However, this will be difficult to achieve without a strong incentive, which could take the form of a fiscal exemption - agreed across the EU - granted to those private savings ready to invest in funds dedicated to capital development and long term loans alongside the EIB. The scope of such intervention should be extended to savings joining local entities to develop productive social infrastructures be them professional training or social housing. ●

Leveraging savings to develop cross-border investment

Contributors

Klaas Knot

President, De Nederlandsche Bank

Towards more sustainable capital mobility within the euro area

Progress has been made since the crisis, yet more cross-border risk sharing is necessary.

It is well established that financial integration holds many benefits, such as the potential for diversification, risk sharing and a more efficient allocation of capital. Yet the financial crisis has shown that capital mobility is not without a dark side. This became clear in most advanced economies, but especially in EMU, where the single currency boosted financial integration even further. Capital inflows that were not used productively amplified existing vulnerabilities in the monetary union.

During the financial crisis and in its aftermath, it became apparent that vast and volatile cross-border flows exacerbated both the boom and bust phases of business cycle fluctuations in euro area countries. During the boom, capital flows towards southern Europe contributed to massive current account deficits. These deficits were increased as the wage and price rises generated by the capital inflows eroded competitiveness and productivity gains. Recent DNB research shows how capital inflows prior to the financial crisis were not used for investment that would benefit productivity. Instead, they led to rising real estate prices, a consumption boom, wage growth, growth of the less productive non-tradable sector, and a deteriorating external position. The resulting divergences in competitiveness and external positions between EMU countries eventually became unsustainable, also because counterbalancing policies (such as prudential tools or increased public saving) were insufficiently implemented. These developments gave way to a sharp reversal in cross-border flows during the bust phase, which led to large-scale financing problems for banks and sovereigns and an amplification of the economic downturn. This financial fragmentation also gave rise to a strong increase in public risk-sharing, as public authorities were forced to step in with financial support.

Since the crisis, European policymakers have been taking many measures meant to alleviate the dark side of financial integration, while trying to retain most of its benefits at the same time. These efforts will allow the EMU to function more properly and benefit the economy in the long term. Financial imbalances can now be more effectively addressed by using prudential policies, such as countercyclical capital buffers and Loan to Value ratios. In addition, stricter banking supervision on a European level has reduced the sovereign-bank nexus that was one of the amplifying factors behind the reversal of capital flows. Moreover, the strengthening of the EMU (the reinforced Stability and Growth Pact and the introduction of the Macroeconomic Imbalance Procedure) should bolster the efficient allocation of capital flows.

Going forward, the volatility of cross-border flows needs to be contained, both during booms and busts. To this end the composition of capital flows should be recalibrated to limit possible procyclicality. Debt flows are quicker to go in reverse when adverse shocks hit, and have proven to amplify business cycle fluctuations. Therefore, increasing the share of equity and FDI flows in the composition of cross-border flows is of paramount importance.

In addition, private risk-sharing mechanisms have to be reinforced in the euro area. In the US, private risk sharing via integrated financial markets is smoothing a >>>

>>> larger percentage of asymmetric shocks (around 62%) than public risk sharing via the federal budget (around 13%). Private risk-sharing remains much less developed in EMU. There is much to gain from stimulating more robust forms of financial integration. The aforementioned recalibration of capital flow compositions towards more risk-bearing capital is again of relevance here. It would also help if (cross-border) credit is not only dependent on banks, but also on alternative capital market channels like securitizations or covered bonds.

Ultimately, these measures will set the scene for investors and countries to reap the benefits of financial integration in a more sustainable way. ●

Dimitar Radev

Governor, Bulgarian National Bank

Addressing Underlying Issues of Cross-Border Investment in the EU

We are witnessing a downward shift in cross-border investment in the EU, while the EU current account moved to positive territory in recent years. The savings-investment mismatches, therefore, are at the heart of the conundrum we face in developing the cross-border investment in the EU.

Several initiatives to address this issue have been launched, including the Investment Plan for Europe, and the European Long-term Investment Fund. A large-scale new initiative is the establishment of the Capital Markets Union intended to further enhance the mobilization of capital and its channeling to companies and infrastructure projects offering new opportunities for savers and investors across the EU. A few other initiatives are under consideration, including the creation of a European Savings Investment Fund.

However, the results of all initiatives have been mixed so far, and cross-border investment is stagnating. Before moving forward we need to better understand the underlying factors behind recent developments.

The current initiatives look technically sound, but the lack of sufficient progress in their implementation reveals a number of remaining underlying issues. These include: (i) the unfinished agenda with regard to banking and financial integration; (ii) slow progress in real convergence; and (iii) limited availability of adequate infrastructure and innovation projects.

Priority actions should, therefore, focus on addressing the underlying issues, and efforts at further expanding the already established toolkit come next. This would require bold steps at both the EU and national levels to regain confidence in the future of EU integration.

At the EU level, there are institutional issues to be addressed concerning the future of the integration process. The five scenarios recently proposed by Commission President Jean-Claude Juncker shed light on the possible patterns of integration between the EU members. However, there remains a potential conflict between the prospects >>>

>>> of "multiple-speed" developments and advancing real convergence between the euro area and the rest of the EU. The EU needs to move promptly on this issue, in order to address uncertainties.

The national authorities, at their end, should promote financial stability and fiscal solvency, and address structural weaknesses and bottlenecks. The experience of Bulgaria may be indicative of what can be done by an EU member state that is not yet member of the euro area. From the central bank perspective this involves: (i) a sound banking sector; (ii) fiscal consolidation; and (iii) structural reforms.

Good progress has been made in Bulgaria with regard to the first two areas. A comprehensive asset quality review in 2016 helped restore confidence in the banking sector. Bank lending is recovering, the overall profit is near historical highs and a process of market-based consolidation in the sector is underway, including a recent deal with a strategic investor from the euro area. Furthermore, the public finances of Bulgaria remain sound and the successful fiscal consolidation is illustrated by the budget surplus last year and the third lowest government debt to GDP ratio in the EU. As for the structural reform agenda, much more remains to be done in order to resolve remaining issues and help attract increased capital flows from the EU.

We at the central bank have already planned the next steps, which will build on recent progress. Among other things, we plan to further strengthen our banking supervision, develop the crisis management framework for the banking sector, and reduce the level of nonperforming loans.

To conclude, decisive actions are required at both the EU and national levels to address the current saving-investment mismatches within the EU. While expending the available toolkit is important, priority should be given to resolving the remaining underlying issues with regard to banking and financial integration, real convergence, and quality of project management. ●

Roberto Gualtieri

MEP and Chair, Committee on Economic and Monetary Affairs, European Parliament

Leveraging savings to develop cross-border investment in the EU

A well-functioning single market for financial services is one of the key enablers for matching savings with investment opportunities and to address the current investment gap in the EU. The cross-border dimension in this field is crucial not only to finance growth and employment, but also to ensure greater diversification of resources and thus limit the impact of asymmetric shocks.

However, cross-border investments channelled through the financial sector is in some areas still lagging behind its full potential. A completion of the single financial market by identifying and reducing unwarranted cross-border barriers is necessary. The Banking Union and the Capital Markets Union are the two main projects intended not only to deepen and complete the single market, but also to develop a regulatory >>>

>>> framework more conducive to long-term investments. In this regards, UK's exit from the EU should be an incentive for the EU27 to accelerate towards these objectives and to promote a greater supervisory convergence.

The completion of the Banking Union by the creation of a European Deposit Insurance Scheme (EDIS) and a common backstop will increase the trust of retail savers and increase cross border flow of savings. The ECON Committee is also working on the complementing banking package proposed by the Commission in November 2016, which will lay the foundation for a further strengthened single rulebook and an appropriate balance between risk reduction and support to growth. Finally, the ongoing discussion within the Basel Committee should lead to completion of the banking prudential standards. The European Parliament has expressed support for a sound international standard addressing excessive variability of RWA while ensuring a real level playing field at the global level and not leading to a significant increase in overall capital requirements.

While bank lending will remain central to the European economy and in its financing to SMEs, it needs to be further complemented by an adequate development of capital markets in order to incentivise the most efficient allocation of savings by deepening and diversifying the funding sources, and to offer more investment choices, greater transparency and portfolio diversification to savers and investors, enhancing the financial system's resilience. Parliament and Council have positively concluded the legislative work on the new Prospectus regulation, and trilogues are proceeding on the two Securitisation files, aiming at reaching an agreement within this semester. Several cross border barriers have already been removed, and further actions will be promoted by releasing the full potential of EuVECA and EuSEF. In any case, the mid-term review of the CMU provides the opportunity to accelerate and re-focus projects already foreseen in the CMU action plan, but also to propose new actions.

A well-functioning single market is a prerequisite to unlock the full economic potential of the euro area and the whole European Union. Nevertheless, the completion of both the Banking Union and the CMU projects would not be sufficient to promote economic convergence and political stability if market failures are not properly addressed. In this regard, while the Juncker Plan is playing an important role, we need further action. The European Parliament is now working on improvements on EFSI regulation in order to promote additionality and close investment gaps, including by means of an integrated and streamlined approach of blending EFSI with other EU and public funds. A European Savings Investment Fund and a permanent investment capacity should also be considered. ●

Ambroise Fayolle

Vice-President,
European Investment Bank (EIB)

Cross border capital flows in the EU: recent evolution and policy response

In 2016, EU real GDP per capita was somewhat above its pre-crises level while investment was still below. In this article, we summarise the most striking changes in EU cross-border financial flows since Lehman´s bankruptcy, changes which suggest an increased financial fragmentation. We then argue that more structural policies need to be developed to benefit from a proper integrated financial system in Europe. >>>

>>> The "Great Retrenchment" of gross international financial flows is only partly reversed

The ramping-up of international capital flows and the accumulation of external assets and liabilities in the decades preceding the global financial crisis were much accentuated. To some extent, this robust expansion can be related to increased financial liberalisation and greater capital account openness. To another extent, it reflects or accompanies the development of current account imbalances that took place over this period (Coeuré, 2016). The new equilibrium level of cross-border financial flows is likely to be lower than thought before the crisis but difficult to assess. Yet, the muted revival of international capital flows remains puzzling as it could mean, if it persists, that the global economy is becoming more fragmented than it used to be, after a decade of increasing globalization.

In Europe, the retrenchment partly reflects the correction of current account imbalances

Changes in financial flows mirror changes in the current account. In the EU, after having been substantially positive from 2012 to 2014, the current account became negative again in 2015, owing to non-euro area countries, mostly the UK and Denmark. Core country members of the euro area continued to record a current account surplus - of around 3% GDP at the end of 2015 -, mostly reflecting the very large current account surplus in Germany. During the same period, a profound adjustment in the current account balance of both vulnerable and cohesion countries was recorded. Starting from large deficits, at the end of the period, the current account of vulnerable countries is balanced and that of cohesion countries is in surplus.

The different components of international financial flows were unevenly affected

The collapse of the "other investment" category explains the bulk of the financial retrenchment in Europe (Bussière, Schmidt and Valla, 2016). This is related to the confidence crisis faced by the European banking sectors at the occasion of the sovereign debt crisis. Banks were forced to deleverage in order to restore sounder balance sheet, and the deleveraging was predominantly operated on external assets. FDI flows have been fairly resilient. In the "core" and "vulnerable" countries, the other investment category now constitutes a much smaller share, while conversely, the share of FDI has substantially increased. Within the portfolio category, the different paths described above have also led to substantial reallocation: before the crisis, portfolio debt used to be two-thirds of the size of equity flows in the "core" and "vulnerable" countries, whereas they are now of roughly equal magnitudes in the former and in opposite proportions in the latter.

Post-crisis stigma, fragmentation and bottleneck in the allocation of savings?

Resulting from a gap in the productivity of capital between two countries, cross-border capital flows contribute to equate returns on investment across economies. In Europe, they are especially important, as differences in standards of leaving across member states are substantial and international labour mobility is relatively low. Several indicators suggest that the EU financial system remains fragmented, eight years after the start of the crisis (Maurin et al., 2016 or Valiante, 2016). Under a fragmented financial system, domestic savings may limit investment.

In Europe, in the core countries, domestic investment is recurrently below domestic savings so that savings are exported. For the vulnerable countries, the financing of domestic investment required capital inflows up to the start of the sovereign debt crisis. Since then, investment has declined, domestic savings have increased and these countries have become overall net exporters of savings. This reflects a return to a more sustainable investment path but also the fragmentation of the European financial system. In this regard, the trend decline in the net inflows to cohesion countries may be worrisome. These countries, which given their lower level of development should be expected to have many investment opportunities, have exported savings since the beginning of the sovereign debt crisis.

Conclusion

Across Europe, a battery of instruments and policies, among which the investment plan for Europe, has been setup since the crisis. In this context, the EIB has taken his part in restoring more benign credit conditions and unlock the credit channel. However, the plan is not deemed to substitute to cross border capital flows within Europe. Structural policies, as emphasized in the third pillar of the investment plan for Europe, are needed. The banking union and Capital Market Union (CMU) should become two pillars to increase the efficient allocation of capital within the EU. The progress achieved since the crisis provide support to some cautious optimism but progressing quicker and deeper in their setup would increase the capacity of EU economy to withstand the risks pointing ahead. In a way, the fact that cross-border capital flows have rebounded but remain well below pre-crisis shows how policies can be successful how much as how much they are needed. ●

Following Eurofi event
Sofia
25, 26 & 27 April 2018

Fostering private risk sharing

Contributors

Mahmood Pradhan

Deputy Director, European Department, International Monetary Fund (IMF)

Private international risk sharing can strengthen the EU's Single Market

How has private risk sharing contributed to growth and financial stability in the EU before and after the crisis and is the role of private risk sharing generally sufficient in the EU? What role may increasing private risk sharing play in deepening the EMU? What are the short term priorities in this respect?

Risk sharing mechanisms, whether private or public, can help smooth private consumption and investment against income shocks, enhancing social welfare. Transacted through financial markets, private risk sharing can be achieved by holding a diversified asset portfolio, with capital income arising from multiple sources, and/or taking out insurance or derivative contracts against specific shocks and risks. On the other hand, public risk sharing typically entails a system of fiscal transfers, where the state shifts resources towards individuals and businesses affected by adverse shocks.

Financial markets in the EU have historically tended to be more oriented towards banks than capital markets, where debt and equity may be bought and sold. Private credit supplied domestically by EU banks was about 120 percent of GDP prior to the crisis, falling to around 100 percent now, about double the share of bank credit in the U.S. Over the same period, EU bond issuance outstanding has stayed at around 40 percent of GDP, while stock market capitalization in the EU fell slightly and is now at around 55 percent of GDP, both about half the size of such markets in the U.S. During the sovereign debt crisis, Europe's dependence on banks became a channel for contagion, with interbank connections across and within countries propagating sovereign and bank stresses (Goyal and others, 2013). New institutions, such as the European Stability Mechanism (ESM) and the Banking Union, have weakened, but not eliminated, the link between sovereigns and banks. Further developing alternatives to bank-based financing would help make the EU and euro area more robust to bank stresses.

Despite the Single Market, there is little to no private international risk sharing against country-specific risks within the EU or euro area, suggesting substantial scope for improvement. IMF staff estimates suggest that about 10 percent of country-specific income volatility within the monetary union is smoothed through private risk sharing, while it is negligible for the EU as a whole (Allard and others, 2013). By contrast, in full federations such as Canada, the United States, and Germany, between 30 to 50 percent of provincial or state income shocks are smoothed through private channels within the countries, while public risk sharing through fiscal transfers smooths between 10 to 25 percent of shocks. In the EU and euro area, (ex-ante) public risk sharing across countries is effectively nonexistent.

Policies to enhance the effectiveness of private risk sharing within the EU would complement the Single Market. Completing the banking union by establishing a common deposit guarantee scheme backed by a common fiscal backstop (such as a credit line from the ESM) would further weaken the sovereign-bank link. Otherwise, during periods of stress, the adverse sovereign-bank loop will lead investors to discriminate across member states ex ante. Beyond banking, the EU's capital markets union (CMU) initiative represents an important step towards creating a truly unified market for financial services. Greater harmonization of financial regulatory and supervisory regimes across countries would help foster greater cross-country investment, by providing more certainty and transparency to investors. The forthcoming MiFID II framework is a good down >>>

>>> payment. Similarly, more harmonized corporate insolvency and foreclosure regimes would also encourage investment. Given the importance of small and medium enterprises (SMEs) in EU value-added and employment (accounting for about half of each), measures to improve SMEs' access to finance and developing venture capital markets should strengthen the real economy's resilience. Together, these policies can improve the Single Market's functioning and thereby enhance the scope and efficiency of cross-border private risk sharing, which is doubly important a means of insuring against large country-specific shocks within a currency union. ●

José-Manuel González-Páramo

Executive Board Member, Banco Bilbao Vizcaya Argentaria (BBVA)

Moving towards a more integrated Eurozone

In 2012, with Europe on the verge of fracture, its authorities recognized that the architecture of the Economic and Monetary Union (EMU) was flawed. One of the elements needed for a sustainable single currency was the creation of a Banking Union. This is a paramount achievement towards financial integration, but it is still incomplete.

The Banking Union represents a significant transfer of sovereignty from member states to new supranational authorities. Currently, its building blocks include by a Single Rule Book, a Single Supervisory Mechanism, and a Single Resolution Mechanism. But common supervision and resolution arrangements call for a Single Deposit Guarantee Scheme in order to ensure that each euro deposited is equivalent regardless of its geographic location. This is the missing pillar of the Banking Union.

In November 2015, the European Commission tried to address this issue by launching a proposal to create a European Deposit Insurance Scheme (EDIS). Building on the existing national schemes, it would move towards a mutualised system where risks are better diversified.

Nevertheless, the proposal is facing some strong opposition. This is based on the misbelief that EDIS implies a risk transfer from weak to sound financial systems, increasing moral hazard problems. Critics argue that a mutualised scheme should not be in place as long as banks' risks are not reduced and become more homogeneous across geographies.

Despite the fact that these concerns must be taken seriously, and the reduction of bank risk is important, we must bear in mind that an incomplete Banking Union could have destabilising effects, increasing financial fragmentation among member states. This would lead to the discrimination of banks based on their location, perpetuating the sovereign-bank vicious circle. Furthermore, since the financial crisis the EU has taken several measures that significantly increased banks' resilience. Even more, in line with the defined roadmap for completing the Banking Union, which established that bank's risk reduction measures that were needed before moving forward, the European Commission launched last November a new comprehensive package of banking reforms. This package amends both the prudential and resolution banking frameworks and includes the implementation of several international standards into EU law and also a package of technical improvements. Moreover, in parallel, a legislative proposal to harmonise creditor hierarchy of senior debt across the EU was also released. >>>

>>> There is a clear objective in this new legislative package which is to further increase the resilience of EU institutions.
Similarly, the lack of fiscal union, including a safe euro-wide security, is considered another weakness in the euro-architecture. This further fuels the sovereign-bank vicious circle, generating fragmentation of financial markets in the Eurozone particularly in times of crisis. The European Systemic Risk Board is working on the potential creation of European Safe Bonds (ESBies). ESBies would constitute the senior tranche of a diversified portfolio of euro area sovereign bonds. This new type of assets would be a new safe euro area security class without risk mutualisation (the combination between diversification and tranches is what confers ESBies the consideration of risk-free asset).

Overall, the process towards a stronger EMU faces an important challenge: the need for more integration. To overcome short-termism, we need a profound rethinking of European and national institutions. This could be done at different speeds, with a faster pace of integration for Euro area members. The aim is ambitious, but the rewards are immense. This objective is even more important given the rise of euroscepticism. We need to move towards a more integrated EU, completing the Banking Union and making progress towards a fiscal and political union in order to reach a more resilient Euro zone. ●

Michel Madelain

Vice Chairman, Moody's Investors Service

Products, operating conditions and uncertainties of the EU project shape risk sharing

The concept of the Capital Markets Union rests on the expectation that a more diversified financial system with a larger contribution of capital markets would deliver a higher growth path and better resilience to economic shocks.

Leaving aside the distorting impact of current monetary policies and divergence in national economies, three broad classes of factors impact the overall volume of activity and degree of risk-sharing by non-domestic investors. They are (1) the structural features of the European financial system, (2) operating conditions impacting investment behaviours and (3) product specific features. To varying degrees, these factors have driven the relative success in the last several years of e.g. covered bonds, derivatives and bonds issued by large corporate and financial institutions. They have conversely hindered the greater use of products such as securitisation of mortgages, SME debt and equity.

Generic deep and resilient structural features of the European financial system have inhibited market developments. These include:

- A dominance of the banking market for savings and the funding of the economy including mortgages;
- The absence of deep and liquid secondary markets;
- A less supportive cultural, political and societal background; and
- A home bias encouraged by information asymmetries.

Operating conditions that remain uneven continue to hinder cross border risk sharing; among them:

- National legal and tax frameworks;
- The favourability (or lack) of the regulatory treatment applied;
- The quality of the disclosure regimes; and
- The depth and robustness of the market infrastructure available to support the origination, distribution and trading of such products. >>>

>>> Last, relevant product-specific features play an important role:

- The risk profile of the security and its transparency;
- The degree of standardisation of the product;
- Its broad acceptability and reputation in the market; and
- The depth, nature and diversity of the investor base.

These three broad classes of factors at play need attention when seeking to achieve a higher level of risk-sharing in the Eurozone. They present however different challenges and complexity.

Improving product specific features and creating the conditions conducive to attract cross-border investors and issuers offer the biggest opportunity. On products and operating conditions a lot has been done already, and more is in motion in many areas through public and private initiatives. It needs to be accelerated without prejudice.

"Improving product specific features and creating the conditions conducive to attract cross-border investors and issuers offer the biggest opportunity."

- MICHEL MADELAIN

Tackling some of the structural features of the European financial system is inevitably a longer haul project facing many headwinds. In the process, its features and momentum need to be preserved by completing the Banking Union and ensuring the proper calibration of risks. Progress will inevitably be slow.

Finally, while very meaningful, these steps will not eliminate price divergence, re-allocation of assets or loss of liquidity resulting from idiosyncratic risks or concerns over the risk of redenomination and the future of the European project, the elephant in the room for many investors. These should not be viewed as undesirable market features. It is their root causes that need to be addressed. ●

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

Safety and transparency are key to restore investor confidence

One important avenue to facilitate greater private risk sharing is encouraging retail investors back into capital markets. To this aim, it is important to restore confidence and ensure better information for investors. In recent years, the European Commission and the ESAs have made significant progress in improving disclosure requirements across all sectors. New disclosure requirements have been introduced through different legislative measures. UCITS - KIID, MiFID/MiFIR, IDD and PRIIPS (once agreed and in force) will generate the data to power full transparency at product level. ESMA is currently working with the NCAs, EIOPA and EBA to ensure that these new product disclosures are put to work and effectively support retail investors in their investment decision choices. Private risk sharing by retail investors should be to their benefit with better long-term returns compared with deposit saving.

Another tool to encourage retail investors to channel savings into the capital markets is to ensure that they can rely on the same level of protection across the Union. This can be done through increased supervisory convergence. Over the last two years, ESMA has increasingly invested in supervisory convergence. In February 2017, ESMA published for the second time our annual supervisory convergence work programme, which details the activities and tasks it will carry out to promote sound, efficient and consistent supervision across the European Union. ESMA elaborated on a number priority areas taking into account different factors, including the market environment, legislative and regulatory developments and NCAs' supervisory priorities. In particular, ESMA focuses this year on the consistent implementation of key new EU legislation such as MiFID2/MiFIR and MAR. At the same time, ESMA aims at ensuring adequate investor protection in the context of cross-border provision of services.

In addition, in 2017 ESMA will continue to promote working methods that are key to ensuring an effective supervisory dialogue and supervisory convergence work. Firstly, day-to-day contacts between NCAs will be facilitated through the continued promotion of discussions on 'live' cases dealing with emerging supervisory issues, as well as supervisory briefings and workshops. ESMA also undertakes follow-up activities when non-compliance or deficiencies are identified, and ensures that recommendations issued in peer reviews are duly considered by NCAs.

"It is important to restore confidence and ensure better information for investors."

- STEVEN MAIJOOR

Overall, since ESMA's establishment, the convergence tools have improved, compared to those available to our predecessor, but experience shows that the current supervisory convergence tools are too weak. This point is illustrated by the case of CFDs and binary options, highly speculative products with a low chance of positive returns, which continue to create consumer detriment across the EU.

While ESMA has undertaken various convergence activities on this matter, and the NCA concerned has stepped up its supervision and enforcement activities, our tools are not sufficiently effective to ensure that the risks to consumer protection are sufficiently controlled or reduced.

The upcoming ESA review is a good opportunity to further develop our tools to achieve greater supervisory convergence. ●

Philipp Hartmann

Deputy Director General Research, European Central Bank (ECB)

Risk sharing in EMU via integrating retail credit and developing capital markets

Macroeconomic stabilisation of large economies functions better when regional risks are shared. In the euro area, absent a fiscal union, the room for public risk sharing smoothing consumption in member countries is limited. This highlights the crucial role that private risk sharing channels may play for the functioning of Economic and Monetary Union.

Evidence from federal states like the United States or Germany suggests that integrated financial systems can contribute a sizeable share to overall consumption smoothing. Across US states, for example, capital markets have been found to contribute most and credit markets came second. In the euro area, however, risk sharing has been found to be low and fragile, with only about 20-30% of countries' income shocks being smoothed over the last years. Moreover, capital markets contribute only little to this and impaired credit markets may even have had an amplifying effect on consumption volatility during the European twin crises. From this perspective the Banking Union and the Capital Markets Union are important policy agendas.

If I had to name one important development for credit and one for capital markets, respectively, then cross-border bank mergers and pension reforms could make a difference. Cross-border bank lending is still extremely low in the euro area (about 8% for firms and less than 1% for households) and more pan-European banks would be the only realistic way to better integrate retail credit markets. Adequately designed pension reforms with a diversified European investment perspective could give a boost to cross-border equity holdings, which tend to make the largest contribution to risk sharing.

At the same time, private financial risk sharing can come with financial stability risks, in particular when it works via interbank markets. The fact that the ratio of retail-to-interbank cross-border lending in the euro area is on the rise since some years is therefore welcome. Moreover, the Single Supervisory Mechanism is well placed for containing such cross-border risks.

One should keep in mind, however, that the type of risk sharing I refer to here only works when divergences across countries are cyclical. ●

Servaas Deroose

Deputy Director-General, Directorate General Economic and Financial Affairs, European Commission

Fostering cross-border risk sharing via the private sector

The economic and financial crisis in the euro area has clearly demonstrated that Economic and Monetary Union (EMU) lacks an adequate degree of cross-border risk sharing, hindering the shock-absorption capacity of individual countries, in turn resulting in a surge of economic divergence and underwhelming growth performance. By its initial design, EMU did not envisage a substantial role for cross-border public risk sharing through fiscal transfers, thereby putting the onus on the private sector through the operations of credit and capital markets to provide for the bulk of cross-border risk sharing. The incomplete and fragmented financial systems in the EU proved to be a major handicap.

While the determination of the optimal degree of cross-border risk sharing is challenging, a comparison with the US is revealing. EU Member States have mature financial markets, integrated in the Single Market. Yet, private-sector risk sharing has been rather low across Europe. Looking at past output shocks in the euro area, the limited smoothing was predominantly carried out through the credit channel. However, roughly 75 % of shocks in the euro area have gone unsmoothed, compared to 25% in the US where the main contribution came through the capital markets (around 45 %), followed by credit markets (27%). There is therefore a huge untapped potential of the financial union.

After the launch of the euro, financial integration initially rose significantly in the euro area, but dropped again after 2008. Banks were the driver of increasing risk sharing before the crisis, as well as of the increased fragmentation in recent years. Moreover, bank lending tends to be more pro-cyclical and volatile and can, hence, at times even magnify the adverse impact of shocks on economic activity. Securities markets held up better, even if their contribution remained limited.

The EU has started to address these deficiencies. For the banking sector, regulation was overhauled, also to allow banks assume a more sustainable role in organising risk transfer. Furthermore, Banking Union addressed some of the root causes of fragmentation, but is incomplete, with a common backstop to the Single Resolution Fund and the establishment of a full-fledged European Deposit Insurance Scheme remaining key policy priorities.

A developed Capital Markets Union allows risk sharing to further expand and be less reliant on the credit channel. It can also create a better balance between debt and equity financing. We are aware that capital markets pose their specific challenges, such as herd behaviour, moral hazard or intrinsic volatility, which will have to be appropriately monitored and addressed. ●

Challenges and impacts of Brexit

Contributors

Cyril Roux

Deputy Governor, Central Bank of Ireland

Changes ahead in the European financial landscape

The financing of the EU economy is conducted in large part by financial institutions located in the UK. The departure of the UK from the EU will naturally entail a relocation of financial activities and firms from the UK to the EU27. Its extent and shape are still in flux.

The extent of relocation will depend on the arrangement or lack thereof between the EU27 and the UK. This will vary from sector to sector. Let's take a few examples. The clearing of euro-denominated securities could continue in the UK only if a proper legal and supervisory arrangement can be found. The creation of new CCPs or the expansion of existing CCPs in the EU27 is likely however. Retail banking, on the other hand, is very likely to be conducted in the EU27 by credit institutions incorporated in the EU27, and not by UK banks availing themselves of vestigial passporting rights. Likewise, EU27 banking groups will conduct retail banking in the UK through UK subsidiaries - the use of branches will not be possible in all likelihood. The majority of FX trades and interest rate derivatives trading in the EU is conducted today in the UK. Over time these lines of business will migrate in part into the EU27, fragmenting a global markets trading hub and increasing costs but distributing risks. More euro-denominated investment fund ranges sold outside of the UK are likely to be issued in the future from jurisdictions within the EU27.

One area of present scrutiny for EU27 financial regulators is that relocation from the UK of banking and investment business, insurance policies or market trades, whatever its scope, is genuine. Setting up a subsidiary in the EU27 to book on its balance sheet financial business, insurance policies or trades actually entered into by staff, traders or underwriters located and managed in the UK would be a transparent circumvention of Brexit, and a serious impediment to supervision – as the BCCI precedent showed. Financial institutions in the EU27 must actually and demonstrably decide locally what financial risks to take on their balance sheet, in line with group strategy, with daily decisions taken by local staff under local management applying business choices made by local executives keeping the final say. Financial institutions incorporated in the EU27 which would be booking trades, policies or operations decided elsewhere, within the UK parent for instance, would be in my view at most third country branches, irrespective of their legal form.

It is too early to draw the geography of relocation of UK business to the EU27. However, it is likely that the City will remain a global financial center, if somewhat smaller, while several other cities will grow a larger piece of the financial pie. Amsterdam, Dublin, Frankfurt, Luxembourg and Paris have already the critical mass and infrastructure in several lines of financial services and they are bound to receive more financial institutions and business as Brexit progresses. The current prominence of London will not be replicated by that of a single city but rather by a multi-centric EU finance. This changes the course of the Capital Markets Union but not the relevance of its aims. ●


© CHARLIE BIBBY

Shriti Vadera

Chairman, Santander UK

Protecting the gains from integrated capital markets

"No generation has had the opportunity, as we now have, to build a global economy that leaves no-one behind." Sixteen years after President Clinton's rhetoric, the negative impacts of globalisation have been laid bare by the glare of opinion from the people left behind and we are seeing a striking wave of protectionism and nationalism across the world. Financial services and capital markets were in the vanguard of globalisation and its participants among the primary beneficiaries. That they should feel the first heat of fissiparous pressures should not be surprising.

Globalisation as we understood it – the integration of capital markets, more open trade, communication and, controversially though never fully, immigration – has faltered. Whether we will see a full blown retreat will depend on whether we can make the case for the prosperity it brought, and can still bring if we find the means to manage it for a fairer outcome. Brexit is in many respects an expression of this frustration with the status quo.

The EU single market has been unique in creating the circumstances for the integration of financial services with unprecedented scale and freedom. The development of the single market for financial services since 1992 helped create one of the deepest, most liquid and efficient capital markets in the world that serves, directly and indirectly, businesses and households across Europe. It has underpinned the investment and doubling of trade within the EU in the last 20 years. Its potential is still to be fully realised which is why the EU Capital Markets Union agenda is so important.

Reversing the progress made so far would be an act of wilful mutual damage. It would not only be disruptive in the short term but the longer term outcome would be less depth, liquidity and efficiency and therefore a greater volatility and higher costs of capital for businesses. While having UK based capital markets outside the EU raises political and prudential challenges, it cannot migrate any time soon or without cost to the wider economy.

"Reversing the progress made so far would be an act of wilful mutual damage."

- SHRITI VADERA

Agreeing a new financial services trading relationship between the EU and the UK based on the principle of mutual recognition of regulatory standards and underpinned by strong regulatory cooperation offers a way forward that protects the gains that have been made and provides a path to a more prosperous future for the whole of Europe, including the UK.

The most important element of this is to keep capital flowing efficiently to EU and UK businesses and households. The alternative is to accept fragmentation and contribute to the increasing drumbeat of protectionism. And as for open markets and free trade, we could find "the good is oft interred with their bones". ●

Joe Cassidy

Partner, KPMG

A Brexit based on mutual interests

There is a tendency to focus on what Brexit will mean for the UK financial sector. But I prefer to focus on what Brexit means for users of financial services across all the current European Union countries.

These users will suffer if the mutual interests of the UK and the rest of the European Union countries (the "EU27") are not recognised. There are multiple layers of inter-dependencies, not least in financial market infrastructure, capital markets, contract law and jointly crafted financial regulation. UK financial markets provide a gateway to and from international financial markets, and are a key driving force behind the development of Capital Markets Union (CMU). Market stability needs to be preserved, in both the EU27 and the UK. A disruptive >>>

"Major financial service providers will want to retain a substantial presence in the UK as well as in the EU27."

- JOE CASSIDY

>>> Brexit will be bad for growth in both the EU27 and the UK.

It can be argued that life will go on much as before for major EU27 corporates, public sector entities and financial institutions. Providers of services currently located in the UK will find a way to continue providing services to them, for example by establishing subsidiaries in the EU27.

However, there are costs and risks here, the magnitude of which will depend on the nature of Brexit. Major financial service providers will want to retain a substantial presence in the UK as well as in the EU27, not least because the UK will remain a major international financial centre serving multiple time zones. This comes at a cost, both direct and through reduced economies of scale, netting opportunities and liquidity. Brexit will also restrict the benefits to EU27 users from investment in UK assets, from UK-based insurance, reinsurance and portfolio management services, and from the deep, liquid and efficient UK capital markets and financial market infrastructure that will not be easily replaced within the EU27. And there will be risks inherent in the re-booking of positions between group entities and in the re-configuration of complex supply chains.

These costs and risks can be minimised only if mutual interests are recognised through transitional arrangements and a broader continuation of the key inter-linkages between the EU27 and the UK.

Retail and SME users of financial services in the EU27 will see no obvious difference because they deal almost entirely with local financial institutions. Other than for UCITS, to a large extent the Single Market has not directly reached them. However, –these local products and services are underpinned by the UK's capital, interbank, insurance and reinsurance markets, and investment expertise, in order to be more efficient and effective. If Brexit reduces the momentum, expertise and opportunities of CMU, these users may benefit less than originally expected. ●

Sharon Bowles

Member, House of Lords

Are some equivalences more equal than others?

The implication of Brexit for the EU financial markets, like everything else, depends on the outcome of negotiations between the EU and the UK. If there is no significantly new arrangement other than existing EU equivalence provisions then there may not be the opportunity to develop a capital market zone of the sophistication and scale envisaged when the UK was expected to be a continuing member.

"Easy to imagine supervisory cooperation between the EU and UK: not so with the US."

- SHARON BOWLES

Some always preferred the idea of a smaller and more perfectly controlled capital market union, but under examination the wider version was seen to offer more financial clout, cheaper funding costs for economic actors, more

likelihood of reducing the reliance on bank lending and more dispersion of systemic risk. The dispersion of systemic risk out of the Eurozone would have added value by way of compensating for some of the inflexibility inherent in the rules based monetary union. Big capital market union is still possible, but now has more political baggage.

Estimates suggest over 75% of the EU's capital market business is conducted through the UK: you may quibble the precise number but they all come out big. Disentangling that which uses inbound passports from that requiring outbound passports, that which is unambiguously exempt, that which can be replaced by business model changes, that which could be covered by existing equivalence provisions and which way the equivalence works – because it often works to EU benefit - will be a major disruption to the EU as well as to the UK. Solutions that are being suggested at the moment tend to deal with large customers.

On both sides the SMEs will have to wait and may find there is some extra link in the chain that they have to pay for. Over time this might induce both further concentration of banking business in the EU and more aggressive competition from subsidiaries of third country banks in EU domestic markets: after all the extra costs have to be met somehow.

EU equivalence provisions are messy. There is a fuzzy compartmentalised logic of 'protect retail', 'assume prudential carve-out', and (somewhat grudgingly) 'recognise the global nature of wholesale markets and infrastructure'. The political discussions were often far away from the liberal nature of freedom of movement of capital with third countries foreseen in the Treaties. However, real business does not fit into the fuzzy compartments and with international standards developing for markets as well as banking, there is a case for wider equivalence provisions in general and especially with the UK. However difficult, given the shared history and regulatory frameworks it is easy to imagine supervisory cooperation between the EU and UK: not so with the US or any other global capital market. A continuing and intense supervisory cooperation would also be better geared to meet regulatory uncertainty or fragmentation generated under the Trump administration. ●

Levin Holle

Director General, Financial Market Policy, Federal Ministry of Finance, Germany

Managing transition

The United Kingdom's regrettable decision to leave the European Union undoubtedly represents a setback to the European integration process. However assuming that Brexit is irreversible, the EU27 now needs to look ahead and recognize this event as an opportunity to build a strong and resilient European financial market. A prudent management of the transition towards a new steady state will be crucial.

Also after Brexit, the UK will remain an important element of the global financial architecture and a close partner to the EU. Due to strong interconnections between both sides of the channel this partnership of mutual interest should be preserved as good as possible. However, the future relationship between UK and EU27 is far from being predictable. Clearly, this relationship has to be balanced: free access to the Single Market can only come with the full acceptance of all related obligations and keeping high regulatory and supervisory standards and equivalence cannot simply be taken for granted.

The persistent uncertainty is worrying for financial services providers focused on European business - some already have begun looking for alternative safe and stable locations in continental Europe in order to be able to maintain smooth business relations to their European clients. Moving elements from a highly integrated financial ecosystem such as London can trigger efficiency losses and thus have negative economic effects in the short term. In order to avoid disruption by cliff edge effects and to preserve financial stability, an orderly transition towards a new steady state is of top priority.

"After Brexit, the UK will remain an important element of the global financial architecture and a close partner to the EU."

- LEVIN HOLLE

However, from an EU27-perspective, Brexit should not be solely associated with downside risk: The EU27 has well-developed financial centres with sufficient capacity to absorb Brexit-related frictions in the medium term. Besides, this "external" event should encourage in the EU the necessary development of a stronger and more resilient capital market. ●

Stéphane Boujnah

Chief Executive Officer, Euronext N.V.

Brexit: an opportunity to strengthen Eurozone financial centers

In the wake of the Brexit decision, it is more critical than ever that the EU places the strengthening of European global competitiveness at the heart of its regulatory and policymaking agenda. In this sense, the response to Brexit in the remaining EU27 should be the further development of capital markets, given the need to maintain efficient markets as a cornerstone of economic growth, alongside a strengthening of overall market integrity and financial stability. In our view, these two overarching objectives require the following broad elements of policy and regulatory action.

Firstly, the EU must carefully consider the way market access between European and non-European capital markets is structured going forward. It is clearly in the interests of the EU to retain a model by which Europe is as open to global capital flows as possible. At the same time, the EU27 must use the new situation created by Brexit to build renewed financial centers on the continent, in particular in the Eurozone. Brexit provides an opportunity to reconsider the European approach taken to equivalence, particularly in respect of critical market infrastructure. The granting of equivalence with third country jurisdictions should not result in the emergence of unlevel playing field issues for European market infrastructure. Above all, an EU objective to ensure Euro denominated assets are cleared in the Eurozone is central to the objective of ensuring financial stability.

"The EU should use Brexit as an opportunity to move forward with further integration of the single market for financial services."

- STÉPHANE BOUJNAH

Secondly, the EU should use Brexit as an opportunity to move forward with further integration of the single market for financial services. While much of the EU's regulatory agenda over the last decade has sought to strengthen Europe's single rulebook, a continued strengthened focus on consistent supervision and enforcement of the rules is needed, in particular via ESMA. This is critical to avoid economic inefficiencies and the likely higher borrowing costs in the EU which would result from fragmentation of this single market. Euronext, as a pan-European market operator, will continue to support such developments from the perspective of its pan-European commercial strategy. ●

Sylvie Matherat

Chief Regulatory Officer and Member of the Management Board, Deutsche Bank

New European Financial Market needs clarity over transition

The intention of the UK to leave the EU is an unprecedented challenge in the recent history of the European construction and to its long-term dynamic of ever stronger integration. London is one of the leading financial markets in the world and will continue to be a global financial hub after Brexit as well. Nevertheless, the current debates suggest there is a real risk of a hard Brexit which could fundamentally affect the way the financial industry operates into and out of the UK.

In that scenario, the UK becomes a third country from an EU perspective and passporting would no longer apply. This would require financial institutions to identify an alternative location in the EU27 to continue servicing EU27 clients. As a consequence, activity and liquidity would be fragmented across various locations both inside and outside the EU.

The prospect of Brexit without new agreements on cross border trade in financial services also raises potential implications for the financial markets infrastructure underpinning European financial markets, namely the role and status of UK-based Central Counterparties ("CCPs") as well as the appropriate location for Euro denominated derivatives clearing which is currently highly concentrated in London.

It is strongly in the interests of all parties involved to safeguard financial stability and ensure undisrupted service provision to clients. Therefore, the industry needs clarity on transitional rules that would allow for grandfathering of existing arrangements. A clearly defined phasing-out is an essential prerequisite for stability and the avoidance of uncontrolled momentum.

Both the UK and EU27 should seek to establish a legal and regulatory environment which supports the strong economic position of the European region to allow it to be a respected player in the balance of power of the world economy and an attractive target for investments. While Brexit per se is an impediment to that, it is in the power of both negotiating parties to alleviate the negative consequences. Putting Europe first will involve keeping Europe open to international capital markets – including the UK. ●

Next Eurofi event
Tallin
13, 14 & 15 September 2017

Banking and insurance regulation

Content

Issues at stake

Regulatory work is underway globally aiming at making insurance companies and banks more resilient. The potential economic impact of proposed policy changes is however a matter for concern.

Many of these changes translate into higher capital and liquidity requirements which may reduce the ability of financial players to invest in the economy and support market liquidity, at a time when a diversification of financing sources is needed in the EU. Implementing international bank and insurance frameworks consistently with comparable outcomes across jurisdictions and alleviating their complexity for smaller institutions is an additional challenge, notably when it comes to preserving the risk sensitivity of these regulations. Business model changes, product design adjustments and digitalization may nevertheless help financial institutions to adapt to this new environment.

Progressing towards a single banking market

Contributors

Sylvie Goulard

MEP, ALDE Coordinator for the Economic
and Monetary Affairs Committee, European Parliament

Collectively designed, collectively implemented for the benefits of all?

Each supervisory system has its own weaknesses. We should face them in a humble way, above all when our own was created in the midst of a crisis. Reviews of legislation key to the functioning of the EU banking system were anyway due, such as the review of the European Supervisory Agencies or the review of CRR/CRD4.

Beyond this, we are living in time of uncertainties due to an unprepared Brexit, the election of a very confrontational Donald Trump keen to invent its own "truth" such as a permanent prediction that the EU will implode or that it would be good to "short the euro".

There are roughly two types of fragmentation. The first one is a consequence of the transitory existence of both the common currency and national currencies. The reluctance of the UK to further integrate banking regulation, supervision and resolution led to the creation of a Banking Union for the banks of the euro area and national authorities remaining in charge for members not using the euro. The decision of the UK to leave the EU will probably mean this fragmentation will slowly disappear. The in/out division will make less sense when only Denmark will enjoy a legal opt out from the euro, all other Member States being committed since their accession.

Institutional questions will have to be answered (such as a single supervisor for the markets).

The second one is trickier to address: the move from mainly national rules to EU rules, even though quite substantial lately, is progressive. National supervisors do still play a role in the daily supervision (even in the Banking Union) and national legislation not repealed by EU law still enables them to impose additional requirements. There might be some misunderstanding too of the motto "internationally active banks live globally, they may well die locally" often used by Mr Tarullo (ex-Federal Reserve). Since then, a comprehensive framework has been put in place in the EU with the BRRD and the SRM notably. It will soon be complemented by the TLAC, for the global aspect, and MREL for the European one. This is a significant change.

On the supervisory side, all supervisors should work in accordance with this new landscape. It requires supervisory convergence. The SSM is working hard according to its own words "to provide coherence, effectiveness and transparency regarding the supervisory policies that will be applied". The EBA has supervisory convergence at the heart of its founding tasks, with the limits imposed by the double majority system that appeared after.

Fundamentally action is required on the legislative side. The first one is a simple reminder: internal market legislation is an EU competence. It is legitimate for the European Commission to propose a legislation. Member States should only legislate in this field if the Commission fails to do so, or if it does not go against the internal market. Recently the interpretation of the treaties has been pretty lax. Secondly, it means seizing the review of CRR/CRD4, BRRD/SRM to keep only the national options and discretions that are >>>

>>> strictly necessary to reflect a legitimate local reality. It shall not in any case be to "protect" a local market from the turbulences a bank in difficulty could create.

We should not dream of all banks becoming active across the euro zone or the EU but we should not prevent cross border business (and a better allocation of capital) if they wish to. The euro zone and the Single Market are the best tool to diversify risks and to seize opportunities. Thus additional supervisory requirements such as an extra layer of capital or segregation designed to ring-fence national markets are detrimental. Extra requirements by national legislators or supervisors fail to recognise the new architecture and, more importantly, fail to recall the mistakes made during the 2008 crisis: opacity, complexity and fragmented supervision worsened the crisis. We all call on the gods of simplification or the divinities of better regulation but when the time comes to act according to the precepts we vanish. Let's agree that the system we have collectively designed must be collectively implemented in order to bring benefits for all. ●

Per Callesen

Governor, Danmarks Nationalbank

A couple of fragmentation issues in EU banking markets

Better EU financial integration can enhance competition and broaden the access to credit and new financial products. In addition, better integration would lead to enhanced risk diversification. Thus, the single market would benefit from eliminating legislative differences and harmonizing supervisory practices while avoiding over-harmonization. Improving insolvency procedures and incentivizing better diversification of holdings of sovereign debt would also be helpful.

Common rules are very helpful when they address similar challenges and business models, or if they are sufficiently nuanced to induce justified and comparable requirements and incentives where challenges and business models differ. That is sometimes difficult to achieve, and it implies a limit to the possibility of simplifying rules.

Common rules should not restrict the diversity of viable business models and products, and they should not prevent targeted action towards different situations. As an example, macroprudential measures should by design differ across countries when challenges differ, insisting on reciprocity.

The stock of outstanding non-performing loans (NPLs) is a challenging legacy issue. No simple solution exists, but more efficient insolvency procedures are indispensable. Insolvency rules, their enforcement and outcomes vary strongly between Member States. The magnitude of the problem is closely related to the degree of coverage by collateral and, not least, the ease of access to this collateral. Stronger creditor protection is needed and Members States should move towards best practices in this respect. The treatment of existing NPL's would send a strong signal about future practices to potential new lenders in a market.

Another issue in relation to the fragmented banking system in the EU is the strong national bias in the banks' holdings of sovereign debt. Currently, there is neither a direct requirement to capitalize against bank holdings of sovereign risk and its concentration nor a regulatory incentive to diversify sovereign risk.

This national bias is an aspect of the sovereign-bank nexus challenge, and it results in a limitation of risk diversification. But it may also be a factor holding back cross-border financial integration. Potential incoming cross-border banks may be reluctant to take ownership stakes in banks having such concentrated exposure. Potential outgoing cross-border banks may hold back such expansion if too constrained by domestic commitments. ●

Elke König

Chair, Single Resolution Board (SRB)

Has fragmentation in the Banking Union reduced and what further work is needed?

While fragmentation has undoubtedly decreased from a regulatory perspective since the implementation of the Banking Union, there still remain issues to address. Most of these issues are not rooted in financial regulation but have economic reasons and there is undoubtedly a divergence between Member States in the core and periphery.

The BRRD is a significant step towards harmonised crisis management across the EU, but significant work remains to be done, for example on insolvency law harmonisation, on subordination, on ensuring there are effective deposit guarantee schemes across the Banking Union and on EDIS.

Regarding the importance of insolvency laws, it should be remembered that when taking a decision to apply resolution tools, the resolution authority needs to carry out a counterfactual insolvency (NCWO) analysis. While the BRRD provides a basic creditor hierarchy current and proposed national laws have set priorities for similar creditors sometimes differently. A common creditor hierarchy across Member States would remove an important source of discrepancies impacting NCWO, make implementation of the resolution process easier, and improve market transparency and pricing of instruments. A clear European-wide solution in this area would be most welcome, and in this context we welcome the intention of the European co-legislators to take this file forward quickly.

As regards national discretion within the Banking Union, the SRB will work with national resolution authorities across the Banking Union to ensure that the different authorities also take a harmonised approach on the so-called Less Significant Institutions. It is important that resolution authorities are able to coordinate effectively, and there is not a wide divergence of practices across the Banking Union.

"While fragmentation has undoubtedly decreased ... there still remain issues to address."

- ELKE KÖNIG

Within the Banking Union, it is important to have a robust framework for determining the allocation of MREL within cross-border banking groups within the EU in a way that facilitates the resolution of these banking groups with the aim of preventing contagion in a crisis. An effective system for allocating internal MREL across different subsidiaries should reinforce financial stability within the EU, and align to the resolution strategy for the different banks. Internal TLAC sets the international standards for this area, helping to support international co-operation, and facilitating the resolution of G-SIBs.

There will always be differences across Member States. National policymaking on areas that fall within Member State prerogatives will naturally reflect the different preferences of national electorates. But the Banking Union reduces the level of fragmentation by providing for harmonised supervision and a harmonised resolution framework. However, a harmonised insolvency framework is still lacking, and while different Member States still have different insolvency systems fragmentation will remain an issue. ●

Edouard Fernandez-Bollo

Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

Completing the European banking union would help limit national discretions

In the aftermath of the crisis, the European banking union was designed as a way of enhancing financial stability on the continent. With the establishment of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), a major step forward has been done in this direction. This new institutional framework has already significantly improved the effectiveness of the single market for banking services, with the ultimate goal of establishing the Eurozone as a single geographic area. >>>

"The gradual implementation of these measures and the simultaneous suppression of specific national discretions on domestic subsidiaries would allow for of an increased integration of the Eurozone, and our aim should be to have it recognized as a single jurisdiction, also at international level."

- EDOUARD FERNANDEZ-BOLLO

>>> One natural consequence of this more integrated supervisory and resolution framework would be to help removing specific discretions currently applied by national legislators to ring-fence capital or liquidity, leading to a most efficient system of fluid circulation and centralized management of liquidity and capital inside the Eurozone. Achieving this key objective would of course be greatly helped if an operational compromise could be found at the legislators level to continue advancing also on the third Pillar of the Banking Union, the European deposit insurance scheme (EDIS) and the implementation of effective guarantee mechanisms. In the meantime, the SSM and the SRB should continue 1) to remove impediments in the Eurozone when they are in fact linked to the exercise of their competences, by demonstrating their capacity to reassure all the parties involved of the robustness of their approach. This for instance could cover the approach to intra group waivers internal MREL issues inside the Eurozone 2) to foster equally confidence with non Eurozone members to allow for more cooperative approaches among authorities.

The gradual implementation of these measures and the simultaneous suppression of specific national discretions on domestic subsidiaries would allow for of an increased integration of the Eurozone, and our aim should be to have it recognized as a single jurisdiction, also at international level. The review of the CRDIV currently under way is also a good opportunity to enhance supervision at the highest level of consolidation, in accordance with the principle of risk based supervision, and to couple it with advances in supervisory cooperation In light of the current international context, any additional step towards the recognition of the status of single jurisdiction at least for the Banking Union should be regarded as a highly desirable outcome by all Member States. ●

Download the Eurofi Malta Seminar App

malta2017.eurofi.net

Answer polls
Post comments and questions during the sessions
Check-out the list of speakers and contact attendees
Detailed programme and logistics information

HOW TO ACCESS THE MALTA SEMINAR APP?

Click on the link contained in the SMS you received after registration.

You can also access directly the App by entering this address (malta2017.eurofi.net) in the browser of your smartphone or by flashing the QR code of the App.

Future of EU banking business models

Contributors

Adam Farkas

Executive Director, European Banking Authority (EBA)

Changes in banks' business models are key to improving the EU banking sector

With significant dispersion across banks and countries, the main challenges for the EU banking sector seem to lie in low profitability, high non-performing loans and overreliance on the central bank funding. Going forward, banks should tackle these problems through an adaptation of their business models. For doing so in the most successful and efficient way they have to consider several factors, including the macroeconomic developments, regulatory changes, structural adjustments in the financial markets and advance in technology.

The first step in the process of banks' business model adaptation should be fixing their strategy. Banks' future strategy needs to take into account the potential prolongation of the current low interest rate environment, the pace of cleaning up of their balance sheets, the finalisation of Basel rules, as well as the possible future developments of the Capital Market Union. In the context of this strategy, banks should also re-assess their risk appetite. The most successful banks have to develop a risk strategy beyond regulatory compliance focusing on the overall business risk management. Besides their risk culture, banks need to properly shape their business culture, addressing both their customers as well as their employees.

The second step is related to signs of overbanking in some areas of the EU and improving efficiency in the whole EU banking sector. Besides rationalising and simplifying their business structures, banks need to focus more on the allocation of resources to activities that differentiate them from their competitors. Where the cost management measures do not increase return on equity (ROE) above a sustainable return, banks have to be open to consolidation through mergers or acquisitions, or be restructured or resolved.

Thirdly, with a fast growth of financial technology innovations, the way banks conduct business is changing significantly. Technological trends such as big data, block chain, cloud services, open banking and machine learning are not only automatising some processes like banking services, trading and underwriting, but they might also change whole methodologies, especially for risk underwriting. On the other hand, with generational shifts and rapid adoption of new technologies by consumers, financial technology is shaping the pallet of financial products and services banks offer to their customers and also changing the way their clients are approached. To compete with non-bank competitors, banks need to get closer to their customers by creating a complete virtual experience, potentially modifying the role of primary account providers.

Finally, the way synergies are captured depends on the operationalisation of the three processes mentioned above. Moreover, one should bear in mind that some of the opportunities may bring additional risks. This is especially the case when cost rationalisation and implementation of new technologies are carried out at the

>>>

>>> same time. Therefore, when revising their business models, banks need to find a balance between mandatory (regulatory) changes, changes to stay competitive also with the non-bank competitors and changes that banks are able to implement without taking on excessive additional risks.

The role of supervisors in the process above is clear. They are assessing and challenging, but not controlling banks' new business models and strategies through their business model analysis (BMA) in the Supervisory Review and Evaluation process (SREP). The EBA has developed an approach to BMA making it one of the key elements of the common SREP framework introduced in its Guidelines on common procedures and methodologies for SREP issued in 2014. Through BMA, competent authorities will develop a view of (a) the current business model of the supervised institution, and its viability; and, (b) how the business model may evolve as a result of strategic choices made by the institution and/or the impact of changes to the business environment in which it operates, and therefore its sustainability; both should improve supervisory practices as well as the health of the EU banking system.

To summarise, the adaptation of banks' business models is essential for establishing an efficient and, above all, sustainable EU banking sector. For ensuring that the process doesn't have systemic implications and is without consequences for most the most vulnerable stakeholders, depositors, supervisors will conduct BMA in their regular supervisory process. Even though one can only assume how this process will shape the current EU banking sector, the ultimate result may be a reduction of number of banks, yet a more effective and competitive banking sector. ●

Tim Sykes

Vice Chairman Global Banking, HSBC

The EU banking sector: the challenges ahead

There are two types of challenges for EU banks: the environment in which they operate and how their operations are structured.

The list of issues with the operating environment is long. A lack of underlying economic growth. Persistently low interest rates. Low demand for credit. Legacy portfolios of non-performing loans. Full implementation of post-crisis reforms. Revised risk weights. Higher capital requirements. Stress-tests and asset quality reviews. CRR2 with binding leverage requirements, long term stable funding requirements and the results of the Fundamental Review of the Trading Book. IFRS 9, maybe with a transition period. The prospect of further changes from the final Basel 3 package. TLAC and MREL requirements. The continued threat of an FTT. And, of course, Brexit and Donald Trump.

And these issues are compounded by an equally long list of issues with the nature of bank operations. If you're British, there is ring-fencing of retail banking and a competition inquiry. If you're French, ring-fencing of proprietary trading. The implementation of MiFID 2. Continued data sharing issues. AML processes and enhanced KYC requirements. Payments Services Directive 2. Distribution through new channels – telephone, mobile, internet, tablet. The demise of the branch network. The disintermediation by non-bank entities. And even the rise of robots and robo-advice.

It is clear, therefore, that many aspects of banking will change in the next few years. But which banks will adapt best to the new environment - there are some essentials to look for. >>>

>>> Franchise – Is there underlying value in the firm? Does it cover sectors or geographies with good economic prospects? Does it have customers who want to deal with it – and pay for the services they get? Does it have the market share to be efficient and effective?

Capacity – Does the firm have short term financial capacity in terms of capital, liquidity and funding? Does it have any room for manoeuvre? Can it generate further capacity from the franchise in the longer term?

Understanding – Does the bank understand the issue which it faces, or has it buried it's head in the sand? Does it realise that change is necessary?

Leadership – Above all, does it have the leadership to take the firm on what is often a difficult journey? Are those leaders prepared to take hard decisions based on imperfect information? Can they adapt as circumstances change?

Ultimately, if firms don't change to reflect these issues, they will not be self-sustaining. Operating costs may be too high given low margins and volume of business and a shrinking capital base will not support any growth. For some firms, this is already reflected in share prices with some price-to-book ratios consistently below 1x. Ultimately, the stakeholders will have to step in and, generally, they have two options: invest or sell. But industry consolidation seems to be difficult. Do we need to address this sooner rather than later, so that we have an industry ready to support the recovery when it comes? ●

José Manuel González-Páramo

Executive Board Member, Banco Bilbao Vizcaya Argentaria (BBVA)

Digital banking: a holistic regulatory and supervisory approach

There is no way back in the revolution of financial services, and this forces us to reinvent banking. For more than 500 years, banks have acted as intermediaries, channelling resources from savers to entrepreneurs willing to realize their projects, but nowadays, the banking institution faces an existential crisis due to its exposure to overwhelming forces of different natures: economic, financial, regulatory and reputational challenges have converged with the digital revolution to create a perfect storm.

Still, the digital disruption may turn out to help the healthiest part of the sector to thrive under the pressures of low growth, waning profitability and dense regulation. In fact, digitisation is an opportunity for the financial sector to improve efficiency, manage risks better, provide more value to clients and solidly re-establish trust from its customers and reputation among society. Nevertheless, this digital revolution raises, at the same time, new challenges: first, increased competition from new digital players – so-called FinTechs and BigTechs. Second, new technologies, such as cloud computing, artificial intelligence and blockchain, will revolutionise how banking itself is performed.

To strike a balance between promoting the new digital value propositions and protecting against the risks involved, the new regulatory and supervisory paradigm needs a holistic approach, since the aim is to safeguard the stability of the financial system and to protect consumers by ensuring that >>>

>>> the vital economic function of the banking sector is not seriously disrupted.

In this context, financial regulators and supervisors could play an essential role, by focusing their efforts on three dimensions: 1) ensuring a level playing field between incumbents and newcomers, so that same services receive the same regulatory treatment, regardless of the provider; 2) promoting a harmonized framework across geographies, thus paving the way for increasing cross-border supply and demand of financial services and overcoming existing market fragmentation; 3) providing effective supervision taking into account how the industry intends to use emerging technologies.

At the current stage of development of the new digital era, collaboration and communication among all stakeholders is vital. This requires a breadth of vision from both the public and private sectors, and a compromise on solutions that is consistent with the innovation life-cycle. The private sector must define policies on the control and monitoring of regulatory compliance risks (cybersecurity, data protection, etc.) associated to new value propositions, while the authorities should provide a specific channel for the resolution of regulatory uncertainty or solutions to limit excessive early-stage burdens, with a limited scope and in a defined time period, and develop appropriate environments for experimentation (for instance, regulatory sandboxes).

An ecosystem in which suppliers and authorities are in permanent contact will enable an up-to-date regulatory and supervisory framework which will facilitate innovation, while addressing risks as effectively as possible. This will allow financial institutions to innovate without fear and make progress towards the transformation that the sector direly needs. ●

Alain Laurin

Associate Managing Director, Moody's Investors Service Limited

The regulatory landscape and new technologies challenge banks' business models

European banks are faced with numerous structural challenges which are complicated by the backdrop of interest rates and subdued growth throughout much of Europe.

We are seeing material changes in banks' business models driven, amongst other factors, by digitalisation and a regulatory framework which is not yet stabilized. Predicting how these factors will affect banks' activities going forward is difficult because both are broader than they appear at first glance.

The regulatory framework encompasses not only the rules that banks have to abide by, many of which have already been enforced, but also the supervision undertaken by the European Central Bank (ECB), which has important implications for banks.

Recent years have seen the roll-out of the global and European banking regulation agenda, including Basel III, Total Loss-Absorbing Capacity (TLAC) requirements and the Bank Recovery and Resolution Directive (BRRD), to name but a few. Based on recent statements from the official sector from both the EU and the US, it seems that the work of the BCBS on capital ratio requirements is challenged both with respect to its process, allegedly characterized as secretive and lacking accountability, and because of its one-size-fits-all approach. Regional and national jurisdictions often claim that rules should be customized to their specific needs, which may eventually distort the level playing field.

For example, the changes proposed by the BCBS under the Basel IV framework would reduce reliance on banks' internal modelling, which could penalize more EU banks than US banks, which explain the difficulties experienced to strike a deal.

Even as the European authorities push to complete the regulatory agenda, banks will still be under pressure from a more intrusive approach to supervision adopted by the ECB. For example, its Single Supervisory Mechanism (SSM) recently issued comprehensive guidance on the management of non-performing loans and launched its targeted review of internal models (TRIM) project to assess and enhance the credibility of banks' modelling tools.

EU banking supervision efficacy is still hampered by national variations of policy frameworks. A lack of consensus amongst EU countries may also delay progress towards a unified and operational Banking Union. Benefits will only be realised after a long and complex phase-in process, with all critical reform elements developed, nationally transposed with minimum national deviations, and fully enforced.

Meanwhile, banks must adapt to the new digital environment in which expectations of customers are shaped by developments in other industries, which means shifting to faster and bespoke solutions. Many banks have undertaken multi-year digital programmes along with cost-cutting plans to address operational deficiencies and digitize banks' processes and services. The upfront infrastructure costs will take place before long-term savings, if any, can be achieved. In this respect, not all banks will be able to cope with the digital challenges in the same way, potentially weighing more heavily on smaller banks. We are also observing a significant reduction in the number of bank branches in some European countries where reliance on physical presence has become less relevant while other countries seem to be lagging as they sometimes are pursing less aggressive strategies towards the reduction of branches.

Against these challenges faced by European banks, we expect more mergers in fragmented systems, while cross-border mergers, despite European authorities' support, may prove to be difficult to achieve as national governments are often inclined to protect their domestic market/players. ●

Korbinian Ibel

Director General, DG Micro-Prudential Supervision IV, European Central Bank (ECB)

ECB Banking Supervision addresses key risks faced by the euro area banking system

ECB Banking Supervision, in cooperation with national supervisors, constantly works on the identification and assessment of risks that may affect the euro area banking system and need to be addressed by supervisory actions. For 2017, a number of risk drivers will require close monitoring and continuous analysis by the Single Supervisory Mechanism (SSM).

Despite an improvement in asset quality, with non-performing loan (NPL) ratios decreasing from 7.3% to 6.5% in 2016-Q3 year on year, high stocks of NPLs remain a concern for a number of euro area countries. This is particularly the case for Greece (NPL ratio 47% in 2016-Q3), Cyprus (40%), Portugal (20%), Ireland (18%), Slovenia (17%) and Italy (16%)[1]. Amid already weak banking sector profitability, a high level of NPLs may lead to further losses for banks by triggering additional impairments and can hinder new credit creation. After the publication of an ECB guidance on NPLs to banks, a dedicated SSM NPL task force continues to support Joint Supervisory Teams with follow-up actions.

The low and for certain maturities negative interest rate environment affects banks' profitability. While the overall profitability of euro area banks remained relatively stable in 2015 and 2016, it is still low by historical standards with an average return on equity of 5.4% which is below the cost of equity. However, some banks have constantly outperformed their peers in recent years. A common feature of these banks is a lower cost-income ratio than the average that is currently at 64.2%[2]. Improving cost efficiency may therefore be one means of addressing challenges. It should be emphasised though that not all cost reductions are welcome from a supervisory perspective, e.g. the observed increase in IT costs in recent years could be a positive sign for addressing operational risk and investing in additional services to generate future income. Nonetheless, persistently high cost structures as observed for some banks which have low profitability ratios paired with high operating costs remain a concern. The ECB has started conducting a thematic review comprising all Significant Institutions under its supervision to assess banks' business models and profitability drivers.

Finally, euro area banks are not immune to other risk drivers such as weak economic conditions, a sudden reversal of risk premia that could impact asset valuations and funding costs, cybercrime and IT disruptions, misconduct, or growing non-bank competition. Such risks, materialising in fragile – albeit improving – market and economic conditions may have the potential to create destabilising forces.

Based on the key risks identified, ECB Banking Supervision has set its Supervisory Priorities for 2017. The three priority areas for 2017 are: 1. business models and profitability drivers; 2. credit risk, with a focus on NPLs and concentrations; 3. risk management. While main initiatives for the first two priority areas have been mentioned above, essential activities within the third priority area include targeted reviews of internal models and an initiative to improve banks' internal assessment processes for adequacy of capital and liquidity. ●

1. Source: ECB Supervisory Banking Statistics Q3 2016, pp 70-71.
2. Source: ECB Supervisory Banking Statistics Q3 2016, p 19. A country breakdown of key performance indicators by SSM countries is available on p 20 of the same document.

Martin Merlin

Director, Regulation and Prudential Supervision of Financial Institutions, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Proportionality in the CRR II / CRD V Review Proposal

In November 2016, the European Commission came forward with an EU Banking Reform package to reduce risk in the banking sector and support financing of the wider economy.

The proposal of the Commission brings significant enhancements to the EU bank prudential and resolution frameworks. It introduces, among other measures, global standards that were recently agreed upon at international level, with limited adjustments to take into account the specificities of the European economy. The leverage ratio, the net stable funding ratio (NSFR), the new market risk standard (the so-called Fundamental Review of the Trading Book, FRTB) discussed in the Basel Committee and the total loss-absorbing capacity (TLAC) standard issued by the Financial Stability Board are the most important examples.

As we complete our regulatory framework with additional risk reduction measures, we also want to make it more proportionate. Standards discussed >>>

>>> in the Basel Committee are meant to apply to large, international banks. In the EU, we choose to apply prudential standards consistently to all banks. This approach implies that our requirements must include elements of flexibility that allow for a sensible, proportionate application to banks of very different sizes, with various degrees of operational complexity, different business models and risk profiles. Moreover, the administrative costs and the compliance burden caused by regulation, which disproportionately affect smaller banks, were the most important tissues raised in the Call for Evidence we organised last year.

For all these reasons, proportionality considerations feature highly in the Banking Reform package presented at the end of last year. For smaller banks, we propose to reduce the supervisory reporting burden and disclosure requirements. We also make sure that, where we propose new, more complex methods to calculate capital requirements, we provide simple alternatives for banks that cannot cope with these sophisticated approaches. In the new market risk standard, banks with limited trading activities can continue using the current standardised approach rather than adopting the much more complex FRTB standard. Banks with even smaller trading books can benefit from an exemption and apply banking book capital requirements. When it comes to counterparty credit risk, we decided to keep the simple original exposure method (OEM) available to banks with limited derivative activities as an alternative to the new standardised approach (SA-CCR). Proportionality elements were also introduced in remuneration rules.

"Proportionality considerations feature highly in the Banking Reform package."

- MARTIN MERLIN

However, simpler rules do not have to be less stringent rules. Where we introduced elements of proportionality in our proposal, we always made sure to stick to high prudential standards.

Beyond the legislative proposal issued last year, important prudential topics such as the revision of the credit risk and operational risk frameworks are still under discussion at international level. To the extent that an agreement can be found, the European Commission will ensure that the transposition of these standards into EU law is done in a proportionate manner so as to preserve the diversity of the EU banking system. ●

Edouard Fernandez-Bollo

Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

The case for proportionality: Managing to foster both the diversity and the integrity of the single market

The regulatory actions implemented over the last eight years came as immediate responses to the global systemic crisis. On the brink of major turmoil and with a sense of emergency, regulations have expanded. Undoubtedly these recent efforts have led to a more robust and resilient financial system but have also exacerbated the challenges in applying regulation, in light of its complexity. Recent trends in the institutional framework (e.g. the reinforcement of the Banking Union) and market developments in the area of Fintechs for instance, have urged the regulators to address the challenge of adapting regulation to the diversity of existing and emerging actors while fostering a safe level playing field.

For prudential requirements to fully reap their positive long term benefits on financial system, the introduction of proportionality is necessary to preserve the diversity of business models within the EU and to facilitate the emergence of new actors meeting new needs. The simplification of administrative or compliance requirements, under appropriate safeguards, aims at reducing disproportionate costs.

The challenge lies in managing to operate this simplification whilst maintaining both high prudential standards and a sectorial as well as geographical level playing field.

Proportionality should not be regarded as a possibility for specific actors to be automatically exempted from prudential requirements. Indeed their reduced size or scope of activity do not necessarily induce a lower risk profile, while their resilience capacity may be more limited. Past events in the European context have shown that the failure of relatively small banks can significantly damage the confidence over the banking system. Furthermore for newcomers (e.g. online banks or crowdfunding platforms) adequate regulation helps promote sounder and healthier business models, while avoiding competition distortion and regulatory arbitrage.

Therefore, combining the objectives of financial stability, cost efficiency and simplicity relies on a two prong approach. On the one hand, future prudential regulation should enable supervisors to tailor their monitoring and enforcement of requirements according to institutions' effective risk profiles. This requires preserving risk-sensitivity in prudential standards, thereby keeping the incentive for financial actors to actively manage their risks, and further developing a harmonized supervision to reflect and nurture the integration of the internal market. On the other hand, solutions to lower administrative burden for intended actors may be implemented: intensifying the use of thresholds triggering exemptions or lower granularity of reporting or disclosure requirement, opting for simplified risk measurement approaches or introducing exemptions on remuneration requirements for instance.

Furthermore, the effectiveness of supervision will be best supported by a "risk-based supervision" in a comprehensive regulatory framework, which will enable the supervisor and the industry to adapt the resources by targeting the most relevant risks. ●

Dr. Karl-Peter Schackmann-Fallis

Executive Member of the Board, Deutscher Sparkassen- und Giroverband (DSGV)

European retail banks under pressure

European retail banks with a traditional business model, such as the German Savings Banks and Landesbanks, are currently facing enormous challenges resulting from the ECB's low interest rate policy, an increased regulatory burden as well as rising cost pressure. The low interest rate environment hits Savings Banks particularly hard, since they have traditionally been generating most of their profit from interest rate related business. European bank regulation largely following a one-size-fits-all approach plays its part in increasing the load for retail banks complemented by other factors, such as the overall economic context and changing dynamics in global politics.

"These factors negatively affecting banks will also have a serious impact on SMEs."

- DR. KARL-PETER SCHACKMANN-FALLIS

As the European economy traditionally predominantly relies on bank financing – and that for good reasons – , all these factors negatively affecting banks will also have a serious impact on SMEs being the backbone of the European real economy. Therefore, European monetary policy should be normalised as soon as possible, while this is still possible, since the attempt to resolve serious economic problems through increasing liquidity and low or even negative interest rates should be considered to have failed.

Moreover, a differentiated approach to banking regulation in the sense of a Small and Simple Banking Box should be considered in order to ensure that simple, small and medium-sized European retail banks can continue to serve the real economy instead of having to dedicate a far too large extent of their resources to complying with regulation. Finally, the benefits of digitalisation should be used to increase profitability and competitiveness by reducing expenses and to innovate, thereby adapting to clients' changing expectations and a dynamic external environment.

Regulatory initiatives such as the European Commission's initiatives promoted under the umbrella of the Capital Markets Union can successfully complement traditional European bank financing and create new dynamics and growth potential, as long as they also strengthen banks' lending capacity, as for example the proposed supporting factors lowering risk weights on SME and infrastructure exposures. ●

Luigi Federico Signorini

Deputy Governor and Member of the Governing Board, Bank of Italy

Bank business models in the EU: dealing with the past, planning for the future

Doing business in the European banking sector has become increasingly challenging. Many banks suffer from low and declining profitability due to a combination of factors, some common to all EU banking systems and some idiosyncratic. To some extent the difficulties have common sources: in most EU countries the financial cycle has not yet fully recovered and credit activity remains subdued; the low interest rate environment has depressed banks' margins; regulatory reforms post financial crisis have increased bank costs, due to more demanding capital requirements, less room for banks to exploit leverage, and stronger constraints on their organizational structure. But there are also specific factors that can account for existing cross-country discrepancies in banks' performances. Cyclical positions vary across EU member States and lending volumes in some banking systems are expanding due to stronger economic growth prospects. Legacy problems inherited from the crisis differ across national banking systems, reflecting different timing and impact of the crisis across business models, different policy responses, structural differences in legal, tax and judicial systems affecting the efficiency and speed of recovery of non performing exposures. There is also wide variety in cost/asset ratios and in capacity indicators.

To face current challenges EU banks need to adjust their business models, cutting costs and improving operative efficiency. Banks can reorganize their internal operations and streamline their traditional retail channels by exploiting automation and data processing techniques. Banks face increasing competition from fintech firms that are expanding in financial markets activities such as asset management, investment advisory, securities dealership and brokerage, as well as in lending activities, through lending based crowd-funding platforms. To succeed in this contest banks need to combine their core skills with the new technological environment and apply their expertise to take advantage of business opportunities, for instance through portfolio diversification and origination and distribution of these platforms. ●

Paul Hilbers

Director Financial Stability,
De Nederlandsche Bank

Banks' business models – a view on future challenges

One of the important lessons that DNB has drawn from the financial crisis, is that supervision should be more forward looking. Therefore, we have altered our supervision in three ways. First, we have increased our focus on macroprudential developments and in particular the interlinkages between financial markets, the real economy and financial institutions. Second, we pay more attention to behavior and culture in financial institutions. And third, we have increased our focus on assessing banks' business models. In doing so, we obtain more insight in the risks that banks are likely to encounter in the future. All this is in addition to the more traditional forms of supervision focused on capital, liquidity and leverage in the financial sector, which still form the cornerstone of our work.

As regards banks' business models, we see a number of key challenges that merit our attention. First, there are developments in financial technology (Fintech). Fintech will have an impact on banks' current activities, such as payment services, credit supply and investments. If banks do not keep pace with Fintech developments, this will put their business models under pressure. As regulator, DNB tries to stay ahead of the curve, for instance through creating a regulatory sandbox for Fintech companies.

Second, there are regulatory developments that affect banks' business models. Liquidity measures have had an impact on the maturity structure of assets and liabilities. Other regulatory initiatives such as the fundamental review of the trading book, the leverage ratio requirement or increased risk weights have also had an impact on business models. Also the recent Mortgage Credit Directive has a potentially large impact on business models of banks' in Europe. Third, there is the current macroeconomic environment, characterized by low interest rates. Dutch banks are relatively dependent on their interest rate income. This means that if the low-interest rate environment persists, this business model could come under pressure.

Banks are thus faced with a number of key challenges with regard to their strategies, and this is of course important to regulators and supervisors as well. That is why we discuss business models and strategies with the banking industry. In this regard, the post-crisis regulatory changes are of course important, as well as changes in the macroeconomic environment, but in the end the structural developments in the sector driven by the changing technological environment may have a more lasting impact, and therefore deserve special attention both from the industry and the regulatory and supervisory community. ●

NEXT EUROFI EVENT

The Eurofi Financial Forum 2017

13, 14 & 15 September

Forum organised in association
with the Estonian EU Council Presidency

Tallinn - **Estonia**

CRR II / CRD V progress

Contributors

Elisa Ferreira

Member of the Board of Directors, Bank of Portugal

Financial reform in the EU and challenges still ahead

The financial crisis that unfolded in 2007 and 2008 paved the way for significant reforms of the regulatory framework at EU level with the purpose of making the banking sector more resilient, with the ultimate goal of enhancing financial stability.

One of the challenges faced by the EU legislators is how to strike the right balance between an increase in institutions' resilience and the possible costs to economic growth resulting from new requirements, in particular when their impact flows through the lending channel. This requires a proper and well-substantiated calibration of the policies to be adopted.

In this context, bearing in mind that Basel standards are originally designed to be applied to internationally active banks, it is of utmost importance that in their adoption at EU level the diversity of both the institutions for which policies are intended and the markets where they act is not overlooked, but never at the expense of fragmentation of the EU internal market.

In this vein, proportionality appears as a principle of Better Regulation, placing responsibility on legislators to design proper frameworks with simpler rules to be applied to smaller, less complex and non-systemic institutions without compromising the robustness of the prudential regime and without creating different tiers of institutions competing in the single market. This can go beyond simpler reporting and disclosure requirements. This challenging task should not only fall to the EU legislators. The ESAs ought to be ready to leverage their experience and continue to advise on this matter.

Additionally, while recognising that supervisors' tasks require some degree of flexibility, the experience acquired with CRR/CRD IV has shown that discretion should be clearly framed in order to increase predictability for institutions and other stakeholders. This implies requiring supervisors' judgment to follow transparent criteria leading to a consistent application of rules, considering not only the impact of decisions on institutions but also more broadly on the financial stability of a Member State or of the EU as a whole.

In its recent proposal amending the CRR/CRD IV, the Commission suggests some important options to address these issues, such as the possibility of using simplified methods for computing certain capital requirements and, as regards Pillar 2, introducing proposals to better frame supervisors' practices across the EU. The legislative process should aim at improving those proposals. This is an important step towards making international standards more commensurate to the EU's current diversity without compromising resilience and integration in the internal market.

However, a resilient EU banking sector should also rely on other Pillars apart from a robust prudential framework. A fully-fledged banking union is yet to become a reality. The EDIS proposal was put forward by the Commission in 2015 and no agreement has been reached so far. The CRR/CRD IV legislative proposal should give a new impetus to this negotiation and allow it to come to a successful conclusion. >>>

>>> Also, there is a clear need to strengthen the current EU safety nets as a last backstop resource. This goal should be achieved by giving more flexibility to existing instruments to be used within a resolution context. In order to provide resolution authorities with the necessary flexibility to ensure the successful implementation of a resolution strategy and the pursuit of the resolution objectives, the financing of resolution action, particularly the conditions for the use of resolution funds, must be revised at EU level.

Lastly, a word on the Basel Committee's work to finalise its post-crisis reforms, focusing on reducing the excessive variability in risk-weighted assets and on increasing comparability between institutions. It is crucial to ensure that this work is successfully completed and properly implemented in the EU in order to prevent attempts to weaken the achievements made in recent years.

Ultimately, the merits of these reforms should be assessed, but a period of regulatory certainty and stability would then be necessary to allow these reforms to be properly implemented. ●

Philippe Bordenave

Chief Operating Officer, BNP Paribas

Global financial standards need to achieve the same outcomes across jurisdictions. Calibration should fit local specificities.

It is essential that international financial regulation ensures financial stability at global level and within each major region. But attaining this goal does not mean having the same rules everywhere, or the exact same calibration. Rather, the rules should aim at achieving the same regulatory outcomes. Divergence from international standards occurs when regulatory impacts are not the intended ones, not when calibration differs. Respecting this distinction is of the utmost importance in order to be able to take into account the specificities of each region.

The CRR II/ CRD V package is in itself an important signal that Europe is committed to international regulation, but those rules must be implemented in a manner that makes the EU banking sector stronger, not weaker, and enables it to continue to support economic growth and employment.

Rules impacting Capital Markets activities should also be calibrated in a way that would not hamper the development of the Capital Market Union, as this project is critical to reduce the reliance on bank funding in Europe.

Finally, the European authorities should monitor closely the implementation of those Basel regulations by other jurisdictions, notably the US, to avoid putting European banks at a competitive disadvantage in the regional and global landscape.

In this context, BNP Paribas welcomes the "targeted adjustments" made by the European Commission, but I believe there is room to go further in some areas.

The Commission has proposed a number of adjustments, in particular a more powerful SME supporting factor, a new infrastructure supporting factor, the recognition that the most liquid assets do not require LT funding. Many of those adjustments >>>

>>> are driven by the results of the Call for Evidence, which helped identifying unintended consequences of existing and proposed regulations. This is encouraging.

Some proposed adjustments are also the signal that the BCBS standard is not satisfactory, or in many cases, not yet finalized: P&L attribution tests and Non Modellable Risk Factors for FRTB, treatment of derivatives for NSFR, G-SIB leverage surcharge, prudential impact of IFRS 9, are major pieces still under discussion in Basel, because initial proposals are now recognized as inadequate. In my view, rather than proposing alternatives or temporary relief, such as in the case of FRTB, the EU should rather postpone transposing international regulations until they have been stabilized.

All in all, the adjustments are targeted to foster EU main policy goals; however, they fall short of compensating for the structural differences in banks' balance-sheets and in market structure between Europe and the US, and rules are evidently over-transposed in some key respects. One example already in force is the need to comply with the LCR at entity, rather than only at consolidated level, which mechanically increases large banks' liquidity buffers by around 10 pp. This explains why European banks have an average LCR of 130%, much above the theoretical minimum, at the expense of other productive uses of cash such as lending. The same goldplating is being proposed for the NSFR ratio. And global European banks, contrary to their foreign peers, may have to comply with both TLAC and MREL requirements.

The BCBS and EBA impact studies suggest that the capital and liquidity shortfalls related to those new pieces of regulation are limited. These impact studies are based on overly optimistic assumptions and thus do not reflect reality, whether in the present or in the future. Also they don't capture the true impact of these rules on Capital Market businesses, and on end-users such as sovereigns and non-financial corporates:

- In the case of FRTB, the 40% average increase estimated by Basel assumes that all desks will pass the tests to qualify for internal models, an extremely optimistic assumption
- In the case of NSFR, the absence of reported shortfall hides the fact that banks currently benefit from a total outstanding of 550bn€ of ECB long term refinancing operations, an extraordinary provision of liquidity which should not be deemed permanent.

Even if the target is reached at the bank level, Capital Markets business lines generate a significant marginal shortfall, which will either have to be priced in to their clients or lead to a reduction of the activity. This will be a major impediment to the development of the CMU.

Worse, as there is currently no timetable for the US to implement the NSFR nor the FRTB, the EU will provide US investment banks with a critical competitive advantage, whereas their market share of European Capital Markets has grown regularly during the last years and has already reached more than 50%.

It should be noted that the health of the European Capital Markets is very important for all EU Member States, including those who may not have domestic investment banks. That is precisely because their access to markets is granted not by domestic, but by foreign banks. If the regulatory treatment under FRTB, NSFR, and leverage is such that maintaining a market making activity on smaller and less liquid sovereign or corporate debts becomes unaffordable, those countries may be the first to suffer.

Were the international standards properly designed as "minimum requirements" and fitted to the broad range of jurisdictions that are G20 or Basel member countries, there would not be a need to deviate significantly. But, post-crisis Basel regulations have been designed to fit a specific financing model largely based on capital markets and government support to residential lending. This is a misfit not only for Europe, but also for Asia and for emerging markets where banks, including international banks, provide the vast majority of the funding to their economies.

In this context, as long as the purpose of addressing financial stability goals is not threatened, it is perfectly legitimate to adjust those rules, when they are detrimental to the financing of the economy, as underlined by a recent European Commission study . With the ongoing review of CRR 2 / CRD 5, Europe has the opportunity to go further in that direction, in order to promote growth and employment. It must not miss it. ●

Dr. Andreas Dombret

Member of the Executive Board,
Deutsche Bundesbank

Preserving a level playing field for international banks will be key

Only by committing to a level playing field across jurisdictions will we be able to effectively curb regulatory arbitrage and stop a potential regulatory race to the bottom, which ultimately promotes global financial stability. It is therefore essential that we have global standards for internationally active financial institutions. But these are only meaningful when they are consistently implemented by the competent national authorities. Therefore, a thorough implementation of the Basel III framework, in the European Union and elsewhere, is of utmost importance.

The European Commission's proposal to implement elements of Basel III in a new CRR II and CRD V is therefore welcome. It includes several key aspects of the Basel III package, such as the binding leverage ratio and the net stable funding ratio. In addition, it introduces market risk reforms, i.e. the Fundamental Review of the Trading Book. This toolkit will effectively counter excessive lending and increase the resilience of banks to funding constraints. Overall, I am convinced that regulatory reforms will strengthen the European banking system, thereby improving market confidence.

"A thorough implementation of the Basel III framework is of utmost importance."

- DR. ANDREAS DOMBRET

Prudent regulation, however, must be mindful of the fact that the Basel III rules were designed to fit the organisational structures and business models of big international banks. This stands to reason given the tremendous systemic importance of these institutions. To a considerable extent, however, the European banking sector consists of small and medium-sized banks with simple business models. Moreover, many of these institutions have a local or regional focus and do not engage in complex, cross-border transactions. It would be disproportionate to burden these institutions with the full set of rules aimed at reining in internationally active banks.

This is why regulatory reforms – at least in my view - need to be guided by the principle of proportionality, which complements the goal of financial stability. The Commission's proposal to adapt the CRR and CRD therefore rightly takes into account the specific characteristics of the European banking sector with respect to the size and complexity of financial institutions. For example, it allows banks with limited trading activities to apply simpler methods of calculating capital requirements for market risk and counterparty credit risk. In view of market risk, the Commission has proposed the simplified standardised approach. It would allow institutions with limited activities under the market risk capital requirements (less than EUR 300 million and under 10% of a bank's total assets) to use the current standardised approach.

While proportionality is a material aspect in doing justice to the diversity of the European banking landscape, it must not compromise the playing field on a global level. Only by consistently implementing the above reforms for the prudential supervision of internationally active banks can Europe set an example of effective international cooperation and encourage others to follow. ●

Dr. Johannes-Jörg Riegler

President, Association of German Public Banks (Bundesverband Öffentlicher Banken Deutschlands – "VÖB") & Chairman of the Management Board, BayernLB

CRD V – stable banking regulation promotes financial stability

The financial crisis of 2008 directly triggered the desire for stricter regulation of banks, in order to strengthen the resilience of financial markets during times of crisis. This goal was – and remains – correct, not least in order to protect taxpayers against financial liabilities caused by misconduct in the banking business. With its Basel III regulation package adopted in 2010, the Basel Committee on Banking Supervision (BCBS) set a key milestone in this reform project. The integral components of the Basel III framework are markedly higher equity capital requirements (in parallel with a stricter equity definition), the Leverage Ratio, as well as new and stricter regulatory liquidity indicators.

Basel III was implemented in the EU through the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR); >>>

>>> these two legislative acts were adopted in 2013 and must be applied throughout all member states. On 23 November 2016, the European Commission submitted its proposals for a revision of these regulations. As the President of a banking association and CEO of a major German bank, I generally take a positive view regarding plans to implement current regulatory developments by way of amendments to the CRD and CRR. I recognise the necessity of establishing a stable regulatory framework through clearly-defined rules and requirements. This is the only way for institutions to continue their existing sustainable and profitable business strategies, or to establish such strategic approaches. However, based on an initial assessment of the submitted drafts for CRD V and CRR II, the proposals are not always in line with the set objective.

"Regulation follows the principles of proportionality and materiality."

- DR. JOHANNES-JÖRG RIEGLER

As banks, our primary role is to provide a service to private individuals, businesses, and the public sector. To be able to sustain our competitive position vis-à-vis international banks, it is crucially important for us that regulatory requirements are applicable to all parties involved. Provided that regulation follows the principles of proportionality and materiality, and that it is implemented with a sense of perspective, CRD V and CRR II will further promote and strengthen financial stability in the EU. ●

Märten Ross

Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, Estonia

It is important to balance banks' supportive role to the economy with longer term financial stability concerns.

Given the post-crisis challenges to achieve sustainable economic growth,

the calibration and the right balance of the new rules for banks are important for the whole Europe. CRR II/CRD V package should ensure or even increase the competiveness of Europe through more sound and competitive financial sector.

Progress made towards creating the first pillars of the banking union and developing a single rulebook have already reduced the risks of the European banking sector. However, further fine-tuning (stemming from international agreements, peculiarities of EU financial sector and needs from wider economy) is needed. In that context the main elements of the package i.e. stronger leverage ratio, well calibrated MREL given the agreement on the TLAC, more balanced approach in home-host roles, supporting proportionality of regulation and SME financing, are in principle supportive to these goals. Moreover, due to some unavoidable discrepancies from the previous legislation, gaps and overlaps in the rules should be reduced.

"Calibration and the right balance of the new rules for banks are important for the whole Europe."

- MÄRTEN ROSS

In addition, new rules should as much as possible support efficient and effective policy actions to address country-specific risks and to counter pro-cyclical effects without undermining the single market. Therefore, measures and procedures should be balanced and flexible enough to allow countries to act at the national level when essential to safeguard financial stability. Due to recent avalanche of regulations that were not negotiated and agreed at the same time, comprehensive view would be advantageous to take into account interlinkages between institutional set-up (supervisory, crisis prevention and resolution) and policy measures available in the post-crisis and banking union environment. These nuances should be taken into account when reviewing CRR/CRD further.

In conclusion, it is important to balance banks' supportive role to the economy with longer term financial stability concerns. ●

Marinela Petrova

Deputy Minister, Member of the Economic and Financial Committee, Ministry of Finance of the Republic of Bulgaria

Banks between regulatory requirements and the need to finance the economy

Since the 2008 financial crisis EU banks have faced intense regulatory reforms. The process of deleveraging (retaining earnings, raising capital and downsizing balance sheets) has started due to market push to reduce risks, demand for higher capitalisation >>>

>>> levels and expectations for stricter supervision. They were further incentivised by the new EU capital requirements rules (CRR / CRD IV). Many industry representatives and policy makers are now claiming that it is time to shift focus on other priorities, financing the economy being the main one.

"Banks' ability to finance the economy is in the balance between stricter regulatory requirements and the affordable cost of capital for the business."

- MARINELA PETROVA

In this context and in line with June 2016 Council Conclusions, on 23 November 2016 the European Commission published legislative proposals (CRD V) implementing some important parts of the Basel post crisis reform agenda: NSFR, LR, FRTB and TLAC. The Commission tried to adapt the Basel rules to the specificities of the European banks through some deviations from Basel framework and simplification of requirements for smaller and less complex institutions. The proposals also aim at addressing the financing needs of the economy through extension of the SME supporting factor, granting of a preferential treatment to specialised lending exposures aimed at funding infrastructure projects, special treatment of covered bonds, and trade finance in relation to NSFR, etc.

It is arguable whether all of the proposed Basel-related modifications and proportionality rules reflect in all cases EU specificities, and reduce risks. At this stage it is also extremely difficult to determine what shall be the exact effect of the proposed changes in the prudential rules on trade finance, real estate, corporate, SME and retail financing, and on specialised lending. Banks' lending activity, although being shaped by regulatory requirements, depends on a number of other factors both on the demand and the supply side. One thing is sure, though:

Banks' ability to finance the economy is in the balance between stricter regulatory requirements and the affordable cost of capital for the business. This balance should be sought and achieved during the negotiations on CRD V in the Council and in the European Parliament. Balance shall be also sought in relation to the home-host issues, the implementation of the principle of proportionality and to the simultaneous application of unified rules and rules that take into consideration the specificities of the Member States' financial markets. ●

Diederik van Wassenaer

Head of Global Regulatory and International Affairs, ING Group

More ambition to deliver on Banking Union is needed

Given the need for regulatory overhaul in response to the crisis, the CRR implemented in 2014 was quite restrictive. Today we find ourselves in a more stable situation, also reflected by the fact that most banks have reached an adequate level of capitalization. Therefore we should carefully consider new regulatory initiatives. As such we appreciate that the need for finance and growth are reflected more in the proposals put forward by the EC in November 2016. When considering these proposals particular attention needs to be given to the following items:

- Interest rate in the banking book (IRRBB): it has been for very good reasons that the Basel Cte has made proposals to address interest rate risk via Pillar II. When considering the EC proposals we fear that the requirements are becoming too prescriptive: mandating EBA to draft technical standards might effectively result in introducing a Pillar I type of requirement for IRRBB. Bypassing the internal model approach applied by banks will lead to outcomes which do not reflect the manner in which interest rate risk is measured and monitored in the banks. Examples of these are generic approaches to prepayments and caps on durations of liabilities.
- The NSFR is a complicated metric compared to the short-term LCR requirements which had been adopted earlier. The requirements for the NSFR might have implications that are difficult to foresee given its longer time horizon. The problem is that funding transactions may work asymmetrically as the two legs of one and the same transaction may apply different liquidity profiles to the different legs of this transaction. An example of this is trade finance where even if the client borrows short term, the lender is still forced to fund part of the transaction long-term for liquidity purposes. This asymmetry will mean that costs will go up, and/or volume available in the market decreases.

Apart from the CRR proposals related to Basel reforms, the EC proposal also contains elements that are relevant in the context of Banking Union. In our view these proposals might be more ambitious. In particular we note the following:

(i) The application of capital, liquidity and MREL requirements on a solo level; to ensure we will have the efficiency gains that should result from Banking Union there should be waiver requirements which are capable of being met in practical terms.

(ii) Macro-prudential policies need to be harmonised across the Eurozone and supervised by the ECB rather than the NCA's. As there can be circumstances warranting country-specific actions, national authorities should remain primarily in charge of executing macro-prudential policies. Nonetheless a deeper harmonisation of how macro-prudential policy is set is justified at Eurozone level. ●

EUROFI MEMBERS

Impact of bank prudential rules on EU capital market activities

Contributors

Martin Merlin

Director, Regulation and Prudential Supervision of Financial Institutions, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

The Impact of the NSFR and FRTB frameworks on the Capital Markets Union

The Capital Markets Union (CMU) is a core component of the Commission's Investment Plan for Europe to boost jobs and growth. It encompasses reforms to our financial system needed to enable the flow of private capital to fund the EU's most pressing investment challenges in the domains of infrastructure, energy transition and particularly in financing growing businesses.

Mobilising capital requires developing capital markets finance as a complement to a restored banking system, and ensuring that, as capital markets deepen, the capacity to supervise and manage risks keeps pace. As intermediaries in capital markets, banks play a central role in the development of market-based finance. They help companies to raise funding in public offers of equity or debt instruments or in private placements.

It is therefore very important that our banking regulation framework, while attaining its primary objective of maintaining financial stability, does not discourage banks to play their important role in the development of the CMU. The banking risk reduction package proposal adopted by the European Commission in November 2016 introduces significant enhancements to the EU bank prudential and resolution frameworks. As regulators, we wanted to make sure that the new prudential rules that banks will have to abide by do not undermine their capacity to support the development of capital markets.

The introduction of the Net Stable Funding Ratio (NSFR) and of a new market risk framework – the so-called Fundamental Review of the Trading Book, FRTB – are two of the most important measures included in the banking risk reduction package. The NSFR promotes funding stability and limits banks' over-reliance on short term wholesale funding. It ensures that banks adequatly fund their activities with stable sources of funding on an ongoing structural basis. The new market risk framework addresses the inadequate level of capital required against trading activities, which proved insufficient to absorb losses during the crisis. It establishes clearer boundaries from trading activities to prevent regulatory arbitrage, makes capital requirements more risk sensitive in order to better capture the actual risks that banks are exposed to when undertaking trading activities and strengthens the conditions to use internal models.

The NSFR and the new market risk framework will enhance the bank prudential framework, and thereby contribute to a more stable and resilient financial system. But these new rules also impose constraints and costs on banks, which may alter their capacity to perform certain activities or provide certain types of services. We considered this issue throughout the banking risk reduction package proposal in general, and for the NSFR and the new market risk framework in particular, where we fine-tuned the proposed set of rules in order not to discourage banks from providing the services that contribute to the development of market-based finance.

The NSFR standard developed at international level foresees, for instance, an asymmetric treatment for short term transactions between financial counterparties. Funding >>>

>>> sourced through this type of transactions, such as repos, cannot be considered as stable whereas lending granted in the same manner, for example via reverse repos, has to be partially stably funded. We decided to adjust this stable funding requirement in our proposal because of the possible impact on the liquidity of repo markets, which are essential not only for interbank funding, but also for the efficient management of inventories that are necessary to run a market-making activity.

We also proposed to phase-in the introduction of the new market risk framework and observe its impact during a transitional period. A sudden increase in the level of capital requirements for market risk could dis-incentivise banks to perform their essential market-making function and discourage corporates from seeking access to the capital market via banks, which would undermine one of the main objectives of the CMU.

Risk reduction in the banking system and the development of the CMU are not contradictory objectives. When smartly designed and calibrated, sound prudential rules for banks will enhance the resilience of essential intermediaries in capital markets and thereby contribute to the sustainable development of the CMU. ●

Michael Manna

Head of Fixed Income Financing Trading, EMEA and Asia Pacific, Barclays

CMU, FRTB, NSFR and Repo: What's the connection?

CMU and other capital markets initiatives which aim to transition lending away from reliance on bank balance sheets to market based financing, still require effective secondary markets. Repo is a prerequisite for the sort of liquid cash market required to support capital market growth. Repo facilitates leverage for non-banks (including sovereigns) and is instrumental in transforming and distributing collateral in the financial system. A well-functioning repo market contributes to liquidity not just in the particular instruments which are borrowed or lent but also in associated securities which trade on the "inferred" available liquidity. Prudential reforms increasing the cost of capital for repo may lead to more expensive leverage (and therefore less of it, all else being equal) in the financial system and larger economy. However, this can also result in more thinly traded markets, subject to volatility and disappearing liquidity when it is most needed, putting bank capital at risk and 'closing the door' on investment looking to access capital.

Increases in market risk related capital requirements as a result of FRTB are likely to have an impact on repo markets, for example, through the introduction of varying liquidity horizons to internal models for market risk that will be relevant to sovereign and corporate debt repo. However, the leverage ratio has already caused banks to shrink repo activity dramatically even before it becomes binding. Increased cost of capital can be addressed through pricing but increased leverage can lead to overall capacity challenges for repo businesses.

The interaction between the leverage ratio and the NSFR, could make matters worse as banks are forced to raise additional long-term funding against repo activity which is already funded; driving up leverage. Whilst the Commission's CRR proposal on NSFR does improve the treatment of repo for banks by providing more flexibility on exemptions for interdependent transactions and permitting more matched book business than under Basel rules, it does not go far enough.

Whilst we support the underlying policy objective of developing >>>

>>> sustainable funding structures and requiring more long term funding of repo businesses, doubt remains on the correct calibration of standards like NSFR. Also, as rules have become increasingly complex, it has become more difficult to assess whether a level playing field exists across all jurisdictions. As banks are challenged to provide capacity to support the capital markets and economic activity, diminishing the effectiveness of fiscal policy, a thorough evaluation of the combined impact of prudential rules is called for; not least because the current back-drop of unprecedented excess liquidity and unconventional monetary policy may be dampening the full effect of regulatory reforms. ●

Laurent Clerc

Director of Financial Stability,
Banque de France

The potential impacts of the NSFR and FRTB frameworks on financial markets

The Net Stable Funding Ratio (NSFR) and the Fundamental Review of the Trading Book (FRTB) are key components of the post-crisis financial regulatory reforms' agenda and of the Basel III framework. The NSFR has been designed to address banks' over reliance on short-term funding to support less liquid assets while the FRTB aims at improving the adequacy of own funds requirements related to trading book activities after banks suffered important losses during the financial crisis of 2008. The introduction of these two standards will contribute to building more resilient financial institutions. However, these benefits must also be assessed against the challenges that the new requirements might pose for the financial system as a whole.

Especially, there is still a high degree of uncertainty on the systemic impact of the NSFR, despite the detailed impact studies carried out both by the Basel Committee and the European Banking Authority (EBA). Moreover, these impact studies have not necessarily factored in the potential detrimental impact of the NSFR on long-term financing and on market liquidity. In particular:

- NSFR shortfalls (240 GEUR according to the EBA last monitoring exercise) are still important and might not be evenly distributed among European banks;
- the NSFR could lead to unintended consequences on banks' hedging incentives because of an over-penalizing prudential treatment of derivatives;
- the impact of the treatment of back-to-back repo/reverse repo transactions remains unclear on market making activities that are essential for a well-functioning financial system;
- doubts prevail about the capacity of the markets to issue the long-term funding needed for banks to close their shortfall, especially with the simultaneous implementation of the TLAC requirements;

Against this backdrop, the proposal recently released by the European Commission to amend the capital requirement regulation goes in the right direction, as it addresses some of its deficiencies, recognising for example the inclusion of Level 1 HQLA received as variation margins or aligning the treatment of residential loans fully guaranteed on mortgages for instance.

The concerns raised by the FRTB also relate to some implementation challenges regarding for instance the complexities of Backtesting and P&L attribution or the production by banks of large sets of computationally-expensive CVA sensitivities to have their CVA hedges fully recognized for the computation of their capital requirements.

Furthermore, the impact of the NSFR and the FRTB should be assessed together with all other regulatory reforms adopted in the aftermath of the 2008 crisis, so that their cumulated costs and benefits are comprehensively evaluated. The dedicated analysis on the cumulative effects of reforms that the Financial Stability Board includes in its annual report to the G20 is a promising step into this direction. In the same vein, finding the right calibration so that costs do not overweight benefits at aggregated level is at the heart of the mandate given to the Basel Committee to finalize Basel 3 without triggering a significant increase in capital charges. Last but not least, ensuring that the costs and the benefits are evenly distributed amongst jurisdictions is an additional key challenge. ●

Olivier Prato

Head of Basel III implementation, Basel Committee on Banking Supervision (BCBS)

Full, timely and consistent implementation of Basel standards is key

The Basel Committee's post-crisis regulatory framework comprises multiple metrics and both the Fundamental Review of the Trading Book (FRTB) and the Net Stable Funding Ratio (NSFR) are significant components of this framework.

The purpose of the FRTB, which takes effect in 2019, is to ensure that the standardised and internal model approaches to market risk deliver credible capital outcomes and promote consistent implementation of the standards across jurisdictions. The NSFR, a longer-term structural liquidity standard, will become a minimum standard by 1 January 2018 and requires banks to maintain a stable funding profile in relation to their on- and off-balance sheet activities.

To promote consistent global implementation of these requirements, the Committee periodically reviews frequently asked questions and publishes answers along with any necessary technical elaboration of the rules text and >>>

>>> interpretative guidance. Earlier in 2017, the Committee published its first set of FAQs on the FRTB and its second set of FAQs on the NSFR.

During the implementation period, the Committee will continue to monitor the impact of the revised standards, as well as other metrics, to ensure consistency in the overall calibration of the Basel regulatory framework. Overall, banks have made impressive progress towards meeting both Basel III capital and liquidity requirements. The Committee's latest monitoring exercise shows that virtually all participating banks meet both the minimum and target risk-weighted Common Equity Tier 1 requirements. In the same vein, around 85% banks reported a NSFR that met or exceeded 100%.

"Full, timely and consistent implementation of Basel standards is critical to improving the resilience of the global banking system."

- OLIVIER PRATO

Full and consistent implementation of Basel standards within the internationally agreed timeframe is critical to strengthening the resilience of the banking system, improving confidence in regulatory ratios and promoting a level playing field. To facilitate the implementation process, in 2012 the Committee launched its comprehensive Regulatory Consistency Assessment Programme (RCAP). The RCAP's objective is to (i) monitor the timely adoption of its standards, (ii) examine the completeness and consistency of the standards adopted by member jurisdictions, including the significance of any deviations from the Basel framework, and (iii) assess the outcomes of the application of these standards.

In December 2016, the Committee completed its review of the implementation of the risk-based capital framework by all of its members. It will complete the assessments of the implementation of the Liquidity Coverage Ratio (LCR) by end-2017, followed at a later stage by the assessments of the implementation of the NSFR and other standards, including the FRTB. The RCAP has effectively contributed to increasing the consistency of banking regulation across member jurisdictions. During these assessments, more than 1,400 deviations from the Basel framework, and their materiality, were identified. Members have taken commendable actions to increase compliance with the Basel requirements as they rectified a large majority of these deviations during the assessments.

Going forward, the Committee will continue to closely monitor the implementation and rigorously assess the impact of its post-crisis reforms. ●

Dr. Andreas Dombret

Member of the Executive Board,
Deutsche Bundesbank

The FRTB and NSFR demand fundamental changes in banks' data and capital regimes.

FRTB and NSFR both limit the degree of freedom that banks have in pursuing their business models, and they demand higher data standards.

The Fundamental Review of the Trading Book (FRTB) aims to achieve a better, more risk-sensitive measurement of capital requirements. Its new Standardised Approach (STA) requires banks to use price sensitivities and default risk, so far covered only by internal models. Where applicable, the EU will issue proportionate regulation for market risk, thereby alleviating the pressure of adaption. For example, smaller banks can apply the current standardised approach for at least 3 more years. The European Banking Authority will then have to reassess standardised approaches.

Institutions that apply the internal model approach (IMA) also face considerable challenges: they need to apply the IMA at the trading desk level, i.e. a bank needs supervisory approval for each trading desk; the calculations are now based on the expected shortfall as a risk measure, and banks have to improve their data quality so as to avoid extra capital requirements.

In sum, both the new STA and the IMA substantially increase the risk sensitivity of capital requirements for market risks; at the same time, they demand improved data quality and higher calculation efforts from banks.

As for the net stable funding ratio (NSFR), one key challenge for banks is that the NSFR will limit the room for manoeuvre regarding the balance sheet structure. Compilation of the necessary data will likewise require many banks to substantially improve their IT infrastructures.

For banks, early adaptation measures will be key. Data quality and data management are among the core challenges ahead; so are the NSFR's constraints on the balance sheet structure. For supervisors, this requires a complete overhaul of the current approval process. In order to ensure a smooth legal transition, supervisors will need to offer procedural guidance and clearly communicate any upcoming steps and changes in regulatory requirements. We as supervisors should all be prepared to commit to this goal. ●

Niclas Hagelin

Head of Balance Sheet Management, Markets FICC, Nordea

FRTB and NSFR – a threat to the Nordic capital markets

Without recalibration FRTB and NSFR could penalize well-functioning Nordic markets and lead to cost increases and risks that would negatively impact retail mortgage holders, governments and corporates.

The Nordic markets are relatively small, largely outside the Euro, have large covered bond markets and a relatively limited number of market participants. As a result a main Nordic market model has emerged whereby dealers manage supply/demand imbalances, find buyers and sellers, and transform and manage risk on behalf of their customers. In short, they provide market liquidity, which sets the foundation for having an efficient financial market.

Around the height of the financial crisis this model helped sustain a certain level of trading, perhaps not present elsewhere, as noted by the Sveriges Riksbank for Swedish covered bonds. Danmarks Nationalbank also noted that in contrast to several other mortgage and securitisation bond markets, trading continued in the Danish covered bond market during the crisis, albeit at reduced levels.

Like other markets, we have observed shrinking dealer capacity along with other indications of declining market liquidity. New regulation is a contributing factor. While NSFR and FRTB are still works-in-progress, they point to more downward pressure on market liquidity. The additional impact of MREL/TLAC should also not be underestimated. One should also acknowledge the effects that accommodative monetary policies, high demand for high quality liquid assets and the search for yield are having on market liquidity.

Of particular concern is the impact that FRTB and NSFR could have on core markets and products, particularly, high-quality government and covered bonds, FX (Euro and Scandi currencies) and standard risk management products. These are critical from both economic growth and financial stability perspectives.

We support the policy objectives and overall framework designs of NSFR and FRTB, but we see evidence that re-calibration is needed to avoid an overstatement of the risk. Some obvious areas include covered bond credit spreads and recognition of the DKK/EUR peg. Even with the changes made in the CRR2 proposal the risk is still overstated. Overstating the real risk would increase capital and funding costs for banks, which all things being equal would require changes in portfolio composition and size, and absolute levels of liquidity provision could drop. ●

Jeff Jennings

Head of EMEA Prime Services, Credit Suisse

Promoting European growth: balancing regulatory constraints on trading activities with the CMU

To revive economic growth and promote investment in European companies and infrastructure, the EC's Capital Markets Union aims to shift credit intermediation to become less reliant on banks, and more on capital markets. It will take time to achieve a material swing to capital markets, and Brexit presents a challenge, but the objective remains a worthy one.

Policymakers have to strike a balance between finishing the post-crisis trading book reforms, whilst simultaneously developing policy to advance the CMU agenda. The current Risk Reduction legislative proposal, introduces some key Basel 3 regulatory measures. Banks need a backstop leverage ratio, more longer-term funding than pre-crisis, and unwarranted variation in market risk weighted assets should be addressed. However, we should also recognise that if not calibrated with care these measures will curtail banks' capital market activities by reducing balance sheet space (LR), increasing funding costs for short-term trading activities (NSFR), and driving up capital requirements for trading assets (FRTB).

The CRR2 makes some positive changes which will support capital market activity, e.g. the changes to risk weights for securitisation and the changes to the leverage ratio which will encourage more central clearing in line with the objectives of EMIR. However, the NSFR rules remain punitive as regards certain client facilitation and market making activities. Consider a pension fund or asset manager wanting to increase exposure to certain market indices; the fund might buy a total return swap from a bank that pays it the economic performance of the index. The bank would then buy certain component equities that make up the index in order to hedge the market risk on the swap. The equities are a hedge, and therefore are linked to the client's trade, and in the normal course both the swap (liability) and hedge (asset) would unwind simultaneously. Unfortunately, from a NSFR perspective, the equity positions are considered in isolation and attract high stable funding requirements. The new treatment significantly increases the cost for clients from today's rules, despite the minimal funding risk. Regulatory assessments of the NSFR tend to concentrate on the impact to banks at a consolidated level, but if not done at business line level then policymakers risk missing significant changes to the incentives banks have to continue investing in certain activities.

A review of the NSFR treatment of "linked transactions" combined with a reworking of the P&L attribution test within the FRTB rules, would in our view be positive steps to take to ensure the Risk Reduction package achieves both its prudential and growth-orientated objectives. ●

Proportionality of EU banking regulation

Contributors

Madis Müller

Deputy Governor, National Bank of Estonia

Striking the right balance with regulation that is both rigorous and proportional

The volume and complexity of banking sector regulation has increased significantly since the last financial crisis. The core objectives of new regulations and strengthened supervision have been clear: to improve the resilience of the banking sector and rebuild the general public's trust in the financial industry. We have increased capital requirements, introduced new regulations for liquidity management, requested market participants to build up sounder internal risk management systems and we are demanding more granular and frequent data reporting. In the euro-area we have reconsidered the entire structure of bank supervision.

While the rationale for the changes in regulations and supervision has been clear, it is also clear that the new requirements do not come without a cost. More granular data, risk assessment and reporting requirements have added to operational costs of all market participants, regardless of their size. Generally speaking, such added expenses are justified when considering the substantial benefits a society reaps from having a well-functioning financial system that is less prone to sudden and costly disruptions. However, not all financial sector companies are similarly prepared to handle the increasing complexity of regulations. Ensuring compliance with all rules is relatively more costly for smaller institutions. New regulations may also motivate banks to change their business models in a way that lawmakers and regulators do not always foresee. In addition, the barriers of entry for new competitors have certainly been increased.

A lot of emphasis has been put on finding and closing various regulatory loopholes. While it is obviously important to make sure that we have banking regulations that cannot be circumvented, it is also important to consider the proportionality of the rules. While we need a safe and sound banking system, we also need a healthy degree of diversity and competition. It is difficult to find a perfect balance. Regulations should be sufficient to minimize the systemic risk from bank failures and the potential cost to taxpayers. However, we should not aim at regulating away all risks that are inherent to the business of banking and managing of which is the duty of a bank's management.

An additional layer of complexity related to proportional regulation arises from our recent experience that also smaller institutions with simpler business models can pose systemic risks. We should avoid creating blind spots or new pockets of vulnerability and carefully consider the criteria that justify applying simplified requirements.

The Commission has published a set of proposals to address some of these issues. Those include proposals to reconsider, from the proportionality perspective, the adequacy of the granularity and frequency of current disclosure and reporting requirements and the calculation of trading-book-related capital requirements. In addition, it should be reassessed whether the current remuneration principles designed for large and complex institutions may be overly complicated for smaller institutions. We should consider if there are areas where simplifications are justified and would enable to reduce an undue burden. At the same time, we have to be careful not to create regulatory loopholes or to allow simplifications that end up undermining our ability to identify risks in due time. We have to strive towards a better balance, while making sure not to compromise the resilience of the regulatory framework. ●

Mario Mallia

Chief Executive Officer,
Bank of Valletta plc

Can proportionality increase lending to the EU economy?

The CRR/CRD proposals issued by the EU Commission on the 23rd November 2016 have taken on board a number of the principles presented in the report compiled by the European Banking Authority Banking Stakeholder Group - 'Proportionality in Bank Regulation'.

The EU Commission proposal defining a small institution is one step closer in the implementation of the principle of proportionality. Financial institutions which fall within this category would require more proportional reporting, disclosure and compliance rules. This is positive, however from an operational perspective the simplified procedures and associated reduced costs may not necessarily translate into more lending to the economies such institutions service.

To increase lending to the EU economy, proportionality needs to contribute more towards reducing capital obligations. The CRR/CRD proposed amendment in the field of small and medium sized enterprises (SMEs) can be presented as an example. The reduced capital requirements on exposures beyond the €1.5 million threshold is a simple initiative that will ensure capital relieve on SME portfolios. The reduced capital required for larger SME transactions will incentivise increased lending to this segment of the economy, which provides a significant contribution to both jobs and economic growth in the EU economy.

A similar initiative proposed in the CRR/CRD review, which in this case also includes corporate lending, is in the area of project finance. The reduction in capital obligations in this area of operation should contribute towards increased investments in infrastructure which are key to the increased competitiveness of the EU economy. These targeted initiatives should increase banks' disposition to lend to project finance ventures which in turn will result in increased investment in the EU economy.

"Proportionality needs to contribute more towards reducing capital obligations."

- MARIO MALLIA

Whilst recognising that the proportionality measures presented in the CRR/ CRD proposals are a step in the right direction from a reduction in regulatory costs, their limited impact on reduced capital requirements is not envisaged to result in a significant increase in lending to the EU economy.

It is through simple and targeted measures aimed at reducing capital requirements that financial institutions, both small and large, will mobilise more of their liquidity to lend to European SMEs and corporates. This is critical in an economy which is heavily reliant on debt financing via both small and large banks. ●

Dr. Andreas Dombret

Member of the Executive Board, Deutsche Bundesbank

Rethinking proportionality: Why a few exemptions may not be enough

Regulatory reforms implemented after the financial crisis made rules much more complex, since they were directed mainly at big, internationally active banks.

While that was more than appropriate, we now have to ask ourselves: Have we created rules that unduly favour large banking organisations which can afford specialised regulatory offices? Or, put differently: Can small banks comply with the rules without their costs skyrocketing – forcing many small institutions to exit the market or to merge? To my mind, the operational burden for small banks has become too heavy, threatening to overwhelm them.

Market dynamics need small firms. And in the financial world, diversity is even more valuable: A diverse financial market, composed of institutions with different sizes and business models, ultimately will proof more resilient under stress. This is why we need to examine and, where appropriate, differentiate rules further – to ensure that smaller banks only need to comply with less operationally burdensome rules, which would mean introducing a so-called "small and simple banking box".

"To my mind, the operational burden for small banks has become too heavy."

- DR. ANDREAS DOMBRET

To some extent, the Basel II and Basel III frameworks were designed to do just that by applying two strategies: >>>

>>> First, less onerous prescriptions for smaller, less risky banks and those that are not internationally active (downward proportionality); second, tougher rules and rule interpretation for bigger, riskier multinationals (upward proportionality).

As such the new framework already applies these strategies. As for downward proportionality, the regulatory framework continues to offer opportunities for choice, where banks can, for example, choose between standardised or internal methods to calculate risk weights.

Upward proportionality, i.e. tougher rules for bigger, riskier institutions, has been strengthened substantially since the crisis – which was only right and proper given that these institutions were the epicentre of the crisis. Post-crisis reforms have therefore placed a lot of emphasis on rules having upward proportionality, thus stipulating more stringent requirements for (global) systemically important institutions.

Emphasizing the significance of proportionality, however, has not sufficiently reduced the burden on smaller banks so far. That is why I am convinced that in the future it will not be enough to continue with the above approach of finding sensible exemptions and gradations for smaller banks with regard to specific rules.

We must also explore the possibility of creating separate regulatory frameworks for smaller institutions, on the one hand, and large multinational ones, on the other. We are talking about a fundamental approach that envisages a dedicated rulebook for smaller banks. By setting graduated rules with less complex requirements, we can do justice to their distinct business models and risk profiles – while only systemically important banks would be subject to the fully loaded Basel III framework.

We need to look hard for viable ways to reduce operational burdens for small banks that are neither internationally active nor have risky business models. But any rule change has to comply with certain preconditions: not eroding financial stability, not creating loopholes, and not softening capital and liquidity requirements. ●

Isabelle Vaillant

Director of Regulation, European Banking Authority (EBA)

Proportionality – Delegation, integration, simplicity

One of the EBA's main tasks is the development and maintenance of the EU Single Rulebook in banking. The objective of which is to provide a single set of harmonised rules for financial institutions throughout the EU. This is not to say that the same rule applies to all types of institutions and activities, but that the same risks should be addressed by the same rules.

The feedback to the 2016 Commission's call for evidence points to the complexity of banking regulation, rather than examples of disproportionality of the prudential requirements with regard to risks. A further issue is the compliance burden and cost of additional supervisory reporting requests. Both of these are areas that can be worked upon.

Beyond the existing level of complexity of the rules which require an appropriate reporting accordingly, it is acknowledged that the reporting burden is high in many instances. Perhaps there is insufficient clarity regarding which core lines or templates are to be reported from the whole reporting framework, something which does not do justice to the existing embedded proportionality in reporting where smaller less complex banks have to report only around one tenth of what global systemically important banks (G-SIBs) have to report. We certainly have to facilitate this understanding and reporting approach. But one large issue stems from multiple ad-hoc and parallel requests for additional reporting going around despite maximum harmonisation intentions. To achieve a simpler and still truly harmonised reporting framework two measures deserve consideration: the delegation of tasks to the EBA and the development of an integrated approach for reporting.

The delegation of tasks should deliver a more efficient and timely process for European banks and supervisors. At present, the European processes give rise to mismatches between reporting obligations and the underlying regulatory requirements. This puts legal certainty at risk and multiplies costs for institutions due to parallel reporting requests. The delegation of such technical tasks, i.e. to define the reporting framework with regard to the prudential framework is definitely needed and could be envisaged in the founding regulation of the EBA. Such delegation should come with accountability mechanisms within the EU institutional framework.

While the EBA issues the common reporting framework (COREP) and other implementing standards defining prudential reporting requirements for the purpose of supervisors and resolution authorities, there are also central banks defining statistical reporting requirements addressed to financial firms and with many of the same data points used in both frameworks. An integrated approach to the data collections, i.e. collecting both statistical and supervisory data using integrated solutions would lead to streamlined reporting and a reduction of the reporting burden. This would in particular be supported with a robust data dictionary being developed and provided to all users to ensure clarity and commonality.

Going beyond those two efforts, which would certainly do a great deal, the idea of clarifying the simplified framework for small and less complex banks still remains. As a matter of fact, the existing proportionality features do not achieve streamlined solutions for the same stable population of banks across the EU as they are more prudential-metric oriented than bank-profile oriented. This can simplify obligations for some banks for solvency ratio reporting whereas for other types of banks it may be a (simplified) liquidity ratio reporting. Identifying a universe of banks to which the proportionate and simpler reporting could be extended in a consistent manner would certainly be welcome. While the diversity of the EU banking landscape makes this a challenging task, the EBA would stand ready to contribute on this matter as a European solution is essential to the maintenance of a Single Market. ●

Dr. Jukka Vesala

Director General, Directorate General Microprudential Supervision 3, European Central Bank (ECB)

Making common rules work in a proportionate manner

The principle of proportionality is explicitly enshrined in the legislation governing European banking regulation and supervision. Nevertheless, representatives of small European banks with a focus on retail business have been arguing that the current framework imposes disproportionate compliance costs on them since their business is less risky than that of many larger competitors and their systemic importance is limited. As a consequence, some have proposed the introduction of a separate, lighter regulatory regime for such banks.

"Common regulatory rules for all banks proportionality in their implementation."

- DR. JUKKA VESALA

It would indeed be disproportionate to expect small banks to invest the same absolute resources into compliance as much larger ones. However, treating "small" as equivalent to "less risky" would be clearly at odds with longstanding international evidence on bank failures. Despite limited systemic consequences, the failure of individual small banks can have a significant impact on customers, depositors and regional economies. Not all creditors of small banks are covered by deposit protection, and when they fail, those banks are often not subject to resolution (which might limit creditors' losses), but outright liquidation. Lighter regulation might also entail adverse effects on the reputation and perceived stability of the banks concerned. And finally, defining meaningful criteria for regulatory discrimination is far from straightforward.

For these reasons, a framework which is based on common regulatory rules for all banks, but allows for proportionality in their implementation, has strong merits. Making it work requires developing concrete approaches that give proportionality a tangible meaning. The Single Supervisory Mechanism has been doing so for numerous aspects of its work, in particular in its oversight role for the supervision of less significant institutions where a prioritisation methodology serves as the basis for adjusting the intensity of supervisory activities based on bank's inherent riskiness and importance for the local economy. Continuing those efforts should deepen the benefits of proportionality while abstaining from a rollback of regulatory rules which have contributed to a safer European banking system. ●

Jesper Berg

Director General, Danish Financial Supervisory Authority (Finanstilsynet)

Proportionality – valid problem but difficult to solve

The more extensive regulatory framework that has been developed in response to the financial crisis can be particularly challenging for smaller credit institutions, where compliance often entails a significant cost. Consequently, there is much focus on proportionality at the EU-level.

The standardized approach to capital requirements from Basel II is an example of proportionality, where smaller credit institutions can use a simpler procedure. The approach offers a less cost-intensive way of determining capital requirements, while also setting a higher requirement than the internal ratings based approach would have. It is a good example of that proportionality should not imply a loosening of standards, but a simplification.

However, while the standardized method is a good tool for proportionality, careful considerations are warranted before applying it for other objectives such as a floor for the capital requirements of more complex institutions. As the Tinbergen rule states, for each policy objective, at least one policy instrument is usually needed.

"The concept of proportionality is important but it is also difficult to apply."

- JESPER BERG

Proportionality is not just an issue in relation to capital. The financial crisis has shown us, that more capital on its own is not sufficient to cover all risks. Credit institutions should also have sufficient risk management frameworks. The Danish FSA takes a risk-based approach to supervision, and demands higher standards for the risk management framework of complex and higher risk institutions. Thus, proportionality should not only be calibrated in relation to the size of institutions, but also to the complexity of their business models.

The concept of proportionality is important but it is also difficult to apply. The framework chosen by the Danish FSA combines proportionality in the risk management and governance requirements with the integrated proportionality in e.g. the capital requirements from the Basel setup. The aim is to ensure, that credit institutions can sufficiently manage their risks, rather than just ensuring that they are reflected in the capital requirements. ●

Dan Sørensen

Member of the Executive Board,
Nykredit Bank

Proportionality is also about respecting well-functioning business models

The Commission has in recent years focused on proportionality in financial regulation recognizing that the one size fits all approach has been too burdensome for many banks. This is reflected in the current CRD5/CRR2 proposal which lightens the burdens on especially smaller banks e.g. regarding reporting requirements. However, proportionality is also about ensuring that specific well-functioning business models are not disproportionately affected by new regulation.

"The output floor will – depending on the final calibration – increase capital requirements for a large number of European banks. "

- DAN SØRENSEN

One example is the discussions in the Basel-committee regarding the introduction of an output floor for IRB-institutions. The output floor will – depending on the final calibration – increase capital requirements for a large number of European banks. But it will especially hit institutions with very low historic losses and therefore low risk weights such as the Danish mortgage credit institutions. This will not enhance financial stability but incentivize these institutions to take on more risk to efficiently manage capital allocation. The result will be more expensive loans to households and companies without added value for financial stability. The lack of trust in internal models should be handled through the leverage ratio, a harmonization of the models and enhanced transparency around the use of models. If an output floor is agreed upon in Basel the Commission when implementing an output floor in the EU should take the special features of the Danish mortgage market and model – and other similar low risk markets and business models – into account.

Another example is the treatment of covered bonds in the revised standardized approach for market risk (FRTB) as set out in the CRD5/CRR2 proposal by the Commission. The stress on covered bonds is lower than in the Basel-standard but still much higher than what has been seen historically especially in the northern European countries. This will make it more expensive for banks in general and in particular medium sized banks to be market makers in covered bonds and therefore negatively impact liquidity in the covered bonds market. Again a more proportionate approach is needed. ●

Dr. Karl-Peter Schackmann-Fallis

Executive Member of the Board,
Deutscher Sparkassen- und Giroverband (DSGV)

A new recipe for Europe's banking regulation: Keep it simple, keep it small!

The European banking landscape is extremely rich and diverse. If this diversity of bank business models ultimately leading to a more resilient overall financial system in Europe were to be preserved, regulators need to take care not to overburden simple, small and medium-sized banks with their legislation. While it is necessary to address the too-big-to-fail problem, regulators need to avoid the creation of a too-small-to-survive problem resulting in a risky monoculture of bank business models. The principle of proportionality is key in this respect.

In 2011, unlike the US, the EU chose to apply the Basel III agreements to all European banks albeit with some adaptations. However, it makes an enormous difference whether supervisory rules that were originally intended for big, global, internationally active banks only apply to 15 Wall Street banks or whether they are mandatory for all 8000 European banks regardless of their size, business model and risk profile, especially against the backdrop of a European economy that is heavily relying on bank financing.

Now should be the turning point to introduce truly proportionate regulation in the form of an actual two-tiered approach to banking regulation at EU level. Based on the EBA's existing definition of other systemically important institutions, a Small and Simple Banking Box should be established, going far beyond a mere size-based differentiation. The Small and Simple Banking Box would ensure that narrower regulatory rules are applicable for banks representing no significant risk to the financial system as a whole.

While the European Commission's recent proposals for the revision of the European prudential, supervisory and resolution framework can be interpreted as a step into the right direction, showing sparks of proportionality in certain areas, such as reporting and disclosure, it would be crucial to come up with a bolder, holistic approach to banking regulation fully respecting the principle of proportionality. The concept of a Small and Simple Banking Box could serve as a blueprint in this respect. ●

Resolution of the NPL challenge

Contributors

Corso Bavagnoli

Assistant Secretary, Financial Department of the French Treasury, Ministry of Economy and Finance, France

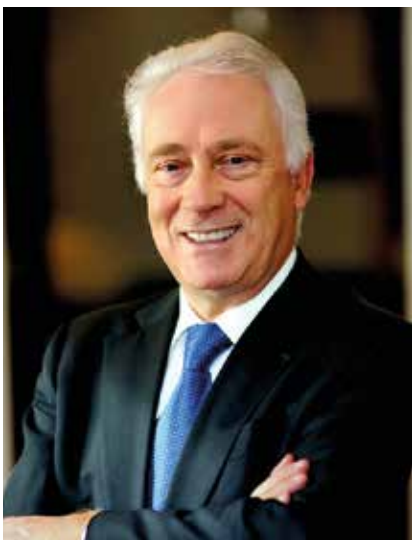
A European perspective to the problem of non-performing loans

Although high NPL ratios only affect a number of European countries, with bank-specific and national-specific features, the problem of persistent high NPL ratios is an issue for Europe. Notwithstanding the overall strengthening of the resilience of European banks over recent years, poor origination practices and the legacy of the crisis have left many European countries with high levels of NPLs. NPLs currently amount to 5.4% of total bank loans on average in the EU[1], remaining at historically high levels. The EU average hides great divergence across countries, in terms of roots causes and characteristics, magnitude (with ratios above 10% in 10 European countries), dynamics (NPL ratios are still rising in some Member States or remaining at significant levels, while decreasing elsewhere) and the level of coverage of the NPLs by provisions. Persistently high levels of NPLs pose a problem through multiple channels at micro and macro level, with adverse effects on the financing of the real economy. NPLs are a drag on bank profitability, with provisioning needs and administrative costs of NPL management, and also higher funding costs as concerns about poor asset quality entail a higher risk premium. NPLs lock capital in banks to back unproductive assets instead of funding new projects, with crippling effects on the bank lending channel for the transmission of monetary policy. One important question is the extent to which NPLs, linked to bank-specific and country-specific features, also have a European dimension. Though high NPL ratios are concentrated in some Member States, high NPL ratios can pose system-wide risks of spill-overs to other European countries and generate negative externalities. A complementary way of looking at the problem is considering the positive externalities stemming from NPL resolution, which would be beneficial for the EU as a whole, by further reducing financial fragmentation, and improving the macroeconomic outlook in the countries affected, which would benefit other countries too via the macro linkages.

It is highly unlikely that the legacy issue of high NPL levels will solve itself spontaneously. Secondary markets for distressed assets are unevenly developed across Europe and are characterized by large bid ask spreads. Capital generation in the most affected banks is probably insufficient to address the shortfalls associated with a more active management of NPLs, be it through restructuring or outright sales. Increased supervisory focus is needed to enhance recognition and proper management of NPLs in some segments of the banking sector. Noticeable steps have been taken in several Member States to tackle the issue, in particular in the context of financial assistance programs and the setting up of state-sponsored asset management companies; however, some of these initiatives involved large state support for the banking sector, for which the framework has evolved since, with the entry into force of the Bank Recovery and Resolution Directive. Milder macro-financial conditions may translate in less pressure to reduce NPLs expeditiously, despite the costs and the risks associated with the current high level of impaired assets. This may lead to relying on less intrusive strategies, which may be unlikely to provide adequate incentives for banks to deal promptly with high NPLs or to be comprehensive enough in addressing the problems of banking systems (including restructuring and possibly exit strategies for unviable institutions) or inefficient legal environments for restructuring and foreclosure. >>>

>>> The design of a successful and sustainable strategy addressing the NPL problem and preventing its reemergence would require a multi-faceted approach. Given the differences across Member States as regards the root causes and composition of NPLs, this approach would combine a mix of policy actions, at national and possibly EU level. Though the primary responsibility rests in banks themselves, addressing NPLs requires determined action from all stakeholders, to enhance supervisory tools and increase pressure on banks to deal proactively with NPLs, implement structural reforms to improve the efficiency of insolvency systems and foster initiatives to develop secondary markets for NPL transactions in Europe to remove NPLs from banks balance sheets. ●

1. EBA data, third quarter of 2016.



Carlos da Silva Costa

Governor, Bank of Portugal

Addressing NPLs at a European level - Leaving the crossroads

Addressing the high level of NPLs was one of the SSM's supervisory priorities for 2016. It remains one of the major supervisory challenges in 2017.

Indeed, the overall stock of NPLs in the euro area is relatively high compared with other geographies, albeit with significant heterogeneity. Some Member States experienced a rapid surge in the NPL ratio subsequent to a burst of a real estate bubble. In other Member States, the increase occurred later and was widespread across sectors. This is the case of Portugal, for instance, where NPLs grew essentially in the context of the 2011-13 recession and are a manifestation of the ongoing economic adjustment process, characterized by a reallocation of resources towards the tradable sector and away from the construction and real estate sectors. The current setting mirrors these differences in pace and drivers, as well as the specificities of national economies: some jurisdictions report double-digit NPL ratios, while others report much lower levels.

In an integrated market, however, different ratios do not – cannot – mean different degrees of concern. Repercussions of high NPL levels cross borders: through banks' balances sheet cross-exposures, through economic spillovers in the face of subdued credit supply and hindered monetary policy transmission and inevitably through market perception. The systemic nature of such risks is heightened by widespread low bank profitability, increasing capital requirements and a still incipient NPL secondary market.

NPLs are, indisputably, a European problem. And a European problem calls for a European approach. But to what extent?

A European approach resides first and foremost on concerted action from all Member States. Enhanced efforts at national level, especially in what regards bank supervision and marked improvements in the legal/judicial/tax framework – notably to reduce the significant bid/ask spread in NPLs secondary market – are a necessary condition to address the high NPL stock and to build the foundations for a better management of flows. But they are certainly not sufficient. The abovementioned risks of >>>

>>> contagion also require targeted and potent initiatives to reduce the NPL stock – and this is where a unified European strategy could prove more valuable.

The first step for a unified European strategy is acknowledging its need. In the face of non-negligible risks to financial stability and financial integration, as well as the referred heterogeneity across banks and economies, a debate should be launched on the possible mismatch between the repercussions of high NPL levels and the current strictness of the EU legal and regulatory framework. In particular, the BRRD was designed for a steady-state, which is still far from the current situation in financial markets, and State aid rules, while placing financial stability at the core, seem to provide little flexibility to address the systemic nature of the problem. To reduce NPLs in a significant and swift way, these constraints must be addressed – but only a European approach can do so while ensuring the necessary level playing field, an essential precondition for the coordinated action that should follow.

This discussion – ideally complemented by enhanced flexibility – would provide decisive clarity on the rules of the game and likely pave the way for bolder solutions at national level, especially in countries where the NPL challenge is more pressing. It could also be the starting point for considering and conceiving a more ambitious strategy to effectively reduce NPL stocks across Europe. A strategy with the necessary firepower to enhance national efforts and complement ongoing initiatives in the SSM and other European fora. Some promising European approaches have been recently put forward and deserve to be further explored. ●

Andrea Enria

Chairperson, European Banking Authority (EBA)

An EU solution for tackling NPLs

Over the past years, supervisors have pushed banks to raise a significant amount of capital, with the CET1 ratio increasing from 9% in 2011 to over 14% in 2016. EU-wide asset quality reviews allowed identifying problem assets and increasing provision levels. At this juncture, legacy assets remain the largest problem for the EU banking sector. Non-performing loans (NPLs) stand at over one trillion euros and the average NPL ratio is 5.5%, with ten jurisdictions reporting ratios of over 10%.

This is a single market problem because of its volume, the risk of contagion, and banks' inability to resume new lending in some jurisdictions, which hinders the effectiveness of monetary policy and holds back economic growth across the single market. The cleansing of balance sheets is therefore a top priority and a precondition for revitalising the EU banking sector.

While supervisory pressure on banks to pro-actively manage and dispose NPLs and structural reforms to improve slow legal systems and overburdened judiciary procedures are necessary, there is also a need for an immediate response to support the development of a more efficient secondary market for impaired assets. In fact, in the presence of information asymmetries, forcing banks to write off or dispose non-performing loans in a very short period of time may lead to an inefficient gap between bid and ask prices that, in turn, may create financial stability concerns.

Practical experience and economic theory tell us that state intervention is needed where markets fail. A catalyst is needed in the form of a state funded vehicle to buy assets at a conservative but "real economic value" or future efficient >>>

>>> clearing price, with a view to selling into a deeper and more liquid market at a later date. Official sector involvement has proven in the past indispensable in the price discovery process, crowding in private investors. Official sector money could be used to capitalise an Asset Management Company (AMC), which would draw in private funding as well. Any public support would trigger state aid and bail in rules, but this is a welcome constraint, not an obstacle. Public support should also respect the principle of no mutualisation of legacy assets i.e. governments should not pay for NPLs originated by banks in other Member States.

First, the process would be triggered by a "precautionary recapitalisation" stress test, which would serve to identify the permissible volume of state aid. This does not need to be complex and could be based on a price deterioration scenario and forced provisioning.

Second, the "envelope" of state aid can be used to fund the purchase of NPLs at future real economic value pricing - the difference between the current market price and real economic value must be within the state aid envelope. This entails a loss for the banks shareholders in the first instance against their book value.

Third, the AMC sells these NPLs onwards as market failures disappear and efficient clearing prices are reached.

Safeguards must be in place. A claw back mechanism safeguards the AMC against losses if the real economic value is not eventually achieved. To reduce the risk that this contingent liability cripples banks in the meantime, the clawback could take the form of warrants, exercised by national governments. The original capital would thus be protected eventually by national governments, so avoiding mutualisation.

To date, a patchwork of national solutions has been trialed for addressing NPL problems, all different in terms of approach. An EU solution, preferably as a single AMC or, as a second best, as a blueprint for national AMCs, has the benefit of clarity for investors, reduces funding costs, and can create a critical mass in supply and demand of NPLs to further support market efficiency. As a key step in the process of repair for the EU banking sector, it will remove one key impediment to economic recovery across the EU. ●

Sharon Donnery

Deputy Governor, Central Banking, Central Bank of Ireland

Resolving NPLs in the euro area

Persistently high non-performing loans (NPLs) are a European-wide problem. Resolving this has been a top priority for the ECB Banking Supervision since its inception. Following the completion of the Comprehensive Assessment, the High Level Group on non-performing loans – which I have the honour to Chair - was established in 2015. Through our work we identified a number of best practices for NPL management. Those practices have been incorporated into the ECB's 'Guidance to banks on non-performing loans' and represent ECB Banking Supervision's expectations on workout and resolution of NPLs going forward.

"Deliberate and determined reduction of NPLs requires concerted action from all stakeholders."

-SHARON DONNERY

Effectively addressing NPLs is critical given banks with high levels of non-performing loans tend to lend less and at higher interest rates. NPLs do not usually generate income streams comparable with performing assets and also require banks to hold additional capital. Moreover, the inherent judgemental nature of provisioning can cause uncertainty as to banks' actual financial position, leading to negative volatile investor sentiment. More broadly, high levels of NPLs hold down economic activity in Europe by affecting the supply of credit.

However, tackling Europe's NPL problem goes beyond the supervisory domain. Deliberate and determined reduction of NPLs requires concerted action from all stakeholders – including Member States, the Commission and the relevant EU fora.

In conjunction with the 'Guidance to banks on non-performing loans', we also published an accompanying 'Stocktake of national supervisory practices and legal frameworks related to NPLs'. This highlights the results of our analysis on some other key factors that are of critical importance in resolving NPLs including legal, judicial, extra-judicial practices, and information frameworks such as central credit registers. The Stocktake shows that lengthy legal procedures and insufficient court capacity represent a significant obstacle to banks in their ability to reduce their NPLs. For this reason, proactive and coordinated concrete legislative changes aimed at improving the efficiency of the judicial system as well as developing a framework for timely out-of-court collateral enforcement would contribute to the workout of non-performing loans.

The underdevelopment of markets for distressed debt is another factor which impedes the resolution of NPLs. Market stagnation in this regard can be the result of specific obstacles in the legal and regulatory framework. We therefore urge Member States to remove the existing impediments for the efficient functioning of secondary markets. Finally, the establishment of an asset management company can help resolve the NPL problem by tackling market failures in the secondary market for NPLs. In some countries, AMCs were beneficial to remove NPLs from banks' balance sheets and ensure progress was moving in the right direction. Developing an EU blueprint for AMCs would represent a step in the right direction. This would need the involvement of all interested stakeholders beyond the supervisory authorities, given the many policy issues under consideration. ●

Bernard de Longevialle

Managing Director, EMEA Financial Services Lead Analytical Manager, S&P Global Ratings

Without a deep secondary market, the NPL workout could be a long and costly exercise for banks

Our ratings on banks in some EU Member States, particularly in Italy, Portugal and Spain, reflect our expectation that their large stock of non-performing loans will weigh on their financial profiles for several more years. We now see less risk for Spanish and Irish banks as they have largely absorbed the credit costs of the bursting of the real estate bubble.

This stems from solid economic growth, a gradual recovery of the property market and the effect of early intervention measures. That said, we expect the stock of NPLs in Spain to still represent 11% of customer loans in 2018, twice as much of the European average. In Italy and Portugal, the reduction of the NPL stock should be slower, reflecting among other things less supportive economic conditions as well as regulatory constraints limiting policymakers' ability to provide support. In Italy, most banks now face the dilemma of eliminating their NPLs through large disposals or gradually managing them down organically.

Significant differences exist between current book value and discounted NPLs' market prices, which partly reflect high double digit return expectations from the few NPL buyers available. Selling most outstanding NPLs would likely force banks to take capital strengthening actions to cover the shortfall that could emerge. We believe only a few institutions have the ability and willingness to do it.

The €20 billion fund recently created by the Italian government mainly to provide capital support to troubled institutions will help them dispose of a large portion of their NPLs and restore their capital positions. It cannot be a cure for all, in our opinion, both for the limited size and for the severe consequence its use would have for shareholders and subordinated bondholders under state aid rules.

The creation within the European Union of an asset management company aimed at buying and managing European banks' NPLs could boost NPL stock resolution provided that it leads to a material decline in discount rates and makes NPL transfers more affordable for banks. ●

Operationalisation of the EU bank resolution framework

Contributors


© MORGANEDELFOSSE

Elke König

Chair, Single Resolution Board (SRB)

The EU Resolution Framework– for more reliable and competitive banks

In the European Union the BRRD and the SRMR provide a solid basis for successful resolution. They provide a broad range of tools and allows resolution authorities to collect the data needed to analyse a bank's structures and operations, to identify and segregate critical functions, to remove impediments to resolution and to make the owners and creditors of an institution pay for its resolution rather than the taxpayer. Having said that, nothing is so good that it cannot be improved.

Triggered by the need to transpose TLAC, which will enter into force in 2019, into the European Resolution Framework, the European Commission has just launched a legislative proposal that will amend the BRRD and the SRMR.

While TLAC and MREL have the same purpose, there are important differences in the scope of these instruments. The Commission has therefore proposed to create a two pillar-system. Pillar 1 MREL would implement TLAC by establishing a harmonized minimum standard exclusively for GSIBs with components of mandatory subordination. Pillar 2 MREL, where no mandatory subordination is foreseen, would be determined individually for the remaining banks, similar to what is currently foreseen. For GSIBs, according to the proposal, an additional Pillar 2 MREL could be required by the resolution authorities on top of the Pillar 1 requirement. Our first experiences over the last two years show that sufficient resolution authority discretion is paramount in determining MREL effectively and we hope that the new legal framework once finalised will reflect this. MREL is a key tool to achieve resolvability of banks.

From another angle, it could pose difficulties if subordination, as foreseen under Pillar 1 MREL, would only be applicable to GSIBs. Cliff effects may arise, in particular with respect to other systemically important banks that do not qualify as GSIBs but often have similar characteristics and a similar footprint and compete in the same markets.

Resolution authorities must be in a position to define bank specific subordination requirements to ensure that instruments are bail-in-able with legal and operational certainty and with sufficient discretion and flexibility.

A workable solution to the subordination conundrum will also help to honour the no creditor worth off principle in resolution and ensure a fast and safe bail-in-procedure both in operational and legal terms. The SRB would of course welcome any workable subordination solution, provided it supports a flexible resolution strategy and ensures MREL is of adequate quality.

It must be noted that, as the BRRD and SRMR are already applicable law, when we anticipate their revision introducing additional requirements, a feasible mode of transition must be found. Whatever the final MREL targets will be, they should be attained as fast as possible, bearing in mind feasibility. We are, however, mindful of the challenges in individual cases.

However, there is no need for any specific changes to the BRRD and the SRMR with the aim of addressing persistent "legacy problems", a term often cited against the >>>

>>> backdrop of current concerns about non-performing loans (NPLs) in certain institutions and markets.

Here, efforts to clean up are indeed needed and any European impulse to support this by providing an infrastructure for asset management companies and the like can be helpful.

And in this context, we should recall that the concept of precautionary recapitalisation under the BRRD and the SRMR is not a tool to avoid resolution or liquidation where a bank is failing or likely to fail. It is – as the name rightly states – a valid but exceptional measure to restore confidence and remedy a serious disturbance in the economy of a Member State with the aim of preserving financial stability. It is meant to be a precautionary and temporary measure, reserved for solvent entities and shall not be used to offset losses that the entity has incurred or – and this is crucial – is likely to incur in the near future. It is subject to approval under the Union State aid framework – which serves as a safeguard against any misinterpretation.

Taken as a whole, the BRRD and the SRMR provide for a resolution framework that safeguards financial stability without using taxpayer's money in case a bank fails. ●

Jérôme Brunel

Corporate Secretary, Crédit Agricole S.A.

Conditions for an MREL regime in support of effective resolvability

When the EU adopted its Bank Recovery and Resolution Directive (BRRD) in 2014, the bail-in tool and the Minimum Requirement for own funds and Eligible Liabilities (MREL) aimed at ensuring effective bail-in and resolvability. That objective was also shared at global level which led to the adoption of the international TLAC standard and its transposition into EU law through the November 2016 European Commission proposals to revise CRR and BRRD. Within the banking union, binding consolidated MREL have not yet been set as the SRB is still developing its MREL methodology and the legal framework is not stabilised. As a cross-border consolidated banking group, we consider that there are two important dimensions for the MREL regime to be effective and comply with the policy objective.

First, we need to address the MREL shortfall[1] while managing the increase in banks' funding costs[2] and facilitating market absorption of simultaneous issuances. This implies three main actions. First, the subordination requirement should be capped at the level prescribed by the FSB for TLAC (14.5% RWAs[3]) so that additional requirements can then be met with eligible preferred senior debt, as already provided by the BRRD. Subordination is important to avoid no creditor worse off issues but a large scope of eligible bailinable instruments is also important to address the shortfall, especially in view of the potentially high levels of MREL. Second, the resolution authority should consider the bank's risk profile and resolution strategy when calibrating the MREL and adjust it accordingly. Finally, grandfathering clauses should be introduced to ensure the continued eligibility of the stock of liabilities issued prior to the entry into force of the revised CRR and BRRD. This would ensure legal clarity and predictability as banks adjust their balance sheets in anticipation of the MREL requirements.
Second, the internal MREL framework needs to be coherent with its initial objective. Internal MREL aims at ensuring a minimum recapitalisation capacity at the >>>

>>> level of material entities which are located outside the resolution entity's home jurisdiction to facilitate cooperation between home and host resolution authorities. A mechanism for loss allocation within banking groups is needed to facilitate resolution and even more so within cross-border groups. But flexibility is needed regarding its calibration and level of application. At banking union level, it would only be logical that no internal MREL be required. As things stand, banking groups headquartered in, and operating across the banking union would face internal MREL for their subsidiaries, despite their centralised risk management, their single supervisory authority, their single point of entry resolution strategy and their single resolution authority. If the banking union is to become a reality, it should be treated as a single jurisdiction. To the very least waivers should be automatically granted for subsidiaries located in the same Member State as their resolution entity. In any case, as a cooperative group, we strongly believe that no internal MREL should be required for entities within the scope of mutual solidarity systems that protect the solvency and liquidity of the affiliated institutions.

Beyond the banking union, the calibration of the internal requirement should, as provided by the FSB[4], be limited to material subgroups and capped by an explicit limit. This would contribute to the effectiveness of MREL as it would enhance legal certainty, facilitate agreement between home and host authorities within resolution colleges and ensure a level playing field with non-EU jurisdictions.

There is a need for aligning the political objectives of strengthening the banking union with the legal framework's incentives under the principle of one supervisory authority – one resolution authority – one jurisdiction. This is all the more relevant for cross-border banking groups which centrally manage their liquidity and solvability and have a single point of entry resolution strategy. ●

1. Estimated MREL shortfall would amount to EUR 154 billion (of which EUR 110 billion for the G-SIBs or 2% of RWAs) under the Loss Absorbing scenario with partial subordination (EBA report on MREL, 14 December 2016)
2. The total increase in funding costs for the EU banking sector would amount to EUR 3.2 billion under the Loss Absorbing scenario (EBA report on MREL, 14 December 2016)
3. 18% minus 3.5% taking into account the subordination exemption
4. Internal requirement should be in the range of 75-90% of the external MREL that would apply to the material subgroup if it were a resolution group.

Olivier Guersent

Director General, Financial Stability, Financial Services and Capital Markets Union, European Commission

A more effective bail-in through internal market driven solutions: a proposal on bank creditor hierarchy

The internationally agreed TLAC standard[1] requires G-SIBs to issue significant levels of subordinated liabilities by following an ambitious timeline[2]. These liabilities should absorb losses in resolution prior to other liabilities that are explicitly excluded from TLAC eligibility, such as derivatives, covered deposits or tax liabilities. For other banks, EU resolution authorities may decide on a case-by-case basis that their MREL requirement should be met with subordinated instruments. >>>

>>> Following the adoption of the TLAC standard by the G20, in order to facilitate a more efficient path towards compliance with TLAC by 2019, as internationally agreed, a number of EU Member States have already proceeded to amend the ranking of creditor claims under their national insolvency law. However, these changes create significant divergences that have the potential to amplify uncertainty for debt issuers, investors and resolution authorities and make the application of the bail-in tool in cross-border resolution cases legally more complex and less transparent. At the same time, the buy-side would experience information asymmetry among different EU Member States, rendering the process of pricing the risk more cumbersome. The resulting uncertainty could also trigger competitive distortions because unsecured debt holders could be treated differently in different Member States and the MREL compliance costs for banks may be different according to the location of the issuance. For these reasons, the European Parliament[3] and the ECOFIN Council[4] invited the Commission to put forward a proposal on a common approach to bank creditor hierarchy.

In response to the above, the Commission proposals[5] include an EU harmonised approach on bank creditors' insolvency ranking that would enable banks to issue debt in a new statutory category of unsecured debt available in all EU Member States. Such debt would rank just below the most senior debt and other senior liabilities for the purposes of resolution, while still being part of the senior unsecured debt category (only as an "un-preferred" lower tier senior debt).

"An EU harmonised approach on bank creditors' insolvency ranking that would enable banks to issue debt in a new statutory category of unsecured debt available in all EU Member States."

- OLIVIER GUERSENT

Clear harmonised rules on the position of bond holders in the bank creditors' hierarchy in insolvency and resolution could facilitate the way bail-in is applied, by providing greater legal certainty and reducing the risk of legal challenges. These rules could also promote a true European bank debt market where both bank issuers and investors alike are treated in the same way in insolvency and resolution.

The Commission's proposed approach is based on the assumptions of a quick adoption and application of harmonised rules (by July 2017) and, to avoid further discrepancies, a stand-still obligation for Member States aimed at not changing their existing approaches before the application date. As a result, the new rules should apply to all new debt issued after the date of application of the proposal. Debt issued before that date will be governed by the national laws of Member States as they were adopted on 31 December 2016, which would effectively grand-father their insolvency ranking.

Whether the ambitious timelines proposed by the Commission will be achieved ultimately depends on the procedure and the outcome of the discussions in the European Parliament and the Council. The time is running against the pertinence of a harmonised approach for a timely compliance with the TLAC standard and implementation of the MREL in the most "internal market" friendly way. ●

1. FSB, Principles on Loss-absorbing and Recapitalisation Capacity of Globally Systemically Important Banks (G-SIBs) in Resolution, Total Loss-absorbing Capacity (TLAC) Term sheet, 9.11.2015
2. 16% RWAs (6% leverage ratio denominator) as from 1 January 2019, and 18% RWAs (6.75% leverage ratio denominator) as from 1 January 2022.
3. Report on Banking Union – Annual Report 2015 (2015/2221(INI)).
4. Council conclusions of 17 June 2016 on a roadmap to complete the Banking Union: http://www.consilium.europa.eu/press-releases-pdf/2016/6/47244642837_en.pdf
5. Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on amending Directive 2014/59/EU of the European Parliament and of the Council as regards the ranking of unsecured debt instruments in insolvency hierarchy, COM(2016) 853 final, 23.11.2016.

Felix Hufeld

President, Federal Financial Supervisory Authority (BaFin)

Internal MREL – it all depends on the right balance

Supervisors and resolution bodies are equally determined to make the best possible use of the EU Bank Recovery and Resolution Directive to improve the stability of the financial system. A crucial element of success is to ensure as part of the resolution planning that institutions and groups of institutions are resolvable at all, should the need arise. However, effective structures within institutions and groups of institutions during their lifetimes are equally important.

The internal minimum requirement for own funds and eligible liabilities (internal MREL) is intended to make the chosen resolution strategy credible. It needs to be clear that resolution actions will really only be put into place at the resolution entity, i.e. the company within a group specified in the resolution plan for this purpose. The subsidiaries of the resolution entity must be able to rely on it refinancing them in the event that they fail.

A particularly secure variant of the internal MREL for the subsidiary is prepositioning. The resolution entity – often the parent company – provides the subsidiary with funds in good times, which the subsidiary does not have to pay back if it fails. This, in turn, has a positive effect on the subsidiary's equity and contributes to its recapitalisation.

However effective this concept may be for resolution, in individual cases it can have negative consequences both for the resolution entity and for the subsidiary in good times: for instance, the available funds of the parent institution and the financial needs of the subsidiary do not always match the prepositioning requirements. In some cases, the existing and economically most reasonable financial relationships within a group of institutions might not correspond to the prepositioning requirements regarding the relationship between resolution entity and subsidiary. This may cause financial management within the group of institutions to suffer, with cost-related restructuring becoming necessary.

Moreover, prepositioning can also raise regulatory questions: To what extent are the resolution entity's own funds requirements increased by the exposure to the subsidiary? Can the requirements for the amount of prepositioning as part of the internal MREL be fulfilled within the provisions of the large exposures regime? In this context, it may be important that relevant group privileges can be applied. In addition, effects on the liquidity coverage ratio or the net stable funding ratio cannot be ruled out, for example if liquid funds are passed to the subsidiary institution as part of the internal MREL.

"The internal minimum requirement for own funds and eligible liabilities (internal MREL) is intended to make the chosen resolution strategy credible."

- FELIX HUFELD

One solution which is under discussion is for the parent institution to grant collateralised guarantees to the subsidiary instead of prepositioning. However, guarantees should be used with great caution since they often do not offer adequate comfort for the subsidiary. It will be necessary to act with a sense of proportion to find a balance between effective financial management within the group and the justified interests of subsidiaries. ●

Elisa Ferreira

Member of the Board of Directors, Bank of Portugal

Financial stability impact and considerations on MREL

The Minimum Requirement for Own Funds and Eligible Liabilities (MREL) set out in the BRRD is an essential tool for resolution authorities, as it helps to ensure that banks have sufficient loss absorbency capacity under resolution without affecting liabilities that are key to the continuity of the banks' business and without relying on taxpayers' money.

"The design and implementation of the MREL framework was not without its faults."

- ELISA FERREIRA

However, the design and implementation of the MREL framework was not without its faults. The problems were broadly identified by the European Commission in the legislative proposals presented in November 2016, but further work is still needed. >>>

>>> Firstly, the BRRD failed to fully take into account the fact that banks would not be able to comply with MREL immediately after its entry into force. This is true for banks in general, but more so in the banking systems that are still recovering from the aftermath of the financial and sovereign debt crisis.

Also, the criteria for setting the MREL laid down in the BRRD, and further developed in the Delegated Regulation, may lead to a significant amount of MREL shortfalls. This is especially the case if those criteria are applied mechanically, without taking into account the specific resolution strategy for each bank and national specificities regarding access to markets and debt issuance needs.

These potential MREL shortfalls present significant risks, of a systemic nature. It is unlikely that markets will be able to absorb smoothly such large volumes of debt issuance. It could even be argued that the magnitude of the requirements being imposed on banks might cast doubts on the ability of banks to address them, which in turn would undermine the credibility of the whole MREL process. Moreover, it cannot be excluded that, if trapped between large MREL requirements and an inability to access financial markets, and given the current low interest rate environment, there might be a perverse incentive for banks to expand their balance sheets and aggravate their risk profile to offset higher funding costs, with riskier practices that would endanger financial stability.

At international level, it also cannot be ignored that the scope of the MREL requirement goes beyond that of the TLAC. Whereas the TLAC applies only to G-SIBs, the MREL requirement applies to all credit institutions in the EU, regardless of their size. Proportionality is thus crucial, in order not to compromise the level playing field.

Taking all of this into account along with the experience gathered so far, it is important that a proper transitional period is provided for, covering the compliance timeline, composition of MREL and location of loss absorbency capacity within the resolution group. In this way, banks would have enough flexibility to adapt their activity and funding structure in a manner that could be accommodated and would not promote unintended behaviours. This would allow systemic impacts arising from the MREL to be taken into account.

In conclusion, the importance and benefits of MREL are indisputable. But, in its design and implementation we must weigh the possible negative spillovers arising from large MREL shortfalls and consider the overarching principles that presided over the creation of the resolution framework, with the ultimate goal of not endangering financial stability. ●

Andrew Gracie

Executive Director, Resolution, Bank of England

The EU TLAC proposal and the international TLAC standard

The agreement of the TLAC standard was a milestone in the international effort to combat the too big to fail problem. Although the Financial Stability Board's Key Attributes for effective resolution regimes provide the legal framework for resolution, the 2015 TLAC standard is necessary to enable resolution to take place.

TLAC sets an international minimum loss absorbency standard to be met by firms whose failure, by definition, would have a global impact: GSIBs. Why is a global minimum necessary? It provides a level-playing field for GSIBs, gives host authorities confidence they will not be cut loose and reduces the risk of conflicting local standards which might stand in the way of agreement of a global resolution plan in the Crisis Management Group.

In November, the European Commission proposed legislation to fulfil its commitment to adopt TLAC. Under the CRR each EU GSIB must meet the minimum TLAC standard of 16% of risk weighted assets (RWA) in 2019, rising to 18% in 2022. Consistent with TLAC, this must be met with subordinated liabilities. The BRRD is to be amended to provide a framework for increasing – up to a cap – this minimum 'Pillar 1' TLAC via a 'Pillar 2' MREL.

Once the CRR is adopted, the EU will have met its commitment to implement TLAC for EU GSIBs, albeit not verbatim. It will join the US and Switzerland in setting minimum requirements, although it is unclear how the final EU Pillar 1 and Pillar 2 requirements will compare in terms of quantity and quality to those set elsewhere. This will depend on the final design of the BRRD and the actions of resolution authorities.

Mirroring recent US rules, the CRR proposes the EU operations of non-EU GSIBs – to be supported in resolution by their parents – will be subject to a requirement set at 90% of that for EU GSIBs. This 'internal TLAC' will be issued to the parent, enabling losses to be passed up and recapitalisation resources passed down.

It is to be seen what impact mandating internal TLAC at 90% – rather than permitting resolution authorities to set this within the 75 – 90% TLAC range ¬– has on the application of TLAC for groups and their flexibility to transfer resources intra-group in a crisis.

The CRR is, however, inconsistent with an important Basel standard linked to TLAC. This requires a bank buying a GSIB's TLAC to deduct this from its own capital, reducing the risk of contagion if a GSIB enters resolution. The CRR proposal falls short of this in two respects. First, the rule only applies to GSIBs, permitting other banks to buy these instruments. Second, it is less penal, requiring a GSIB to deduct a holding of TLAC from its own TLAC rather than its capital. This reduces the disincentive the standard is designed to address is inconsistent with the level-playing field Basel standards are intended to accomplish.

Finally, it should not be forgotten, that while TLAC is necessary to end TBTF it is not sufficient. Other jurisdictions need to match Europe in implementing resolution regimes and further work is required to overcome other impediments to resolution. ●

Mark Venus

Head of Recovery
and Resolution Planning, BNP Paribas

MREL - TLAC an opportunity

The proposed revisions to BRRD and CRR/CRD contain many positive elements, creating the perspective of a harmonious reconciliation of the EU concept of MREL with the FSB concept of TLAC.

A first and major step has been the proposal to align the metrics of MREL with those of TLAC, using RWA's and leverage as the reference values for MREL. This does not change the absolute value of loss absorbing capacity, but creates comparability and simplified management for banks.

The next major step has been the presentation of a clear insolvency hierarchy for banks, with the introduction of a new statutory ranking , allowing 'Opco' banks to issue debt that is economically perfectly comparable to the 'senior Holdco' debt that has to date been the primary source of TLAC eligible liabilities.

With identical metrics and comparable liability classes potentially in place, it now remains to harmonise three key elements; calibration, the treatment of breaches, and internal MREL.

The ingredients are present for the harmonisation of calibration. If one can regret the recourse to 'formula-style' fixing of the requirement, rather than the focus on an absolute number (16%...18%) as for TLAC, the proposed split into 'requirement' and 'guidance' opens the perspective of EU GSIB's facing 'requirements' that are drawn from strict application of the TLAC Term sheet, with any necessary resolution authority discretion exercised through 'guidance', that sits above buffers and allows for dispassionate discussion between banks and resolution authorities on a one to one basis. This coherent vision of the calibration of overall MREL objectives must be preserved and reinforced by the co-legislators.

The treatment of MREL breaches still needs considerable improvement. The application of MDA rules to MREL breaches, as envisaged in the draft texts, may have the apparent advantage of applying identical treatment to capital and MREL breaches. But this is a simplistic vision, which ignores the essential difference between capital and debt; capital, once raised, does not leave a bank save for major losses, whereas debt needs to be raised, repaid and re-issued. Difficulties in re-issuing debt can arise for reasons independent of the health of banks, as the closure of the bank debt market in early 2016 showed. This feature of debt cannot be ignored, it is an essential difference in the nature of the underlying liabilities, and entirely justifies differential treatment of MREL and capital breaches. Distribution restrictions might be appropriate in some instances of MREL breaches, but there should be no question of automaticity, which would have inevitably disruptive impacts on the markets. MDA should not stand for 'Market Disruption Assured'!

Internal MREL currently needs more analysis, and the SRB has wisely recognised this in its policy statements. Whilst all jurisdictions understandably want to see local institutions protected by a layer of capital and loss-absorbing debt, the distribution of these liabilities inside banking groups must take into account the reality of risks present in each subsidiary, and above all must recognise the reality of the EU and Banking Union, with its unified supervisory and resolution regimes and authorities. Internal MREL is an opportunity for Member States and national authorities to reiterate their commitment to Banking Union.

The current reforms thus present clear opportunities to create a harmonious integration of MREL and TLAC in a consistent framework giving reality to the Banking Union, this opportunity should not be passed up! ●

Olivier Jaudoin

Director, Resolution Directorate,
Autorité de Contrôle Prudentiel
et de Résolution (ACPR)

Strengthening the EU banking market through an enhanced resolution framework

In 2017, the transposition of the TLAC requirement into EU law will have a significant impact on the MREL requirement and the European Commission has prepared amendments to CRR and BRRD to this end. This is a strong and welcome evolution.

Despite sharing the same objective of providing that sufficient loss-absorbing capacity is available for resolution, TLAC and MREL regulations have different features in terms of scope - GSIBs vs all credit institutions - and requirement - minimum standard (pillar 1) vs case-by-case approach (Pillar 2).

For the sake of efficiency of resolution measures and level playing field, the TLAC requirement >>>

>>> should apply in substance to the bulk of bailinable entities beyond GSIBs, and stand as the pillar 1 part of MREL. The EU should tend towards the reconciliation of the MREL and TLAC requirements by setting up a pillar 1 matching the TLAC requirement and a pillar 2 set up by the resolution authority.

It is also important to prevent the introduction of a general subordination criterion in the MREL setting. Beyond the TLAC type pillar 1 for systemic entities, partial or full subordination should be required only on a case by case basis. Furthermore, in case of full subordinated MREL, markets would not be able to absorb such an amount of subordinated debts even over a reasonably long transition period.

"The EU reform must strengthen the Single Banking Market or there will be a strong risk of ringfencing."

-OLIVIER JAUDOIN

The EU reform must strengthen the Single Banking Market or there will be a strong risk of « ringfencing ». The MREL should be required at the appropriate level in the group through "Intra-EU MREL" (more than "internal MREL") in order to reflect the approach contained in the resolution plan. Otherwise, each concerned Member State might be tempted to require MREL at its level independently from the resolution strategy. This would be unnecessarily costly and at odds with the principle of the Single Banking Market.

The so-called "banking package" proposes at the EU level a new "unpreferred" class of senior unsecured debt to be bailed-in in case of resolution. This new class of debt will rank between subordinated debt and senior preferred unsecured debt. It represents a valuable tool to build MREL relying on robust instruments with clear common features of subordination across the EU.

It is of paramount importance to go fast in adopting and implementing this proposal to facilitate the respect of TLAC/MREL requirements and the use of resolution tools on EU banks. ●

Steve Hottiger

Head Governmental Affairs, UBS

What are the main issues raised by the introduction of TLAC in the EU legislation?

As a result of the evolving regulatory environment, the financial sector is undergoing a substantial change. One particular driver are stricter loss-absorption requirements, making capital a scarce resource and the cost of capital a key element of competition. Comparable capital regimes are thus essential to ensure a level playing field for internationally active banks. As such, it is encouraging that the European Commission aligned its proposal for MREL-requirements to the FSB TLAC standard. Certain remaining deviations could however – if implemented – have negative implications for the competitiveness of non-EU headquartered global systemically important institutions (G-SIIs). A particular concern is the proposed internal MREL requirement for material EU subsidiaries of non-EU G-SIIs. As the EU does not impose similar requirements on the subsidiaries of EU headquartered G-SIIs, this would not only lead to a competitive disadvantage for subsidiaries of non-EU G-SIIs. By fixing the pre-positioning requirement at the top end of the range for internal TLAC set by the FSB, the proposal could also amplify the risk that the consolidated amount of internal TLAC/MREL exceeds the external TLAC requirements of non-EU G-SIIs obliging them to hold excessive TLAC at the Group level. Instead of 'hardwiring' the internal MREL we believe the resolution authorities should have the discretion to set internal MREL requirements taking into account the specific characteristics of the subsidiaries (e.g. business mix and risk profile) as well as the requirements imposed on other banks in the same jurisdictions.

"Internal MREL requirements for subsidiaries of non-EU banks should reflect their specific characteristics."

-STEVE HOTTIGER

Another issue relates to the proposed requirement to establish EU IHCs which would add to the competitive disadvantage for non-EU G-SIIs by significantly increasing costs. More broadly such a requirement has a ring-fencing effect, which, besides fragmenting the global banking activity, also could negatively affect trust and cooperation among regulators and thus might in fact be damaging to the goal of making the financial sector more stable. ●

Jean Naslin

Executive Director,
Head of Public Affairs, CaixaBank

Right balance between costs and benefits when setting MREL: A challenge

MREL needs to be an effective bail in resolution tool which preserves the specificities of European banking models. The focus must be on resolvability without ever needing resolution funds to absorb losses.

However, the benefits of the framework will not be achieved if the requirements were to be arbitrarily set at maximum level as has been suggested in early stages of the process.

A successful resolution framework will improve market and investors confidence. Implementing the >>>

>>> framework will necessarily be costly. It increases the cost of funding, especially for institutions predominantly deposits funded. This will in effect require substantial access to financial markets and indeed for the sole purpose of MREL.

The capacity or appetite of the market to absorb the huge volume of instruments to be issued remains an open question. Early clarification on ranking hierarchy is of particular relevance in this respect.

The Resolution Authorities should look at the balance between the benefit of having MREL fully implemented in the shortest timeframe and giving enough time for its implementation, to enable banks to design and execute feasible cost effective plans whilst allowing markets to absorb high volumes.

"Nobody will deny that banks must have a sufficient and an adequate level of MREL."

-JEAN NASLIN

The clarifications introduced in the European Commission proposal of November 2016, which is very much welcome, should guarantee sound, well calibrated, and reasonable levels of MREL, for each institution achieving the objective of adequately balancing costs and benefits.

This can only be achieved after a timely and transparent careful analysis on a case by case basis, avoiding mechanical determination at maximum levels, taking full account of the size, business model, funding model and the risk profile after the resolution strategy has been implemented as well as the full range of recovery tools available not just bail in .

Nobody will deny that banks must have a sufficient and an adequate level of MREL. Developing a methodology which addresses very different banking models is certainly not an easy task. It represents a considerable challenge for the Resolution Authorities. There is no such a thing as a "one size fit all" or mechanistic formula for an effective resolution strengthening the financial system. ●

Insurance industry outlook

Contributors

Sandrine Lemery

First Deputy Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

Conditions for defining appropriate macro-prudential policies for insurers

For many years, the traditional model for insurance firms has been considered as immune to the main risks that characteristized SIFIs: since liabilities were prefunded, there was no possibility of leverage; and active asset-liability management limited liquidity mismatches. However, any macroprudential framework aiming at enhancing financial stability is now viewed as necessarily including insurers. In its Financial Stability reports, EIOPA defines financial stability in the field of insurance "as the absence of major disruptions in the financial markets, which could negatively affect [insurers] or pension funds. Such disruptions could, for example, result in fire sales or malfunctioning markets for hedging instruments. In addition, market participants could be less resilient to external shocks, and this could also affect the proper supply of insurance products or long-term savings products at adequate, risk-sensitive prices." As such, insurers can be either originators or amplifiers of risks with a systemic effect, due to their interconnection with the financial system. This is one of the rationales for, when appropriate, having recovery and resolution plans for insurers.

When defining macroprudential policies for insurers, as for any other sector, the interaction with other policies – e.g. monetary, fiscal or microprudential - should be taken into account. Geographical scopes of these policies also vary: the Eurozone for the Euro monetary policy, country level for fiscal policies. It is then essential to define, together with the framework, a hierarchy between the policies in order to avoid conflicting frameworks when principles underlying the policies are contradictory. Collective interest will also need to prevail against the individual ones and responsibilities between all involved authorities clearly defined.

The general purpose of financial stability can be broken down into 2 intermediate objectives: reducing the likelihood of a major crisis; reducing its impact. A macroprudential framework can then be composed of several tools, which can target different operational objectives. Countercyclical measures, as the volatility adjustment or the matching adjustment in Solvency 2, are implemented in order to smooth the impact of sudden variations of financial markets on the valuation of the insurer's balance sheet. Resolution frameworks are aiming, among other operational objectives, at ensuring the continuity of insurers' critical functions without exposing public funds to loss, as stated in the FSB Key attributes[1]. All measures should however not be applied simultaneously and permanently. Indeed, measures need to vary over time according to the financial environment.

In autumn 2016, the French parliament voted the Sapin II law, providing for a future macroprudential framework dedicated to the insurance sector. In this future framework (to be completed before end 2017), ACPR will be the resolution authority for the insurance sector (as it is already for the banking sector). ACPR will be allowed to require significant insurers and insurance groups to establish prevention and recovery plans, and will draft resolution plans for these insurers. Insurers will also be required to take any measures aiming at removing any obstacles to their resolution; the definition of the conditions of entry into resolution and its legal consequences, the establishment of a bridge institution, and the revision of remunerations of the management of a failing insurer are part of this framework. But the Law goes further by reinforcing the powers of the French High Committee for Financial Stability, in order to prevent risks which threaten the financial strength of the insurance market, taking into account the financial stability and the policyholder protection. Enforcement powers which currently exist at the microprudential level are made available as macroprudential powers which can apply to the whole

>>>

>>> French market (power to modify provisioning rules and reverse profit sharing, to limit some transactions including premium underwriting, to restrict the free disposal of assets, to limit lapses, arbitrage or policy loans request, to limit the distribution of dividends to shareholders...).

France has then decided to implement a global macroprudential framework. Other countries in Europe, as the Netherlands or Romania, have put in place resolution frameworks. National initiatives, even if welcome, need to anticipate potential implementation difficulties for cross-border insurance groups. Just like the microprudential rules are harmonized in Europe through Solvency II, just like the monetary policy is shared throughout the Euro zone, it makes sense to develop a shared macroprudential framework in the EU. As groups are developing cross-border, a proper cooperation between national authorities is key to ensure financial stability. Beyond an EU framework, on-going discussions at global level should further prevent the spread-out of crises in markets which are more and more interconnected. ●

1. See Preamble of the FSB Key attributes, 1st § page 3

Dr. Frank Grund

Chief Executive Director Insurance and Pensions Funds Supervision, Federal Financial Supervisory Authority (BaFin)

Why is there a need for macro-prudential policies for insurers?

It is evident that there are macroeconomic developments that could affect the financial industry as a whole, for instance the current low yield environment. Therefore, the question arises whether there is a need for macro-prudential instruments to address the resulting risks. Currently, there is no clear picture of macro-prudential policies yet for the insurance industry. Discussions are going on but there is a long way to go to a global or European common approach.

From a supervisory perspective the question is how to deal with macroeconomic risks. In the event of an industry-wide stress scenario that hits a large number of entities in a similar manner, a micro-prudential approach entails the risk to act too slowly. In this case, it may be preferable to take certain supervisory actions for a large number of undertakings or the sector as a whole and not to wait until solvency issues materialize at an individual level.

However, the effective use of macro-prudential instruments is an issue of the right timing as well. That underlines the interrelation of micro and macro instruments and makes clear the necessity of a carefully designed concept regarding the use of such instruments or a combination of them. Such a discussion should lead to a balanced view to which extent macro-prudential instruments can support existing micro-instruments.

In Europe, the common European solvency regime Solvency II contains several elements that may have a macro-prudential impact, e.g. the volatility adjustment to the risk-free interest rate term structures. Still, the focus of this regime is clearly micro-prudential. In Germany, the national legislator has also implemented a variety of micro-prudential instruments for the insurance sector, which have a reasonable macro-prudential effect, e.g. the additional premium reserve in life insurance. There have also been first developments of policies with a clear macro-prudential focus at the national level, such as under Sapin II in France. However, I am convinced >>>

>>> that that we can learn more from each other in this area in Europe. A first step in this direction would be a review of macro-prudential regulatory measures at a European level.

In conclusion, it is therefore very important that any macro-prudential policy should take into account the interrelation with existing micro instruments and should mirror in an appropriate way the specific nature of the insurance industry and be tailor-made, since otherwise the risk is not negligible that non-insurance relevant considerations gain an inappropriate influence. ●

Alberto Corinti

Member of the Board of Directors, Italian Insurance Supervisory Authority (IAIS)

Developing systemic risk measures in insurance

The development of policy measures to mitigate systemic risk in insurance has mainly focused, until now, on the impact of the failure or distress of an individual (insurance) entity. This has led to the definition of systemic risk measures applied to those globally active insurance groups, to be identified based on a specific methodology, whose distress would cause or amplify disruption to the financial system and economy.

In this context, the recent review of the IAIS methodology and in particular the work on systemic risk from insurance product features, highlighted the main sources of systemic risk and the main transmission channels through which the distress could potentially impact the system. This includes the concept of interconnectedness, both in terms of exposure to counterparties and of correlated exposure to market risks, as well as asset liquidation, stemming from liquidity mismatch between assets and liabilities.

This approach, however, may fail to identify and address vulnerabilities which, rather than being related to the impact of distress of single insurers, depend on commonalities of behavior or correlated exposure of more insurers within the sector, independently from their size and degree of interconnectedness. As noted by the IMF (April 2016), systemic importance of insurers has grown since the global financial crises and this increase has been driven mostly by higher commonalities in exposures and greater exposure to market risk through the combined effect of assets and liabilities, rather than from the default risk of individual institutions. Persistent low interest rate risk or common reaction to shocks or macroeconomic strains could be associated with this type of vulnerabilities.

Those considerations led the IAIS and other regulatory fora to start an analysis on the so called "activities based approach", which entails identifying potential sources of vulnerabilities across insurers, including correlated exposure and incentives for similar behavior. Under this perspective, careful consideration needs to be given to the fact that the insurance sector is embedded in a broader financial sector. Cross-sectoral consistency is, hence, an integral part of any such analysis.

Any regulatory development based on this approach, before leading to any new policy measure, would require mapping and evaluating the role of the existing micro-prudential measures in mitigating potential systemic risks. Several policy measures, even if designed for micro-prudential purposes, may actually fulfil a macro-prudential objective too. In Europe, a similar project is under way with regard to the Solvency II framework.

The "entity based" and the "activities-based" approaches look at systemic risk from a different angle. Further work needs to be undertaken to fully understand to what extent the two approaches complement each other and, if at all, they could be substitutes. In any case, the methodology used by the IAIS to identify G-SIIs could be reviewed in the future also in the light of any "activities based" component of the overall framework and could focus on the entity specific source of systemic risk that cannot be addressed by market wide measures. ●

Dimitris Zafeiris

Head of EIOPA Risks and Financial Stability Department, European Insurance and Occupational Pensions Authority (EIOPA)

Macroprudential framework in insurance: Relevance and differences to banking

A macroprudential framework may be needed if a sector, or some activities of a sector, can create or amplify systemic risk. Indeed, the main goal of macroprudential policy is financial stability, and the concept of financial stability is strongly linked to systemic risk.

One potential definition of systemic risk is the risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy. How can insurance become a source of systemic risk? As a starting point, we could identify four potential sources of systemic risk:

- Exposure to common shocks and vulnerabilities (such as a prolonged low interest rate environment) leading to a generalised deterioration of the solvency position of the sector as a whole. >>>

>>> • Potentially dangerous interconnections or excessive concentrations that might have spill-over effects in case of adverse developments.
- Involvement in certain activities or products not directly connected to traditional insurance, which may involve maturity transformation and leverage and/or generate systemic risk by means of domino effect.
- Potential collective behaviours by insurance companies that may exacerbate market price movements, such as herding behaviours, "search for yield" or fire sales in case of adverse market developments.

The above mentioned sources, although may appear similar to the ones of the banking sector, require a tailor-made approach. Different business models, liquidity profiles, asset and, especially, liability structures require different treatment of risks and possible transmission channels. Replicating the policy measures of banking into insurance, may pose higher risks than the absence of a macro prudential framework.

Underlying, insurance specific issues may not be addressed and, therefore, any regulatory initiative put forward on this basis runs the risk of being inefficient or even detrimental. EIOPA approaches the issue of a macroprudential framework in insurance by applying a stylized framework that considers a final objective (i.e. the achievement of a stable financial system supporting long-term economic growth), two intermediate objectives in which the final objective can be broken down (i.e. mitigating the likelihood and the impact of a systemic crisis) and several operative objectives, such as increasing the resilience of the insurance sector and avoiding procyclicality.

Before embarking on discussions for additional policies and tools, the specific insurance risks need to be identified, followed by an assessment of the adequacy and features of the existing frameworks. Solvency II is a new micro-prudential regime that already includes some potential macro-prudential and counter cyclical elements (e.g. symmetric adjustment of the equity capital charge, LTG package, extension of the recovery period).

Hence, their macro-prudential impact needs to be analysed and assessed to find out whether some additional tools, as an integral part of Solvency II framework, are needed in order to properly avoid the build-up of systemic risk.

The ongoing review of the Solvency II regime presents an opportunity of incorporating such debates and exploring policy options within a single framework, promoting consistency and complementarity between macro and micro prudential supervision. ●

Yoshihiro Kawai

General Secretary, International Association of Insurance Supervisors (IAIS)

Is there a need for a resolution framework in the insurance sector?

Yes. The IAIS has developed a framework for Macroprudential Policy and Surveillance (MPS) in insurance. This work builds on the foundation laid down in the Insurance Core Principles (ICPs) approved in October 2011, and in particular on ICP 24, which provides the principles and standards for macroprudential surveillance to be implemented by supervisors. This is not a new concept. The financial crisis showed, in some cases, the inadequacy of past supervisory practices that relied exclusively on microprudential, individual firm-level policies.

Having looked at the systemic risk from the failure of individual institutions, the IAIS has also found it relevant to assess the risk from the sector as a whole. In this case, it is not only about failures but simultaneous actions that could have wider repercussions on other market players.

In recent years, research has been undertaken to understand if and to what extent insurers engage in procyclical behaviour. While this research is not fully conclusive, there are examples (of considerable divestments in crisis periods) that indicate that firms may act simultaneously. As such, insurers may act as risk amplifiers. Some research has also shown some flight to quality or a home bias in recent years.

While these individual actions are fully rational, taken together they may have a negative effect. The April 2016 Global Financial Stability Report issued by the International Monetary Fund also indicates that systemic risk stemming from common exposures may have increased in recent years

Concerning resolution, there is no doubt that resolution regimes should be in place for insurers to make sure they are resolved in an orderly fashion. This helps to protect policyholders and minimise the adverse impact of the failure of an insurer on, if any, the financial system and the real economy.

It should be understood that resolution regimes for insurers must be able to address specificities in the resolution of insurers. In other words, copying the resolution regime of banks for the insurance sector does not make sense. Rather, resolution regimes for insurers should be designed for the insurer business model and the potential impact of a failure on financial markets, the financial system, and the real economy. For example, the IAIS considers the traditional tools for the resolution of insurers, eg portfolio transfer, run-off, and liquidation, effective tools to resolve insurers in an orderly manner. Another example is statutory bail-in. In July 2016, the IAIS expressed its view on the bail-in for insurers when it determined that it would not establish for global systemically important insurers a common minimum standard for loss absorbing capacity in resolution at that time on the basis of available information and analysis.

The IAIS is currently developing international standards for the resolution of insurers as one of its core principles and, building on this ICP, for the resolution of Internationally Active Insurance Groups within ComFrame. A consultative document on this material will be published in March. ●

Joseph L. Engelhard

Senior Vice President, Head of Global Regulatory Policy Group, Global Government Relations, MetLife

The future of global insurance standard setting is at a crossroads

The global insurance regulatory agenda is at a crossroads. The recent U.S. elections resulted in Republican control of the White House and Congress for the first time in a decade. The common view is that this development threatens the prospects for two IAIS priorities: the current focus on entities as sources of financial instability and a global insurance capital standard (ICS).

The Trump administration does not support individual designations of nonbanks as systemic. While this contradicts the prior U.S. view, we see an opportunity to develop a more effective macroprudential framework to address potential threats to financial stability. MetLife has thought all along that an entity approach does not provide the appropriate macroprudential lens or policy measures to address potential threats such as interest rate risk or capital market volatility. Choosing an new path must start with properly measuring the potential risk of the few relevant activities via the risk transmission channels of counter party risk and asset liquidation and lead to policy measures that are tailored and proportionate to identified activities.

MetLife has consistently argued that an activities-based approach is superior to an entity approach because it takes into account all relevant market activity as well as best practices in risk management and micro prudential regulation that may mitigate macroprudential concerns. We are encouraged by the recent formation of an IAIS task force to explore how to better assess systemic risk. While it will take time to fully develop this alternative, it will eventually better identify and address both the domino and tsunami theories of potential threats to financial stability.

With respect to the ICS, MetLife believes there is value in an objective global minimum standard that creates a level playing field and incentivizes strong risk management. However, if this standard is to improve supervision of large global groups and address key risks, the current work on liability discounting options must better address non-economic volatility and avoid approaches that do not recognize the long-term illiquid nature of insurer liabilities. Similarly, an ICS should reward good risk management and discourage reaching for yield in riskier assets that could ultimately destabilize the sector.

As the U.S. moves away from designations of nonbanks toward group supervision of large U.S. based insurers by lead state regulators, more consideration of an aggregation and calibration (A&C) approach to group capital may be necessary. In the future, the Federal Reserve will likely regulate just twelve insurers based on an A&C approach and U.S. state regulators are developing a similar group capital calculation.

This very important trend must be recognized and reconciled if the ICS is to be a true global standard, which we believe must be accounting agnostic and take into account the local regulatory regimes that were developed around the types of insurance liabilities that are country or region specific. ●

Dr. Martina Baumgärtel

Head of Group Regulatory Affairs and Public Policy, Allianz SE

Global insurance regulation: The right focus will make the difference

The wave of global regulation that set in after the 2008 financial crisis to mitigate systemic risks is being recently increasingly challenged from a juridical as well as a political perspective. Against this background it seems more vital than before to take stock of existing regulation and review further development plans regarding their effectiveness and efficiency.

With respect to the GSII designation framework, proper identification and ensuing mitigation of potential systemic risks will be a key success factor. As we continue to see serious problems with the existing entity-based designation process regarding its effectiveness and efficiency, we welcome the intention of the IAIS to develop an activities-based systemic risk approach, as only such an approach can ensure effective systemic risk mitigation while securing a level playing field.

This approach should be based on a sound analysis regarding potential systemic risk transmission channels with a view to address the related activities in the most effective and efficient way. As a result, tailored regulatory tools - like for example limit systems - should be explored for critical activities.

Additional capital is no panacea in this context and should only be applied as a last resort and only if meaningful – which provides the link to the second major IAIS project, the development of the ICS as a basis for potential systemic risk capital add-ons (Higher Loss Absorbency). In this context, it is of paramount importance to ensure that the ICS will not inadvertently incentivize pro-cyclicality and herding behavior, thereby ultimately increasing systemic risk.

The ICS valuation and risk capital approach therefore needs to recognize the long-term business model of insurers including their ability to hold assets to maturity while at the same time internal models which are approved by supervisors should be recognized. In summary, we believe that the further development of the IAIS framework will only stand the test of time, if the ICS is defined appropriately and combined with an activities-based systemic risk framework which includes targeted and proportionate risk mitigants. ●

Consistent and reliable use of internal models in the insurance sector

Contributors

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

The future of internal models in insurance regulation - Consistent supervision as a key success factor

With the implementation of Solvency II, European insurance undertakings and groups are allowed to use internal models to calculate their capital requirements.

Even though the insurance industry has long experience in modelling the future behaviour of different risks, and a lot of work was devoted by groups and supervisors to the development, validation, and approval of internal models, the use of internal models for solvency purposes creates a number of challenges both for groups and supervisors.

EIOPA has been devoting special attention to the on-going monitoring of internal models, because material differences between supervisory approaches can have a huge impact on the level playing field between firms and ultimately on policyholder protection. Already in 2015 EIOPA issued supervisory opinions on risks related to sovereign exposures and the absence of formal decisions on equivalence, by which we sought convergence amongst National Competent Authorities (NCAs). We continue to prioritize areas where different approaches have the potential to lead to material impacts like the modelling of sovereign risk and the volatility adjustment. Consistency analysis is also underway on the modelling of market and underwriting risks.

EIOPA is also focused on the development and testing of sound on-going appropriateness indicators and benchmarking for internal models. This work is fundamental to ensure that internal models fulfil required standards and are not used as a capital optimization tool. A 'race to the bottom' kills the underlying goal of internal models.

As a result of its participation in colleges of supervisors, peer reviews and visits to national supervisory authorities, supplemented by information from market participants, EIOPA still sees material differences in national supervisory practices. Also discussions amongst supervisors concerned in the approval process of group internal models have continued to highlight differences in national approaches. Different legal interpretations taken by group supervisors within colleges can lead to significant differences in application and implementation. Divergences can drive regulatory arbitrage, leading undertakings to reconsider the geographical scope of their group internal model in order to ensure smooth approval processes.

A 'race to the bottom' in terms of weaker model calibrations ultimately can lead to lower Solvency Capital Requirements, not only threatening level playing fields, but also policy holder protection in the European insurance market.

The EIOPA regulation currently does not provide sufficient tools for properly addressing these problems, even where EIOPA pro-actively engages in colleges and in the development of common processes and technical and analytical tools, such as by fostering peer comparisons, sharing of practical solutions and examples, and pooling expert knowledge and advice. Without appropriate access to information or a decision power within colleges, EIOPA's impact is limited. To counter diverging developments, enable early interventions as necessary and simplify existing processes, EIOPA's mandate should be extended to a full approval and ongoing supervision of cross-border internal models.

Consistent supervision is a key success factor for the future of internal models in insurance regulation, both in Europe and globally. ●

Sandrine Lemery

First Deputy Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

Addressing the challenges raised by the complexity of Internal Models

Internal models (IM) are one of the most emblematic novelties of Solvency 2 regime, which ACPR has now experienced: in collaboration with other Supervisory Authorities, ACPR approved 8 IM in 2015, and dealt with 29 major changes or extensions of scope in 2016.

For supervisors, main IM challenges are linked to their moving complexity, while there is an obligation to perform on -going appropriateness assessment.

IM inherent complexity lies mostly in the necessity for each IM to fit to the specific risk profile of the firm. It implies - with a subtle mix of requirements and allowance in the legal texts - the use of great variety of methods, to be calibrated with an even greater variety of "data" (both observed and expert judgment ones), that need all to be assessed by supervisors. In practice, these methods and data differ from one firm to another, if not in their underlying principles, but at least in their operational implementation. The additional need for the IM to stay adapted to the risk profile means also that the use of this methods and data can change during time within the same firm, or their past relevance questioned, and the supervisory assessment thus needs to be regularly updated. Eventually, the comparison between IM, one key aspect of supervisory judgment when level playing field is at stake, is a real challenge given this complexity, and we need to take great care before coming to conclusion based only on comparison.

In this complexity context, an additional challenge for supervisors lies obviously in its resources management. IM supervision is time-consuming as supervisors, while monitoring numerous other prudential aspects, have to assess IM on-going appropriateness, and deal with the regular approval process of major changes or extensions of scope. This IM supervision requires also the use of specific expertise, rare and thus expensive.

To address these challenges, ACPR has adjusted its functioning by creating, in addition to traditional supervisory teams, a dedicated IM unit, to carry on more detailed and IM focused on-site inspections and to develop this specific expertise thanks to a transversal overview. It was of great help to add specific and relevant IM inputs to the traditional ACPR decision making and supervisory review processes.

"For supervisors, main IM challenges are linked to their moving complexity."

- SANDRINE LEMERY

From the industry perspective, IM represent an opportunity to compute a regulatory capital requirement that reflects their risk profile better than the "one size fits all" Standard formula, and let's be realistic, to reduce thus capital requirement. However, based on the feedbacks we received, it appears that the development of an IM is a substantial financial investment, and that its on-going management can be burdensome in particular in term of processes to be built and maintained to fulfill the IM governance legal requirements, while the benefit in capital does not always match the initial expectations. Thus, the cost-benefit balance is not necessarily positive and, we noticed, at least in France based on the applications submitted, that IM are deemed profitable only for the large cross-border groups and for the undertakings with a specific risk profile not at all taken into account in the standard formula design. ●

Dr. Frank Grund

Chief Executive Director Insurance and Pensions Funds Supervision, Federal Financial Supervisory Authority (BaFin)

Main challenges from internal models for insurance firms and supervisors

The use of internal models for determining risk based regulatory capital requirements is a significant innovation of Solvency II. In Germany, insurance firms with regulatory approved internal models (IM) constitute nearly half of the market weighted by total assets. The supervision of IMs forms therefore a significant part of supervisory activities at BaFin, and over the last year we were able to experience both its challenges and opportunities first hand.

Even before the official go-live of Solvency II both firms and supervisors became aware of the increased fluctuations in figures on the coming regulatory capitalization - a result of the market-based approach with often severe impact on key financial figures - in the standard formula as well as IMs.

The desired risk sensitivity of Solvency II creates challenges for many stakeholders, especially in volatile markets: Risk managers have to separate artificial volatility from true risks, and IMs can facilitate this separation. Firms need a conscious management of capital, including buffers that protect against the natural fluctuations of capital requirements and leveraging on the two layers of SCR and MCR introduced with Solvency II.

Both insurance firms and supervisors have made significant progress in addressing this challenge, and at the same time are reaping the benefits from IMs. These provide an excellent basis to understand better how insurance firms are impacted by market events, and thereby substantially improve risk management – for firms as well as supervisors.The requirement for a supervisory approval for IMs brings supervisors and insurance firms >>>

>>> closer together than ever before, which can initially be perceived as unfamiliar and create challenges on both sides. However, this close relationship is absolutely necessary for supervisors to assess the quality of IMs, hugely improves supervisors' expertise of insurance firms' risks and consequently the quality of supervision.

"IMs initiate a lasting relationship between an insurance firm and its supervisor."

- DR. FRANK GRUND

The increased need for communication continues after the initial approval of an IM, as supervisors engage in ongoing model monitoring. Thus, IMs initiate a lasting relationship between an insurance firm and its supervisor.

Model changes can pose challenges to this relationship because of the time pressure under which they need to be implemented at insurance firms and reviewed by the supervisor, but are necessary to keep the IM up to date.

Insurance firms have great flexibility when constructing their IMs. This is a prerequisite for adequate risk measurement given the variety of insurance markets but can pose challenges regarding the comparability of IMs. Supervisors are in a unique position to know both the risk profile as well as the details of the IM of each insurance firm. They can compare approaches on national as well as on European level to ensure regulatory convergence.

IMs pose a rich set of opportunities and challenges to both insurance firms and supervisors. I am convinced that all of these serve to improve risk measurement and risk management as well as supervision, and that time and money spent on IMs is therefore spent well. ●

Nina Arquint

Head Group Qualitative Risk Management, Swiss Re

Internal Models in insurance: still the best choice to assess required capital

Regulators are becoming increasingly weary of allowing insurers to utilize Internal Models (IMs) to determine regulatory capital requirements. This skepticism originating in banking is not justified in insurance.

The fundamental difference to banks and the main reason why IMs work in insurance regulation is that insurers' use IMs throughout the business cycle – from setting risk appetite, to business steering, underwriting and costing, and finally for performance measurement and reserving for the business life cycle. This results in the risk-adjusted profitability assessment that is the foundation for attributing performance and setting individuals' compensation. Insurers are therefore required to ensure that IMs realistically reflect the risks to which they are exposed. Insurers have no incentive tricking the IM to reduce regulatory capital costs, as this results in real loses due to business mismanagement. This is in sharp contrast to banking, where IMs are primarily a tool to calculate, and optimize, regulatory capital. In assessing IMs of insurers, supervisors get an unfiltered view on the risk landscape of the insurer and an unbiased assessment of risk. In insurance, IMs add to the agility of the watch-dog catching the next frisbee[1].

Due to the pivotal role of IMs in business steering and assessment, insurers' boards naturally demand that appropriate governance is in place to lay the groundwork for the management of model risk. It is in their interest and duty to develop an understanding of the IM, including its structure and its impact on business steering. In insurance, boards' governance requirements regularly exceed what is mandatory by regulation.

Mandatory governance does however provide checks to reassure supervisors. In most regimes, a central element of mandatory governance is the "use test" in which insurers show that their IM is indeed used in a fully integrated manner throughout the business cycle. Boards must take full responsibility for IMs and be able to consistently explain results. Models must be independently validated, and thoroughly documented. Finally, IMs must also be approved by the supervisor.

One further point is the misconception that IMs are less comparable than standard approaches. IMs are indeed inherently and necessarily complex. This complexity, if well managed, provides an accurate picture of an individual insurer's risk situation. Especially the adequate assessment of diversification, which is most material in insurance, does not allow for a one-size-fits-all approach. Standard approaches, by striving to be applicable to all, are unnecessarily complex for any individual insurer, while also being horrendously imprecise. That is, the results of standard approaches are in fact less comparable than those generated from well-managed IMs.

Insurance regulators should embrace the fact that IMs provide an adequate, well governed capital assessment that is fully owned by the board. IM bashing is counterproductive and not justified. ●

1. The dog and the frisbee (Andrew Haldane, BoE) http://www.bankofengland.co.uk/archive/Documents/historicpubs/news/2012/075.pdf

Lukas Ziewer

Chief Risk Officer – Europe,
Middle East & Africa, MetLife

Challenges posed by internal models in the global context

Internal models serve to understand the consequences of potential stresses on a company's financial strength, to assess capital management strategies, and to compare business opportunities and risk/return trade-offs. They are central to strong risk management and tie closely to how the company values its assets and liabilities. They reflect product and investment strategies, business objectives, and risk appetite, and incorporate ability to diversify or mitigate risks. These models evolve over time and will materially differ between insurers. This is one reason internal models are not appropriate for international solvency standards. Regulatory capital needs to be comparable, predictable, and open to external validation. To provide robust protection for consumers, it should reflect industry not company experience. Therefore the specificity of internal models to company exposures runs counter to the desire to benchmark assumptions and prescribe modelling methods on a global basis.

A second reason is the significant supervisory effort and uniform supervisory capacity required to avoid inefficiencies, uncertainty, and industry distortions on a global playing field. Solvency regimes that accept internal models require fact-based, objective, regulatory approval processes. These processes require significant resources. For example, the complexity of internal models requires judgment from many fields of expertise with extensive demands on supervisory and company time, often involving external consultants. Once approved, internal models need to be maintained, perpetuating these obstacles.

"Internal models... are central to risk management...[but] are not appropriate for global solvency standards."

- LUKAS ZIEWER

Ultimately, using internal models for international regulatory solvency requirements weakens comparability of regulation across jurisdictions and distorts competition. While regulators benefit from engaging with companies' management on the risk insights from their internal models, solvency requirements should be based on robust, transparent, and consistent standards that apply pragmatically across the industry. ●

Stephan Unterberger

Head of Financial Risk,
Zurich Insurance Group

Efficient internal model approval – can we make the impossible possible?

A risk-based insurance supervisory regime, whether Solvency II, a future ICS or any other, needs to include the option to use internal models for determining capital requirements. Simplified approaches (such as many standard formulas) cannot cope with complex risk situations, in particular of insurance groups. When a simplified approach would be applied to very different risks, a lack of consistency and comparability of firms' solvency position would be the result.

Internal model approval processes must be clear, certain and efficient. A clear advance understanding of the process and the nature and amount of work in terms of applicable requirements (e.g. documentation, validation, back-testing, sensitivity testing, justifications for expert judgments, governance and evidence of use-test) is essential for all parties concerned. Moreover, the process should display a high level of legal certainty with limited possibility for diverging regulatory expectations. Together, these features benefit the overall efficiency of the process.

"Internal model approval processes must be clear, certain and efficient."

- STEPHAN UNTERBERGER

Whereas Solvency II provides a harmonized legal framework for the approval process, this does not in itself prevent a wide range of regulatory expectations as long as the competence to decide remains with national competent authorities. In the Solvency II internal model approval process, I have seen considerable differences in approach, for instance with regard to documentation requirements, the treatment of sovereign risk, loss-absorbency of deferred taxes or the treatment of pension risk.

That raises the question whether within a single legal framework, approval of internal models should be centralized. Would, in the Solvency II context, approval of internal models by EIOPA be beneficial to the certainty and efficiency of the process as described above, at least for internationally active insurers? However, this would mean a segregation between the firm's day-to-day supervision and its internal model approval, which could imply other inefficiencies in the process. ●

Download the Eurofi Malta Seminar App

malta2017.eurofi.net

Answer polls
Post comments and questions during the sessions
Check-out the list of speakers and contact attendees
Detailed programme and logistics information

CMU implementation

Content

Issues at stake

The Capital Markets Union which aims to diversify the financing of EU businesses and better connect savings to investment was launched 18 months ago. The CMU mid-term review will take stock of the progress made so far and update priorities. During this Seminar, we are focusing more specifically on four objectives that are key for achieving the CMU: developing EU equity markets, enhancing the consistency of insolvency and securities laws, developing the EU cross-border investment fund market, and leveraging blockchain and fintech developments.

Brexit is another major issue to be considered. On the one hand it is a major challenge for the CMU given the importance of the City for EU capital markets. On the other hand Brexit reinforces the need to further develop and integrate EU27 capital markets and achieve an ambitious CMU.

Delivering CMU with Brexit

Contributors

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

Consistent supervision is essential for delivering full integration of the EU financial markets

Financial markets perform essential functions in our societies. They finance economic activities that result in jobs and growth, and they allow citizens to save and invest. As financial markets are prone to risks, they are governed by extensive rules that are supervised and enforced by financial markets regulators, including ESMA at the European level. Unique to the European Union is the combination of integrated financial markets, where market participants have extensive freedoms to decide where to locate their activities, with most day-to-day supervision conducted by competent authorities at national level (NCAs).

When looking to the future, and in line with the CMU's objectives, we should expand the role of financial markets in the EU's financial system. Looking back at the past decade, financial markets have performed relatively well in terms of stability and an improved balance between the banking system and financial markets has several additional benefits: it provides another source of funding; it allows a shift from debt-funding to equity-funding, and it can increase the overall competitiveness of the financial system. The fact that the UK has decided to leave the EU, reinforces the need for the EU27 to progress with CMU.

In a successful CMU, where financial markets grow and are more interconnected, it is even more important to achieve consistent supervision across the national competent authorities.

The decision of the UK to leave the EU results in increased risks to consistent supervision. As UK- headquartered market participants are considering their options across the EU27, it is essential that national regulators do not compete on regulatory or supervisory treatment. Some practical examples where this may be a risk include such issues as the possibilities to delegate and outsource to a UK entity, while being registered and supervised by one of the EU27 financial markets regulators.

ESMA, as a well-established EU regulator, will remain committed to supporting the objectives of the CMU within its mandate and powers, paying particular attention to consumer protection, financial stability and orderly markets. Supported by effective regulation and supervision, Europe will be able to deliver full integration of the EU financial markets, and make the CMU a true success. ●

Olivier Guersent

Director General, Financial Stability, Financial Services and Capital Markets Union, European Commission

CMU mid-term review

The Capital Markets Union (CMU) is a core component of the Commission's Investment Plan for Europe to boost jobs, including youth employment, and growth. It encompasses the reforms of our financial system needed to better enable private capital to fund the EU's pressing investment challenges – in the domains of infrastructure, energy transition, and particularly in financing growing businesses. CMU seeks to better connect savings to investment and to strengthen the EU financial system by enhancing private risk-sharing, providing alternative sources of financing, and increasing options for retail and institutional investors. Removing obstacles to the free flow of capital across borders will strengthen the Economic and Monetary Union by supporting economic convergence and helping to cushion economic shocks in the euro area and beyond, making the EU economy more resilient.

CMU has become even more important in a changing economic and political context. This is why the Commission presented on 14 September 2016 its Communication calling for an acceleration of reforms and to review priorities. The prospect of important changes in EU capital markets in the years ahead also calls for a careful assessment of the investment and financing environment for businesses, institutional investors and retail investors. The EU financial system needs to have a solid and competitive capital market capacity to complement and support bank finance.

The mid-term review of the CMU Action Plan in June will be an important milestone in assessing the effectiveness of the measures taken so far to address policy challenges, and in further shaping the CMU to ensure it boosts the capacity of the EU to support a resilient non-bank financial ecosystem. The CMU mid-term review is the time to reframe actions and consider new priorities in light of the evolving political and market circumstances.

The Commission launched an online public consultation on 20 January until 17 March and the results will feed into the CMU mid-term review. The consultation document builds on the CMU Action Plan and, in order to foster a discussion, points to some policy areas where additional actions could be envisaged at the EU level. The consultation seeks views, for example, on the potential of FinTech to develop and strengthen EU capital markets, input on actions that could better corporate governance, emphasise the use of FinTech and capital markets and actions to support sustainable finance. Views are sought on possible measures to further support access to finance by EU businesses, for example, through better corporate governance and the development of non-bank finance to finance companies ahead of initial public offerings (IPOs). Capital markets could also help the banking system to manage non-performing loans (NPLs) and views are sought on the potential for the creation of a secondary market for NPLs.

Building a CMU is a long-term project. The diversification of the EU financial system will require building new funding circuits and ecosystems. The change will not happen overnight. The progressive implementation of the CMU is taking shape on the basis of a comprehensive action plan, containing both legislative and non-legislative measures. The CMU mid-term review in June will take stock of progress made so far and set out the work and priorities ahead. ●

Levin Holle

Director General, Financial Markets Policy, Federal Ministry of Finance, Germany

Capital Markets Union - Ambition crucial to reap the higher hanging fruits

The Capital Markets Union action plan encompasses a bundle of approaches that can help developing and integrating European capital markets and at the same time foster the financing of companies and investment projects. In June this year, the European Commission will present a Mid-term Review of the action plan which will take stock of the progress made so far. Within the Mid-term Review the Commission will furthermore discuss whether a reframing or complementing of the action plan is warranted.

We are looking forward to the results of the Mid-term Review.

- Some measures are finalized, for instance the modernization of the prospectus directive and the adjustment of solvency II calibrations for insurers' investment in infrastructure and European Long Term Investment Funds.
- Important measures are initiated and need to be finalized in consent with the European Parliament as soon as possible, particularly the so called >>>

>>> securitization package but also the Revision of the European Venture Capital Fund Regulation (EuVECA) and of the European Social Entrepreneurship Regulation (EuSEF). The securitization package is the flagship project of the action plan and has the potential to generate additional funding in the real economy. We need to strive for an approach that addresses effectively financial stability risks and at the same time revives the securitization market and does not impede functioning markets. This means a robust framework for capital requirements for securitization exposures and operational criteria for the definition of simple, transparent and standardized securitizations (STS).

Capital Markets Union is at its core a long-term project. It is important not to lose momentum and to strive persistently for removal of barriers to free movement of capital and for deepening of capital markets integration. After having reaped the lower hanging fruits it will be important to be ambitious: Therefore we look forward to the upcoming proposals of the Commission. However, appropriately designed measures under the umbrella of Capital Markets Union are only one side when it comes to better connecting savings to investment. Investment friendly national framework conditions and public goods represent the other side of the necessary two-pronged approach. While respecting proportionality and subsidiarity the two levels of government intervention need to interact smoothly and coherently to support jobs and growth in Europe.

For the EU 27 the Capital Markets Union will still be an important undertaking, potentially even more important. Brexit will make implementation more challenging, but at the same time serve as a catalyst for further financial market integration among EU 27. ●

Michael Cole-Fontayn

Chairman EMEA, BNY Mellon

Brexit and CMU – The need for a positive way forward

At time of writing, the situation is serious.

We expect that in the coming weeks the UK will trigger Article 50, and the clock will start on a two-year negotiation process.

We currently see no clearly-articulated proposals for an outcome that will meet the real needs of the UK and the EU-27, and of issuers and investors across the continent of Europe. And it is clear that the negotiations will be complex and difficult, and will have a significant risk of failure.

The situation is also serious with respect to the ongoing Capital Markets Union (CMU) project.

Brexit is both an existential threat to the CMU project, and an urgent call for the EU-27 to make progress in building an effective CMU.

London is currently the pre-eminent European financial centre for capital markets activities.

A common estimate is that more than a third of EU wholesale financial services activity takes place in London. But in specialist areas, the figures are much higher, and can range from 74% for trading in OTC interest rate derivatives, to 78% for foreign exchange trading, and in some cases to around 90%.

This means that it is in the interests of all parties that we achieve a Brexit outcome that minimises disruption to existing economic and financial flows. But it also means that the EU-27 has a critical need to develop its capital markets, and to further the CMU project.

The best Brexit outcome (and the outcome with the least negative effects) would be an outcome in which the UK and London remain part of a single market for financial services.

The next best Brexit outcome would be a situation in which there is high degree of coherence in regulation so that issuers and investors, borrowers and lenders, from both the UK and the EU-27, have access to markets, and to service providers, both from the UK and the EU-27.

"The EU-27 has a critical need to develop its capital markets."

- MICHAEL COLE-FONTAYN

The best CMU outcome would be the creation of a real Capital Markets Union in which there is a consistent oversight of markets, and a consistent and coherent interpretation and enforcement of common rules. In such a CMU the EU-27 would continue to benefit from the strengths and capabilities of London.

The critical question is how to reach these outcomes. I perceive that there is a lot of scepticism that we can actually succeed.

I am reminded of two episodes from the Memoirs of Jean Monnet. In

the context of the lengthy and difficult discussions leading up to the UK joining the European Economic Community, he argued that civilisation equals rules plus institutions. In 1923 he left the League of Nations, and went to work for the business of his father, a cognac merchant; the family business was close to bankruptcy, as his father had stubbornly refused to adapt his business practices to the evolution of the market; he succeeded in persuading his father to adapt, and by 1926 the business was healthy again.

These episodes contain two important truths. One is that it is not enough to have appropriate rules; it is also necessary to have an institutional process for compliance. The second is that circumstances change and that old solutions may no longer be appropriate.

Throughout his career, Jean Monnet showed a great capacity for adaptation to changed circumstances. Let us try and demonstrate a similar agility. ●

Corso Bavagnoli

Assistant Secretary, Financial Department of the French Treasury, Ministry of Economy and Finance, France

The action plan of the European Commission on Capital Market Union should be amplified

The Capital Market Union (CMU) action plan, launched in September 2015, was a timely initiative to deepen financial integration in the EU, to offer new opportunities for savers and to fund long term projects, in a situation where the potential of development of EU financial markets remained under exploited. Today, while the goal remains the same, i.e. more diversified financing sources to foster EU growth and job creation, the CMU has to overcome the challenge brought in by the UK referendum : to achieve the same ambition with the City outside the EU. The reasons behind the project remain as relevant as ever but a thorough reevaluation of the way financial services are provided, and financial stability risks are tackled in the EU is necessary.

First of all, we have to acknowledge that, with the City outside of the EU, the focus needs to shift from one of deepening and integrating EU-28 financial markets, to one of developing EU-27 financial markets. For this to happen, the provision of financial services within the EU should rely on an open and competitive marketplace. In support of that marketplace, the EU has to develop a strong and efficient financial industry, with appropriate risks oversight and control. The modality of the relationship with third countries will important in this regard: we have to ensure that the EU has at its disposal the appropriate tools to understand and manage financial stability risks emanating from the provision of third country services. Besides, for EU-based firms, we need to secure an effective level playing field, by ensuring that they compete against firms that abide by equivalent regulations at home and are supervised in a way that is comparable to what takes place in the EU.

Second, this requires a new approach of financial market supervision. The Commission is right to point out that more supervisory convergence should be pursued. This should encourage a level playing field across jurisdiction in the EU. Besides, the ESMA is now a world-recognized financial supervisor and regulator, and we should be able to build on that experience for the future. A first area of progress could be the setting up of a pan-European reporting and market data oversight system, with the ESMA at its centre.

Third, we need to tap into the potentialities of EU financial markets, which is hindered by cross-border difficulties. Building a stronger, safer and more competitive financial system requires abolishing impediments to adequate allocation of capital across the EU. This is the case for instance of insolvency laws, and the recent initiative of the European Commission is welcome in this regard. In addition, more could be done to develop European saving products: pools of savings remain essentially country-based, limiting the possibility for EU financial actors to tap into a larger European pool of savings. ●

Alexander Batchvarov

Head of International Structured Finance Research, Bank of America Merrill Lynch Global Research

CMU success relies on bold and flexible decision-making

The development of a CMU is a key policy objective of the current EU administration. CMU is meant to compliment the EU Banking Union and must be pursued despite Brexit.

A number of policy measures were undertaken in recent years with a different degree of success, among them: Prospectus Directive and introduction of better Solvency II treatment of infrastructure. Other key measures, such as the securitisation framework, are still work in progress.

In reality, a number of regular surveys uniformly point to capital markets' activity decline in the EU and to a widening gap between the EU and US, in contrast to the EU political goals and efforts.

AFME data highlights continued decline in EU capital markets activity, with equity markets' decline deepening last year. ECB SESFOD survey suggests a drop in market-making, most pronounced in covered bonds, sovereigns and convertibles. The decline in the European securitisation markets in terms of the number active dealers, investors, originators and issuance post-crisis is well known. Ironically, the revival of the EU securitisation market is a key CMU pillar, unlikely to be achieved in this Parliament if draft laws are not improved fast and decisively.

What are the reasons behind such statistics? In the near- term: macro uncertainty, market volatility, tactical shifts in risk appetite, low rates, >>>

>>> ECB QE. Factors of a longer-term nature include discrepancy of the insolvency laws, uncertainties surrounding Brexit, pressure on banks' balance sheets and internal risk constraints; unwillingness to take risks, unavailability of hedging instruments, reduced market-making profitability. Many are the results of tighter or uncertain regulations.

Addressing the above problems, many unrelated to Brexit, is the surest way to propelling the CMU. Further market fragmentation due to Brexit must be avoided and clarity about third country regime is needed sooner. But beyond that, the decision-makers need to ensure that the legislation adopted is not just the lowest common denominator, as is often the case, but an enabler for unified capital markets growth. ●

Dr. Alexandra Hachmeister

Chief Regulatory Officer,
Deutsche Börse Group

Bringing Financial Markets Infrastructures at the heart of CMU

The CMU Action Plan is one of the most ambitious and forward-looking actions of the Juncker Commission. It has successfully changed the focus from post-crisis regulation to a growth and jobs agenda, which is indispensable at a time when the EU is at a crossroads. The low hanging fruits, such as the Prospectus Regulation, have been picked – but it is now time to climb up that tree and collect the prizes of further European integration to ensure that the EU remains competitive at global level.

"Reinvent FMIs in Europe and bring CMU to life."

- DR. ALEXANDRA HACHMEISTER

Member States will need to come to grips with the fact that further convergence is needed to achieve a real and thriving CMU – diversifying sources of financing beyond banks, addressing the debt-equity bias and harmonizing insolvency and securities laws will have to be brought forwards sooner rather than later. The political uncertainty generated by recent events, such as the British referendum and the US elections, emphasize the need for further European integration to enhance the competitiveness and attractiveness of Europe.

At Deutsche Börse Group, we believe that Financial Markets Infrastructures (FMIs) can play a significant role in making the CMU a reality. Market led initiatives, such as the Deutsche Börse Venture Network (DBVN), can make a substantial contribution by bringing growth companies together with international investors at a critical pre-IPO stage. In March, we further concentrated our efforts on closing gaps in the funding escalator by launching a new exchange segment designed to enhance access to growth capital for SMEs. These initiatives can make a serious difference by facilitating the financing opportunities for the backbone of the European economy, if the ecosystem is set right.

To achieve a thriving CMU, it is also crucial that Europe becomes the forefront of innovation and digitalization. We see great potential in the development of the Distributed Ledger Technology (DLT), especially when it comes to overcoming market barriers. By combining new technologies with our financial infrastructure savoir faire, we believe such developments could provide important efficiency gains and help us reinvent FMIs in Europe and bring CMU to life. ●

Post comments and questions
malta2017.eurofi.net

Developing EU equity markets

Contributors

Fabrice Demarigny

Chairman, European Capital Markets Institute (ECMI),
Special Advisor of the EU Presidency

European Equity Capital Markets: room for improvement and ambition

It should be acknowledged the European Equity Capital Markets have experienced significant growth over the past decades and contributed to the financing of EU corporates and to the creation of jobs. Companies can list, raise capital and be traded across the single market thanks to a harmonized and trustful regulatory framework created by the Single Market. This been said, since the financial crisis, a number of weaknesses have emerged: (1) the number of IPOs has not come back to the levels experienced prior to the crisis, (2) capital increases are mainly done by large corporates, (3) trading volumes have increased but are fragmented across several trading platforms with diverse regulatory regimes, (4) markets makers providing liquidity to the markets have reduced their presence and order books are high frequency trading captive, (5) cost of clearing and settlement has not significantly decreased. In addition, most of the current EU regulatory framework has been designed for large corporates and has only very recently been amended to create a more proportionate regime to open the public market to Small and Mid-Caps.

Most of these trends have been properly identified and the EU intends to revitalize Equity Capital Markets. The revision of MiFID and the Action Plan to create a Capital Markets Union (CMU) are key objectives in that direction.

The purpose of MiFID 2 is to reinforce the current EU rules on secondary securities markets by better organizing trading taking place on regulated platforms, introducing rules on algorithmic and high frequency trading and enhancing investor protection by improving conduct of business rules as well as conditions for competition in the trading and clearing of financial instruments. MiFIR sets out more refined disclosure requirements of trading data. A significant number of implementing measures are still due since the application date of MiFID II and MiFIR, initially scheduled for 3 January 2017, has been extended to 3 January 2018.

As part of the CMU Action Plan, an improved prospectus regime has been agreed. The new Regulation will make it easier and cheaper for smaller companies to access capital and a specific stock exchange regime has been created for Small Caps. Simplification and flexibility for all types of issuers has been introduced, in particular for secondary issuances and frequent issuers which are already known to capital markets. A more 'to the point' financial information disclosure for retail investors will now exist thanks to a friendly summary of key information, catering for the specific information and protection needs of investors. If the implementing measures are really drafted in a manner that favors proportionate access to Regulated Markets for Small and Mid-Caps, the new prospectus regime will ensure that appropriate rules cover the full life-cycle of companies from start-up until maturity as frequent issuers.

The CMU Mid-Term Review consultative paper published in January 2017 by the European Commission is positively focusing on equity financing and long

>>>

>>> term investment. Actions points to create a funding escalator for innovation, startups and non-listed companies have been launched, barriers to SMEs admission on public markets and SME Growth Markets will be assess (including the risk of erosion of local ecosystems) and changes to prudential regimes that are detrimental for equity investment are contemplated. What remains unclear is the level of ambition of the Commission and the two co-legislators to go beyond studies and intentions. A more ambitious and tangible agenda, having in mind a Single Market without the City of London, is still lacking. ●

Lauri Rosendahl

President, Nasdaq Nordic & Nasdaq Stockholm

How can capital markets further support SME growth?

Nasdaq Nordic markets have seen an exceptional inflow of new listings in recent years. In 2016, we welcomed 94 new companies to our markets, raising a combined 7.8 billion EUR. A clear majority of these companies are small and classified as SMEs. What explains the strong Nordic IPO climate for SMEs? And what can be done to further develop the European capital markets and support SME growth?

IPOs are good for the economy. They enable companies to move from private to public funding and allow among others venture capital firms to recycle capital and entrepreneurs to fund new job creating businesses. A public listing also brings visibility and credibility that potentially can help companies as they expand internationally, while all investors, both big and small, are allowed to take part in the value creating growth journey.

"While our Nordic markets currently thrive, there is still potential to make capital markets even more accessible for SMEs on a sustainable basis."

- LAURI ROSENDAHL

Nasdaq Nordic is currently the leading European exchange for IPOs – both measured in number of new listings and capital raised – and more than two thirds of our Nordic listings last year occurred on our junior growth market, Nasdaq First North. And investors are excited as well – those who invested in all 151 IPOs in Sweden between January 2014 and December 2016 have received an average return of 27.6 percent in three years – well above the market as a whole.

While the inflow of companies to Nasdaq First North is partly due to macroeconomic drivers, it is the strong local ecosystem that makes our markets unique. The Nordics, in particular Sweden, have an active ecosystem, including financial advisors, working exclusively with SMEs. There is also a strong equity investing culture where not only professional but also retail investors are willing to support smaller growth companies. Nasdaq continuously makes efforts at strengthening our overall offering and services towards issuers and investors, together with stakeholders in the whole ecosystem.

While our Nordic markets currently thrive, there is still potential to make capital markets even more accessible for SMEs on a sustainable basis. European SMEs still rely too heavily on debt financing from banks.Educating both companies and the market about the benefits of public equity finance is essential. EU >>>

>>> could proactively encourage a larger part of households to take part in the SME growth journeys, rather than having their savings in bank accounts.

The SME Growth Market label as created by MiFID II can have an attractive place in the ecosystem. Policy measures can be directed to enhance this market segment and the ecosystem around it. One measure on the agenda is the 'growth prospectus', which will be introduced as a result of the review of the Prospectus Directive. It is an opportunity to create an information document useful for both companies and investors of all types. This can only be achieved if it becomes significantly more easily digestible than the current prospectuses.

In order to reach long-term, sustainable growth across Europe, both investors and SMEs need to get better access to capital markets. It will improve Europe's competitive position and ultimately create more jobs and growth – while European savers at the same time can be transformed into investors. ●

Eric Le Brusq

Global Head of Equity Derivatives, Natixis, BPCE Group

European SMEs' Equity Financing: Threats and opportunities

Around 99% of all non-financial companies in the European Union are SMEs, i.e. firms with fewer than 250 employees and less than €50m in annual turnover.

European SMEs' financing strongly relies on loan and debt while US market SMEs rely in major part on Equity Financing from private investors. The European SMEs financing structure has two major consequences. On one hand, banks legitimately tend to prefer established business with stable cash flows. On the other hand, the funding mix restrain borrowers' risk taking and growth capacity. As a result, while, Europe provides more funding to SMEs (€ 2 trn) than the US (€ 1.2 trn), the vast majority of this funding is not fostering innovation and growth. Start-ups and businesses who need to finance development while they have uncertain cash flow need Equity Financing more than loan financing.

In this regard, banks support Equity Financing for SMEs through two major activities.

First, banks support access to Equity Capital Markets for high growth SMEs through IPOs. As one of the French leaders of the mid-cap market segment for IPOs, Group BPCE has good visibility.

The cost, complexity, and disclosure schedule for SMEs IPOs can be improved. The CMU action plan on this specific topic is promising. Also, a leading challenge of SMEs IPOs is the post IPO secondary market animation and availability of Mid Cap Equity Research guarantees such animation. MIFID 2, PRIIPS and MAR impacts on SME Equity Research should be monitored. Potential damage to this specific ecosystem (analysts, brokers, etc.) should be avoided as it would weaken SMEs IPO activity in Europe, an activity already down 51% in 2016 compared to 2015.

Also due to our SME IPO ecosystem, several of our clients across Europe decided to first get listed on the NASDAQ, considered a Reference Market, before they considered listing on their domestic exchange. This leads to the conclusion that a major European accomplishment would be to create a European Reference Exchange in some specific domain. Green Economy and ISR Reference Exchanges come to mind.

The second activity related to SME Equity Financing for banks is to organize access to SMEs' Equity investments for all categories of investors.

Here, banks provide leverage to PE funds for LBO operations, banks also structure and propose investment products to various categories of investors, from unsophisticated retail investors to Financial Institutions. In this activity, banks deal, in Europe, with specific idiosyncrasies. The lack of personal pension's funds to link long term savers with long term investment in equities is a well-known concern of the EU financial markets structure. Banks professionals have expressed for several years that SMEs Equity Financing requires an environment favorable to mobilization of retail investment capacity, typically through large Personal Pension Funds.

"SMEs Equity Financing requires an environment favorable to mobilization of retail investment capacity, typically through large Personal Pension Funds."

- ERIC LE BRUSQ

Beyond the scope of traditional banking activities mentioned above, we should mention SMEs' Equity Market's disruption brought by the FinTech. They will play an important role in SMEs Financing in the years to come. I am referring to crowdfunding.

Well aware of the imperative to protect retail investors from the risks inherent such activity, we believe a homogeneous European Crowdfunding regulatory framework will jumpstart SMEs Equity Market and will be in line with the CMU project's objective to broaden access to Equity Market for innovative companies.

Banks can help in at least 3 different ways: by providing proper custodian service to investors and issuers leveraging blockchain technology and ensuring customer protection, by developing investment products that offer risk mitigants like diversification and capital protection, and by organizing calibration, validation and labeling of SMEs information between investors and issuers. ●

Guillaume Prache

Managing Director, Better Finance - The European Federation of Investors and Financial Services Users

Develop EU capital markets: let EU savers go back to equities

"Today, retail investors in Europe ... are less directly involved in capital markets than in the past ... the proportion of retail investors among all shareholders is less than half the level it was in the 1970s."(EC, CMU Action Plan)

EU Authorities should help revive and develop direct retail equity investments, a missing action in the CMU Plan. Why ? Because this would be very beneficial:

- for EU savers and individual investors,
- for EU capital markets,
- for the real economy, growth and jobs
- for the sustainability and governance of European listed companies,
- and for the functioning of capitalism and of democracy.

Of course, "packaged" retail investment products such as life insurance and pension products (32% of EU households' financial savings) and funds (8%) will and should remain the core of people's long term financial savings, as they provide diversification and professional management, in particular for low income and financially illiterate citizens. But, at a time of very low market returns often more and more eaten up by commissions and fees, the more affluent savers would benefit a lot from investing more directly into capital markets (stocks and broad index ETFs). Indeed, Better Finance independent research shows that a majority of packaged investment products under perform capital markets over the long term.

Despite their reduced direct involvement, individual investors also provide key benefits to capital markets: recent academic research shows that individual shareholders tend to be actually contrarian, whereas institutional ones tend to be momentum investors. This is good for the efficacy of asset pricing and for markets' liquidity. Also individual investors play a relatively more important role in small and mid caps investing than institutional ones, which is good for the economy as growth and jobs come mostly from SMEs, and it is good for EU savers as small and mid caps (and broad indices such as the Stoxx Europe TMI) massively over performed the big caps (and narrow indices such as the Stoxx Europe 50) over the long term.

Finally, individual investors are mostly long term ones and therefore will help improve the sustainability and governance of the economy if given the possibility to become engaged investors. This is better than a totally financial capitalism controlling firms with "other people's money" and with shorter time horizons. EU citizens regaining part ownership and control of their economy is also in the end better for democracy.

"Stop discouraging the more affluent and knowledgeable savers to invest in equities."

- GUILLAUME PRACHE

EU decision makers should therefore stop discouraging the more affluent and knowledgeable savers to invest in equities, by reviving the equity culture at all levels (citizens but also financial retail intermediaries who have stopped promoting equities for decades, the media and politicians who should lead by example and be proud of it). In particular, the EU must at last move full speed on improving the transparency of past performance disclosures (this is part of the CMU Action Plan but is moving in the opposite direction, with the appalling draft rules on "PRIIPs" eliminating all of it). Also, the EU must allow direct investments in equities within the projected "PEPP" (Pan-European Personal Pension): there is no better and more long-term vehicle to do that for EU citizens. ●

Michel Heijdra

Director International Affairs, Ministry of Finance, The Netherlands

Promoting equity finance in Europe for financial stability

The capital markets union strives to diversify the sources of finance for European companies from the current prevailing bank-based debt finance to more equity finance. A larger reliance on equity finance will improve European financial stability.

Capital markets are an important channel for smoothing asymmetric shocks in currency unions. It is often thought that the United States function better than the euro area because of fiscal smoothing. In fact, less than 10% of shocks are smoothed by fiscal transfers in the U.S., compared to over 45% by capital markets. In the euro area, however, capital markets smooth only 8% of asymmetric shocks which indicates there is significant potential for improvement.

Not only the functioning of the EMU, but also financial stability in general can benefit from more equity >>>

>>> financing. A larger availability of equity gives investors more options for risk diversification. Moreover, it supplies companies with alternative methods of financing other than bank lending. This weakens the relation between the health of banks and the real economy and reduces the sensitivity of economies to financial shocks.

We are undertaking several steps to promote equity finance in Europe. For example, an important condition is creating ample liquidity to make equity attractive for investors and lower transaction costs for companies. With the new prospectus regulation, requirements for public offerings are adjusted to accommodate issues on public markets. Also, the regulations for European Venture Capital and Social Entrepreneurship Funds are currently being reviewed with the aim to promote investments in these funds to foster investment in the real economy. And MiFID-II introduces the SME Growth Market, a multilateral trading facility that makes it easier for small and medium-sized enterprises to go public and attract equity investors.

"A larger reliance on equity finance will improve European financial stability."

- MICHEL HEIJDRA

In addition, further steps can be taken to ensure predictable and consistent application of European regulation in order to facilitate cross-border capital flows. Supervisory convergence, supported by the ESA's, is important in this respect. Given the diverging national application of the single rulebook, the role of the ESA's, especially ESMA, could be strengthened further.

However, we can also take steps in other areas to develop equity markets. In the area of corporate governance, important steps have already been taken to strengthen the position of shareholders and lower information asymmetries, reducing agency risk and thereby lowering the price of equity. Furthermore, reducing divergence in corporate governance frameworks across Europe can lower barriers to cross-border equity investments.

Increasing the efficiency and cross-Europe consistency of insolvency frameworks can also promote cross-border equity finance. Inefficient frameworks raise the cost of recuperating investments and reduce the willingness to provide (equity) capital. World Bank indicators show that the recovery period for bankrupt companies varies between 6 months and 4 years in EU member states, indicating there is ample space for progress.

If we continue to work in these areas we will promote equity investment and as such contribute to growth and resilience of the European Union. ●

Vincenzo La Via

Director General of Treasury,
Ministry of Economy and Finance,
Italy & Chairman, Financial Services
Committee (FSC)

EU equity markets at the crossroad: what are the key priorities?

Equity markets are a key component of a sound financial system serving the needs of the EU real economy.

At the current stage, however, the weight of equity financing in the EU is disappointing: firms, including SMEs, do not generally use equity as the main avenue for financing and investors are reluctant to deploy their savings in this inherently volatile financial instrument. The reasons behind this state of affairs are both structural to be tackled as part of a broader economic policy and contingent on the way equity markets are organized and regulated. The latter can be tackled in day to-day policy, which anyway has to govern competing trends and priorities related for example to investor protection, efficient price discovery, competition amongst trading venues and technological innovation.

While broad underlying obstacles should not be overlooked, in the shorter term key priorities are those instrumental to well-organized and regulated EU equity markets that both lenders and borrowers, in particular smaller ones, can trust and use.

This can only be achieved through a balanced approach that takes into account trade offs. While not starting from scratch, the project of the Capital Markets Union is an opportunity to better calibrate such a balance in view of evolving trends and in a way that is increasingly uniform amongst Member States.

Key CMU priorities are double fold: on the one hand, increase further the efficiency and access of EU trading platforms by clarifying the regulatory framework of Fintech and bringing down the well known legal barriers that hinder smooth cross border transactions; on the other hand, secure a truly European stance in the way equity markets are regulated and supervised. In this last regard, implementing swiftly the newly approved Prospectus Regulation, in particular the simplified regime for SMEs (the so called EU Growth Prospectus), is key in order to reconcile the needs of issuers, including SMEs, with those of investors who need meaningful, accurate and not overloaded information. In addition, further supervisory convergence should be aligned to the highest standards: this is a challenge that needs to be assessed with an open approach, which could encompass a revision of the existing framework of ESMA and other ESAs , also considering a common EU supervisor, where appropriate, as one of the options. ●

"Key priorities are thos instrumental to well-organized and regulated EU equity markets."

- VINCENZO LA VIA

Ugo Bassi

Director, Financial Markets Directorate, European Commission

CMU – Making Europe an attractive place to raise capital

Despite their strategic importance as a cornerstone of economic development, public listings of companies remain low in Europe. Worse still, the amount of equity raised on public markets through IPOs and follow-on offerings decreased by 44% in 2016, compared to 2015. In the context of the Capital Markets Union (CMU), the European Commission (EC) has already taken several measures in order to facilitate the listing of EU companies and especially of SMEs.

As the costs of being and remaining listed are said to be discouragingly high, there is a weak pipeline of companies seeking a listing. To partially address this situation, the new Prospectus Regulation – agreed by the co-legislators in December 2016 – contains a series of measures to make prospectuses more fit for purpose, deliver better and more concise information for investors and a fast-track regime for companies that frequently tap capital markets. In particular, a new EU growth prospectus will exempt the smallest capital raisings (particularly from SMEs) from the burden of producing a lengthy and expensive prospectus and is to become the blueprint for disclosure when securities are offered on SME growth markets (but not for regulated markets). On the supply side, listed SMEs can suffer from a narrow investor base. To make it easier for insurance companies to invest in listed SMEs, the Solvency II Delegated Regulation – that was adopted in April 2016 - grants equities traded on Multilateral Trading Facilities (MTF) and equities held through European Long Term Investment Funds (ELTIFs) the same capital charge as equities traded on regulated markets. The revision of the European Venture Capital Funds (EuVECA) – started in July 2016 – should expand the list of eligible assets, to allow investment in mid-caps. In the tax area, the EC aims to address the preferential treatment of debt over equity in its proposal for a Directive on a Common Consolidated Corporate Tax Base in October 2016. This will make it easier for large corporates to attract equity investors and reinforce companies' capital structure.

Beyond those targeted measures, the EC has launched a workstream to boost the profile of the 'SME Growth Markets', a new category of MTF that are being created under MiFID II and will apply from 2018. The Commission will use the insight garnered from its workshops on "barriers to listing for SMEs" organised in October and December 2016 to feed into any policy follow-up in the context of the CMU mid-term review in the first half of 2017. The Commission will also build on the findings of "The Call for Evidence". This identified the market abuse regime as placing a high burden on issuers listed on the future SME Growth Markets. The EC will also assess the implementation of the rules under MiFID II on investment research in relation to SMEs. While the changes are expected to reduce conflicts of interest, the effect of the rules on the provision of equity research needs to be monitored closely. ●

Beatriz Alonso-Majagranzas

Head of Equity Unit, Bolsas y Mercados Españoles (BME)

Enhanced transparency and competition under MIFID II and challenges of CMU

MIFID II means a reinforcement of transparency, reviewing the MIFID I regime for equity instruments with special attention to SMEs, and extending the requirements to equity like and non-equity instruments. For equity instruments, the revised regulation intends to attract to trading venues more trading, trying to reduce the OTC trading or making it more transparent. The aim is that all these measures will contribute to more efficient markets through a better price formation process with more volume contributing to the process while maintaining enough flexibility through the use of waivers authorized and monitored.

In terms of competition MIFID II maintains and develops a proper level playing field establishing equal requirements for regulated markets and MTFs as well as including new trading systems under the MTF regime. The quality of this competition environment will have to be closely monitored in order to guarantee that the objective of a harmonized European market is achieved. In a context of further changes in the European equity markets landscape, Brexit may bring further changes to the regulation implementation.

In the context of CMU, advances in the objectives of modernizing the Prospectus Directive, reviewing the regulatory barriers to SME admission on markets, addressing tax treatment issues fostering retail and institutional investment as well as cross-border financing will allow bringing to public markets more capital under harmonized transparency rules and will contribute to higher levels of liquidity. Achievements in these areas are essential to the development of markets, specially, for SMEs and retail investors. Investor protection shall be granted through the information on products that must be accessible and adapted to every kind of investor and through enough and efficient supervision under harmonized rules. ●

FOLLOWING EUROFI EVENT

25, 26 & 27 April 2018

Sofia - **Bulgaria**

Developing the EU cross-border investment fund market

Contributors

Joe Bannister

Chairman, Board of Governors,
Malta Financial Services Authority (MFSA)

Cross-border fund distribution and the Capital Markets Union

Creating a deeper single market for capital - a Capital Markets Union (CMU) - will strengthen the EU's economy and encourage investment. This would help to diversify the funding of enterprises and notably SMEs, channel more investment into infrastructure projects creating jobs and offer new investment opportunities to savers and investors than those currently existing. Development of distribution to increase the cross-border activities of investment funds is therefore important for the success of the CMU.

The EU has a successful trackrecord of promoting the cross-border distribution of UCITS funds. There is no restriction on the sale of UCITS funds across the EU as the initial Directive introduced the market passport and the legislative regime is harmonised. Recently the AIFMD introduced a passport for AIFs. However, only 57 % of the funds (UCITS and AIFs) are marketed on cross-border basis and the overall picture is quite uneven as one third of UCITS are sold cross-border in only one Member State while another third are not sold cross-border in more than four Member States. The main reason for this is presumed to be the cost of distribution which weighs heavily on the size of the funds. There are more than 30,000 UCITS funds in contrast to 7000 mutual funds in the US and while the average UCITS is valued at approximately €200 million, the US funds are almost seven times as large. It is therefore clear that if European funds can do business more easily cross-border they can grow, become more efficient, allocate capital across the EU, and compete within national markets to deliver better value and greater innovation for consumers.

The barriers to cross-border distribution are varied. Eliminating unjustified barriers would support fund managers to engage more in cross-border marketing of their funds, increase competition and choice and reduce costs for investors.

Marketing restrictions: EU funds marketed cross-border are usually required to comply with national requirements which differ across Member States. Significant costs can be incurred in researching each Member State's financial promotion, consumer protection regime and providing appropriate materials on an on-going basis.

Distribution costs and regulatory fees: EU funds can be subject to regulatory fees imposed by home and host Member States that vary significantly in both scale and how they are calculated. These costs and the need to research them act as a barrier to cross-border distribution.

Administrative arrangements: Where EU funds using the marketing passport are sold to retail investors, host Member States sometimes introduce special administrative arrangements intended to make it easier for investors to subscribe, redeem and receive related payments from funds, as well as receive tailored information to support them in doing so. These additional burdens may not always justified by the value added for investors.

>>>

>>> Distribution: Issues relate to closed-architecture models, barriers that hinder the use of online platforms and direct cross-border distribution, lack of incentives for managers to compete. Investor-related issues: financial literacy, cultural preferences for funds managed in investors' home states

Notification processes: The process is very fragmented. Where funds are marketed on a cross-border basis and there is a need for documentation to be updated or modified, asset managers are required to give written notice to the competent authority of the host Member State. This can add cost and time to the process.

Taxation: Differential tax treatments and withholding tax procedures also create barriers to cross border business.

The situation therefore requires urgent attention and a harmonised set of rules are required so the investment market can flourish. ●

Neena Gill

MEP, Committee on Economic and Monetary Affairs, European Parliament

Tackling regulatory fragmentation in times of Brexit

The CMU was to be one of the most inspiring EU projects of the decade. In an ideal world, it would've created a seem less capital market union that served 500 million customers, in which innovative SME's in Greece were able to tap into the German capital market, in the same way as a German SME could raise capital in Estonia. Without major administrative, linguistic or fiscal obstacles. It would've been a truly European project, aiming to boost the EU economy, jobs and growth.

However, the realty is quite different, despite the progress in the EU regulatory framework on UCITS and AIFMD, there are still far too many examples of 28 differing national markets. A plethora of obstacles have been identified: including marketing restrictions, distribution costs, regulatory fees, administrative arrangements, and taxes.

"If not managed carefully, Brexit will become the ultimate example of fragmentation."

- NEENA GILL

Such a structural fragmentation along national borders has consequences for the economies of scale that investment funds could potentially reap and moreover it limits the customers getting a better deal.

Tackling this national fragmentation should therefore be a top priority for the European Commission. The consultation which was launched by the Commission last June and closed in September to identify the obstacles to the cross border distribution of the investment funds was more than timely.

The consultation identified that removing potential obstacles could significantly boost the investment sector and reap benefits for the end investor. The onus is on the Commission to come up swiftly with targeted measures to tackle this fragmentation.

But the biggest challenge for the CMU is Brexit. If not managed carefully, Brexit will become the ultimate example of fragmentation.

In broad terms, Brexit risks becoming a huge setback for the objectives of the CMU. For 16 out >>>

>>> of 21 capital market segments, the UK is the most important location. When the UK leaves the EU, the depth of the European capital markets relative to GDP would shrink by about 16 %. The UK accounts for 40% of Europe's assets under management and 60% of its capital markets business, and UK-based banks provide more than £1.1 trillion of loans to the other EU Member States.

To avoid the CMU becoming CMU-light with the remaining 27 Member States, targeted action by the EU and the UK is absolutely necessary. Otherwise, the risk is that the consumers and businesses will bear the brunt of cost with more expensive financial services.

However, the British Prime Minister has stated that the UK will be leaving the single market, it is obvious that investment funds based in the UK will not be able to continue to market their funds cross border based on an EU passport. The equivalence route is one that many are considering as the way forward but this is not the most stable legal basis, as it can be revoked by the European Commission at any time.

An intermediate solution in the form of transitional arrangements need to be put in place. On the cross border distribution of investment funds, this should be technically possible, as UCITS/AIFMD allow central management to delegate functions to third countries provided cross border regulatory cooperation agreements are in place.

However this route is only a politically realistic option provided that the investment funds sector do not adopt too broad an interpretation of the concept of delegation, making any appropriate supervision virtually impossible. If such an approach were to be taken by investment funds based in the UK, it's highly unlikely that a workable deal will be found.

Furthermore, it is in no one's interest to go for a race to the bottom and there's concern that with Brexit, Member States are sprinting into regulatory competition to attract new fund providers to their jurisdictions.

This certainly wouldn't be in the interest of the end investor, nor the investment funds, it would only increase fragmentation and would mean it's the final nail in the CMU coffin. ●

Niels Lemmers

Managing Director,
European Investors' Association

Keys to more competition in the EU market for retail investment funds

A competitive European fund landscape with considerable degrees of retail participation is key to the overall success of the CMU. Investment funds are of crucial importance to investors allowing them obtain high levels of diversification in their portfolios.

Enhanced cross-border distribution of investment funds should allow for more competition within the EU. The. infamous comparison with the US where, due to higher levels of competition, the number of funds is significantly lower, the average fund size is higher and fees are lower, is relevant in this regard. Also, the move towards passive fund investment is much stronger in the US.

MiFID II brings important changes to the distribution of funds, but will it be enough? To allow for more cross-border sale, distribution channels need to be opened up. MiFID II, by only banning commissions for firms when providing independent advice and not requiring traditional banks to offer anything other than commission paying products and their own inhouse funds, seems to do exactly the opposite.

In the Netherlands and the UK, where there is a full ban on commissions, independent (automated) advisory services have proliferated. Also, fund platforms, allowing investors to choose among a wide range of funds, have gained enormous popularity. MiFID II however puts these platforms under pressure, for example through the broader product scope of the appropriateness test and the stringent product governance obligations.

Also, key to proper protection for retail investors is transparency around the costs, risks and performance of funds. PRIIPs will definitely help. But, again, will it be enough? Firstly, investors often do not read the UCITS KIID (and there is little reason to assume that they will read the KID). Instead, they tend to rely on marketing materials that do not always provide a balanced view of the ups and downs. Stricter European rules for such materials could provide a solution. In Belgium, for example, rules exist on the use of historical performs, awards, ratings and comparisons as well as minimum standards in relation to the content of advertisement.

Through the introduction of a centralised notification process for funds that are marketed in more than one Member State, the administrative burden for fund managers could be alleviated. However, this requires more ambitious work of ESMA on supervisory convergence, in order to prevent regulatory arbitrage. Or maybe the centralised notification process should be mandated to ESMA.

"The KID does not solve one of the major issues in fund landscape."

- NIELS LEMMERS

Secondly, the KID does not solve one of the major issues in fund landscape, namely the lack of proper transparency around the objectives of the fund manager (i.e. the benchmark it aims to beat) and its success in achieving them (disclosed in a cumulative way).

Underperformance is also not punished through lower fees. Managers get rewarded for good performance (also if it concerns an absolute loss or if they simply benefit from rising markets), but do not get punished (through a discount for their clients) for bad performance. Performance fees should be symmetrical. Also, fees should decrease when the size of the fund increases. ●

Frédéric Bompaire

Head of Public Affairs,
Finance and Strategy, Amundi

A unified EU market for funds is not realistic

European Union introduced passport as an efficient way to lower barriers for cross-border activities in the asset management industry. There are 2 types of passports: one allows firms established in one member state (MS) to setup and manage funds registered in another member state, the other organizes cross border distribution throughout the European Union of funds based in one MS. Thus, Capital Market Union should be a reality with respect to funds : the principle is clearly established that an asset manager can sell its EU based funds in all the MS. It applies for retail clients with UCITS or professional clients for AIFs. However, we do acknowledge that reality is not exactly as intended: there are still limitations that do not allow EU to be a unified market place. Some may be justified and many are just burdensome.

Obviously language is a barrier that cannot be removed. We do understand that when addressing retail clients we need to speak their mother tongue. Translation does imply cost but it is not avoidable. Cultural habits and education in financial matters can largely differ from one country to another and we should respect that. Economic and patrimonial situations are also not comparable so that a threshold expressed in € can be inappropriate in some countries. There is room for national authorities (NCAs) to maintain their control on legal documentation (KIID for example), marketing documents and eligible distribution channels... Online subscription of funds facilities, for example, need appropriate regulation to ensure total compliance with KYC/AML requirements.

Amundi believes that proximity with investors is key and prefers a multi-local approach that enhances confidence instead of a standardized cross border offer. With the acquisition of Pioneer we feel at home in Italy as well as France, Austria and Germany for example and intend to integrate cultural, historical and economic specificities that impact investment behaviours of retail and many institutional clients.

"Amundi believes that proximity with investors is key and prefers a multi-local approach."

- FRÉDÉRIC BOMPAIRE

Conversely, purely administrative impediments should be removed and efforts should be made to clarify grey areas. In that respect we do support the Commission's suggestion in its Report COM (2017) 102 published at the end of February to identify 'premarketing and reverse solicitation practices' and aim at 'promoting convergence in this area'. We do not believe that prohibiting NCAs to levy a fee for funds asking for a passport is a priority but we totally support the call for clarity and transparency as well as centralization of information on that matter in a unique data basis. We would welcome a unified notification procedure where updates made to the home NCA would automatically extend to NCAs in all countries for which passport has been granted. Our most acute concern, though, relates to tax and in particular tax reporting that varies so much.

We are not very confident on the ability for the EU to soon make decisive steps towards harmonisation of fiscal policies. But we keep hoping. ●

Jean-Paul Servais

Vice Chairman, International Organization of Securities Commissions (IOSCO), Chairman, IFRS Foundation Monitoring Board, Chair, ESMA's Financial Innovation Standing Committee & Chairman, Belgium Financial Services and Market Authority (FSMA)

Ensuring a high level of consumer protection within the Capital Markets Union

The key to building a successful Capital Markets Union does not only depend on the supply side, but also on the demand side. Consumers will only invest in products if they have the reassurance that the offered products are sound, appropriate and well-supervised.

"It is also key to designate the supervisor that has the incentive to supervise."

- JEAN-PAUL SERVAIS

A harmonised set of rules should ensure that financial products placed on the market are sound and appropriate. In this regard, important steps have been taken to improve transparency to consumers by introducing standardised key information documents. However, behavioural research has shown that transparency is not sufficient. Therefore, the regulatory system should also ensure that inappropriate or >>>

>>> particularly complex products are not allowed to be marketed to retail investors.

In the CMU debate, one should not only focus on the harmonised set of product rules, but equally important on the designation of the supervisory authority and the accompanying competences and tools. Consumers must be reassured that the products offered to them are continuously well-supervised. It is therefore essential that each supervisory task is designated to the supervisor that is best placed and that has the proper incentive to supervise. For example, it is clear that the supervisor of the Member State were advertisements are disseminated should perform the supervision of the marketing documents, as it is impossible for the 'Home' supervisor to check the publicity spread in other Member States. It is also key to designate the supervisor that has the incentive to supervise. In consumer protection supervision, it is the supervisor of the Member State where the products are offered and thus where the investor risk lies that has the proper incentive to supervise. The financial crisis has shown the potential risks when incentives are misaligned. The Capital Markets Union should therefore foresee the necessary tools and powers to host supervisors to react promptly to ensure a high level of consumer confidence in cross-border products. ●

Tanya Pieters-Gorissen

Head Asset Management Supervision, Netherlands Authority for the Financial Markets

Increasing cross-border distribution while maintaining investor protection

Especially after Brexit, a strong, robust and future proof EU asset management industry can only exist when industry, policy makers and regulators get their act together.

Asset management is a key player in mobilising retail and professional capital into the economy. Cross-border distribution of investment funds plays an important role in creating a CMU which

strengthens Europe's economy and that of each individual Member State (MS). It allows funds to grow, allocate capital efficiently across the EU, and compete within (inter)national markets to deliver better value and greater innovation. However, the internal market can only become succesful if the interests of investors are sufficiently adressed. This is a shared responsibility of policy makers, regulators and the industry itself.

What could contribute to a more efficient cross-border distribution process without weakening investor protection is on the one hand, to prevent cross-border distribution of funds being unduly hampered due to unnecessary home/host regulation and regulatory fees. Where additional requirements in respect of marketing to retail investors could be appropriate, it seems less fit to impose gold-plating for professional investors. It would be good to explore initiatives that could increase cross-border distribution, e.g. to explore if ESMA could play a central role, for instance by keeping a single record of all cross-border distributions in the EU.

> *"Asset management is a key player in mobilising retail and professional capital into the economy."*
>
> - TANYA PIETERS-GORISSEN

At the same time, it is essential to increase supervisory convergence by national competent authorities (NCAs) as this will ensure EU wide supervision to be sound and effective. Without 'supervising' how NCAs apply and implement the rules, it is uncertain whether all NCAs apply the same standards, a real level-playing field and sustainable EU regulatory approach is secured and whether passporting can be continued in the long run. How can a NCA, subject to sub-optimal peer-pressure and an EU supervisory structure without effective tools to see to it that agreed upon practices are collectively adhered to, resist the temptation of opportunism? Increasing supervisory convergence will prevent regulatory arbitrage or a race to the bottom between MS. ●

Benoît de Juvigny

Secretary General, Autorité des Marchés Financiers (AMF)

Three proposals to develop cross-border distribution in Europe

In a blurred political context, and as the Commission is assessing the progress of its CMU plan, it is essential to re-emphasize the importance of ensuring the development of capital markets in the EU. Europeans must push forward a competitive and dynamic CMU, facilitating cross-border investment and enhancing investor confidence, to enable the long-term financing of the EU economy.

In a study recently published, the AMF shows that the EU passport for investment funds is a major >>>

>>> success of the Single Market. Evidence also shows that there are however some residual obstacles to the cross-border distribution of savings products. These barriers mainly relate to differences in investors risk appetite and tax incentives in the various Member States, or simply the existence of a home bias from investors, who may prefer to invest in products or brands they know.

Three proposals can be made to invigorate cross-border marketing and restore investor confidence by offering equal protection for all investors in the EU, regardless of a product's country of origin.

The first idea is to offer investors more choice. Europe needs to broaden access to a large range of investment products, by promoting an open architecture and facilitating the development of digitalization and innovation. In this perspective and for instance, the definition of marketing and pre-marketing could be harmonized at EU level.

"A reflection should be launched on the supervision of the freedom to provide services."

- BENOÎT DE JUVIGNY

The second field of focus is to shield investors from misleading advertising. National competent authorities should maintain an efficient supervision of promotional and marketing materials distributed in their jurisdiction, to ensure their consistency with the regulatory documents. This is vitally important since they have the relevant knowledge of local cultural norms, distribution networks and advertising methods. It would thus help maintain confidence in products from other Member States.

Thirdly, a reflection should be launched on the supervision of the freedom to provide services. Powers of the "host" authority should be strengthened to give the latter the capacity to intervene rapidly, when they do not receive sufficient assistance from the "home" authority in order to put a stop to practices that cause damage to the "host" country investors. It is urgent to give "host" authorities clear and immediate power over service providers targeting investors in their country through the free provision of services. ●

Stefan Gavell

Head of Regulatory, Industry & Government Affairs, State Street Corporation

A successful CMU needs an EU funds market without borders or barriers

While much attention is focussed on Brexit and the upcoming elections in the EU, it is important that progress continues on the Capital Markets Union (CMU). Unlocking additional and new sources of non-bank funding for the EU economy as well as further integrating and deepening EU financial markets is essential against the background of continuing pension funding gaps, low economic growth, unemployment and restricted bank lending. Also, end-investors will benefit from CMU with regards to widening the availability of products and services lowering their related costs. The funds industry has an important role to play in this as a financial intermediary and allocator of capital and investments.

However, barriers to cross-border distribution continue to be an impediment to achieving a fully integrated EU funds market and thereby to the CMU. These barriers are well known and include national marketing and disclosure requirements, notification procedures, as well as tax-related issues. They also have been well documented by the EU Commission in its recent report on "Accelerating the capital markets union: addressing national barriers to capital flows". From the perspective of a service provider, State Street would also add the lack of a depositary passport which, while not creating an immediate barrier, would allow the development and domiciliation of investment funds in more EU Member States, and allow depositaries to provide their services across the EU more efficiently.

But now is the time to address and remove these barriers. Digitisation, regulatory harmonisation, including in areas such as securities law, operational matters such as asset segregation, as well as supervisory convergence all have important roles to play in breaking down these barriers. While the task won't be easy, its benefits are clear and tangible: the creation of larger and deeper pools of assets, economies of scale, increased competition and broader choice for the end-investor as well as a more diversified funding base for Europe's real economy. ●

Eurofi would like to thank very warmly
the sponsors of this event for their support

LEAD SPONSORS

SUPPORT SPONSORS

REGIONAL PARTNER

Enhancing the consistency of insolvency and securities laws

Contributors

Sébastien Raspiller

Head of Corporate Financing and Financial Markets, Ministry of Economy and Finance, France

The EC proposal on insolvency is a must-have for achieving a genuine CMU

Inefficiencies in national insolvency regimes generate legal uncertainty for investors and may prevent the effective restructuring of viable companies in the European Union.

In this context, recent efforts made by the European Commission to reach across the European Union a far more consistent insolvency framework through the proposal for a Directive on Insolvency, Restructuring and Second Chance are going in the right direction. The proposal aims at facilitating the restructuring of viable businesses where formal insolvency procedures leading to liquidation would be value-destructive.

It will thus increase the opportunities for companies in financial difficulties to restructure early on so as to prevent bankruptcy and avoid laying off staff. It will also lead to more efficient insolvency procedures within the European Union. More efficient restructuring and insolvency frameworks can furthermore contribute in a significant way to the efficient management of defaulting loans and their accumulation on banks' balance sheets.

Insolvency law is deeply rooted in national legal traditions and involves other areas of law (e.g. labor). The European Commission is rightly focusing on targeted, effective improvements to ensure higher predictability and efficiency of insolvency regimes. Practice and outcome matter as much as the legal framework itself: It is not about rules-based convergence for the sake of harmonization, it is about outcome-based convergence for the sake of the well-functioning of the internal market.

Convergence of principles and targets within the European Union in insolvency and restructuring proceedings can facilitate greater legal certainty for cross-border investors and encourage the timely restructuring of viable companies in financial distress. In order to improve the foreseeability, effectiveness and speed of restructuring and insolvency proceedings, the following topics could be precisely addressed and monitored:

- Setting up common targets to reduce the average duration of proceedings, both out-of-court and judicial ones;
- Enhancing the capacity of out-of-court proceedings to address with anticipation difficulties of viable businesses and measuring their efficiency in the long-run;
- Clarifying the rights of creditors and shareholders during insolvency proceedings in order to maximise the chances of sustainability of the company.

Such initiatives could strengthen the Capital Markets Union as they would contribute to providing more legal clarity to cross-border investors and companies operating across the European Union. ●

Lieve Mostrey

Chief Executive Officer, Euroclear

A pragmatic approach to securities law and cross-border investment

Delivering legal certainty in securities markets is core to the efficient, safe and reliable functioning of European capital markets. This has long been recognised by the European Commission which has been examining, and monitoring the removal of, barriers within European securities markets for several years.

The legal landscape for securities holding and disposition and the exercise of rights attached to securities is fragmented. The international nature of securities transactions leads to situations where the law of more than one country can influence the legal status of a securities holding. This is a consequence of the fragmentation of legal regimes, which broadly respect national boundaries. This is not a European issue but, in international markets, it is a global one.

The Commission most recently looked at this issue in 2013. It considered whether book entries on an account should be given identical legal significance throughout the EU, and whether conflict of law rules relating to intermediated securities should be harmonised; although the legal and political complexity of these issues meant that no specific action was taken at the time.

As cross-border investment and settlement increases, particularly as a result of the introduction of T2S, securities law reform is now, quite correctly, being reconsidered as a core part of the CMU Action Plan. For the issue to be addressed successfully, a focused and pragmatic approach is needed which does not require a complete review of property laws in each member state. And we need to be clear which risks we wish to mitigate before embarking on such reform. Sometimes there might be complex trade-offs to be made by the authorities between investor protection, operational efficiency and systemic risk issues.

The Commission has announced that it intends to bring forward a conflict of law reform later this year. From a post-trade perspective, we do not see this as a major concern, at least within the EU, so we would urge caution before embarking on too ambitious a project. But we understand that elsewhere in the securities chain there are real concerns about which law applies to which securities account. Over 15 years ago the Hague Convention valiantly tried to address this globally, but ultimately failed.

"Legal uncertainty can pose barriers to the safe and efficient functioning of the Single Market."

- LIEVE MOSTREY

In the wake of the financial crisis, significant efforts have been undertaken by EU regulators to ensure a more stable financial system in the future. Legal uncertainty can pose barriers to the safe and efficient functioning of the Single Market, but its successful resolution requires careful analysis and a proportionate response. ●

Laurence Caron-Habib

Head of Public Affairs - Strategy and Corporate Development, BNP Paribas Securities Services

If a securities law reform should be undertaken, considerable changes undergone by the custody market must be taken into consideration.

The debate about "securities law" reform started more than 15 years ago. The entire debate, on the interlinked European and Global level, was blurred by the impossibility to answer a simple question: was "securities law" a real legal obstacle to cross-border securities trading? Or was it all about a paradigm change and resulting economic benefits that intermediaries could reap from the billions worth of securities that they held in securities accounts for clients?

Many arguments were thrown into the debate such as high cross-border settlement cost, long and complicated custody chains, erroneous credits to the wrong securities accounts. Arguments extended to perfidious pettifoggery such as "when the client accesses his securities account from his mobile devise whilst travelling to Singapore, is the securities account then located in Singapore, despite the client being UK resident, investing in Italian securities through a Belgian custodian?"

As the debate got overwhelmed by ever more complicated legal – technical questions, it became more difficult to separate the wheat from the chaff. >>>

>>> One thing is certain though: in the last 15 years, the custody market has undergone considerable changes and if a securities law reform should be undertaken as part of the Capital Markets Union, the current market must be analysed. This debate should no longer be blurred by legal technical arguments that aim at achieving an undefined objective. First, settlement cost, including cross-system settlement cost have been reduced to negligent. Second, most global custodians have extended their global network, reducing recourse to sub-custodians and therefore making custody chains shorter and simpler. Third, as a result of competition and concentration, custodians have grown in size, pushing automation of processes to the extreme and therefore further reducing cost. Fourth, most €-zone CSDs participate to T2S, thus removing cross-system settlements amongst participants.

The temptation to repeat statements and questions of 15 years ago is high; but the essence is to flatten the debate and see what we are really talking about in the end. We see a conflict of law rule that extends the conflict of law rule of the Financial Collateral Directive to all types of securities transfers and holding as a helpful clarification. Other than that, we consider that reforming fundamental legal concepts such as "ownership", "title" or "shareholder" leads to considerable legal uncertainty. An operational approach would be more beneficial.

That approach would consist in isolating the legal aspects of those parts to the custody market that need improvement. ●

Ugo Bassi

Director, Financial Markets Directorate, European Commission

Capital Markets Union – good progress removing obstacles to cross-border investments

The Capital Markets Union is making good progress in removing obstacles to cross-border investment and a truly integrated market for capital. One important area where further work is required is post-trade services. The European Post-trade Forum was set up by the Commission to analyse the post-trade environment for persisting or potential new barriers. This group should deliver its recommendations before the summer. Based on this report, the Commission will consider what further actions are required to create a safe and efficiently functioning post-trade environment. Nevertheless, some areas have already been singled out in the CMU Action Plan. In particular, the Commission will present a legislative proposal for uniform conflicts-of-law rules to determine with legal certainty which national law shall be applicable to securities ownership and the third-party effects of assignments of claims. These areas are of growing economic relevance given the increased demand for collateral and the growing volumes of cross-border transactions, not least with the arrival of TARGET2-Securities. Rules on debt assignment will lead to an increase in legal certainty which can also be a building block for facilitating the management by banks of non-performing loans.

Banks, but also potential cross-border investors, would also benefit from more efficient national insolvency regimes. In November 2016, the Commission released a proposal for a Directive providing for minimum harmonisation of preventive restructuring frameworks and second chance, geared, inter alia, at avoiding the unnecessary liquidation of viable businesses and encouraging measures to enhance the efficiency of insolvency proceedings. To establish a reliable picture of national debt recovery systems in terms of rates, speed and costs, the Commission has initiated an outcome-based benchmarking review aiming to inform the further discussion and to assist Member States seeking to reform their systems.

We continue to put strong emphasis on further integration of capital markets and removal of obstacles to cross-border investments in our work towards a mid-term review of the Capital Markets Union. ●

Jochen Metzger

Director General Payments and Settlement Systems, Deutsche Bundesbank

T2S key to harmonisation in post-trade area beyond securities laws

Following the completion of T2S migration wave 4 early February the volume of securities transactions now being settled on the platform has almost doubled. 18 CSDs, representing 16 markets, are now settling securities transactions on the pan-European platform covering almost 90% of the grand total. Based on the network of links CSDs are establishing across Europe T2S is making a solid contribution to post-trade integration in Europe. >>>

>>> Moreover, T2S will allow for consolidated issuance processes across Europe and enable issuers to reach several markets from just one CSD as a single point of access to T2S markets. That means T2S plays the key role for the creation of the Capital Markets Union. Furthermore, as approved by the latest harmonisation report, the integrated T2S infrastructure will bring more technical and operational harmonisation to the "single" market for settlement services in Europe.

Harmonisation of collateral management arrangements is complementary to T2S harmonisation as their importance has grown in recent years with respect to regulatory requirements. General objective when addressing enhanced collateral needs is prompt access to available collateral to have the right collateral at the right time at the right place. Remaining gaps e.g. in the area of corporate actions as well as collateral mobility and cross-border interoperability will be addressed by the Eurosystem's newly established Advisory Group on Market Infrastructure for Securities and Collateral (AMI SecCo).

With regard to a possible further harmonisation of substantive securities laws, past experience has shown that such harmonisation is very difficult to achieve as securities laws are deeply enshrined in more general principles of law in many countries such as property and insolvency law with the effect that any change in the former may have a severe impact on the latter two. Thus, from our perspective the limited added value of a further harmonisation does not justify the effort needed to achieve it. However, we welcome the Commission's „legislative initiative" to determine with legal certainty which national law should apply to security ownership as this will further contribute to strengthening the legal environment for availability and mobility of collateral in the context of the Capital Markets Union.

Looking ahead, further harmonisation efforts should not only address €-denominated securities but also foreign currency to reap full benefit of harmonised and streamlined procedures. ●

NEXT EUROFI EVENTS

13, 14 & 15 September 2017
Tallinn - **Estonia**

25, 26 & 27 April 2018
Sofia - **Bulgaria**

5, 6 & 7 September 2018
Vienna - **Austria**

Technology and climate-related innovation

Content

Issues at stake

Technological innovation and climate-related developments are two trends that are bringing about major changes in the financial sector.

Digital and blockchain technologies have the potential to increase operational efficiency and transform customer experience in banking and capital markets, but pose significant challenges in terms of regulation (how to favour innovation while preserving a level playing field and ensuring user protection?), scalability and legal certainty for blockchain and safety, notably regarding cyber risk.

The evolution towards low carbon and more climate resilient economies also brings its share of challenge in the financial sector. Beside developing innovative financing opportunities, financial institutions also need to assess and adapt their own exposure to such large-scale and long-term risks.

Climate-related and green finance

Contributors

Jonathan Taylor

Vice President, European Investment Bank (EIB)

The EIB: Mobilising private finance for climate action

Bruno Farber's Ginkgo Fund raised EUR 80 million for seven industrial decontamination and redevelopment projects in Belgium and France, all of which are on course to be cleared for construction by the end of 2018. The fund included EUR 15.6 million from the European Investment Bank. The success of Ginkgo led Farber to start raising money for Ginkgo II, which will expand his reach to the UK, Luxembourg and Spain. With the backing of the Investment Plan for Europe, the EIB immediately joined with a EUR 30 million investment in February 2016.

Without the Investment Plan's EU budget guarantee, built to accelerate investment in innovative projects, the EIB wouldn't have been able to invest as much in Ginkgo II.

That is important, because the EIB's involvement was key to convincing other investors, including the private sector, to put their money into the first Ginkgo fund. The same has been true for Ginkgo II. As a cornerstone investor, the EIB's presence showed other institutions that real, in-depth due diligence had been carried out, and that the predecessor fund had been well managed in a challenging economic context.

Like the EIB's involvement in Ginkgo II, its support for wind farms in Sweden and Scotland or low-carbon rolling stock in Italy shows that EFSI helps the EIB to support larger climate deals, and to do them more quickly.

The EIB is already the world's largest multilateral provider of climate finance. In the last five years we provided over EUR 90bn for climate action with funding to every EU member state and to projects from Nicaragua to Nepal. Over the five years to 2020 we expect to finance climate projects worth USD 100 billion.

Our Climate Action Strategy, finalized ahead of COP21, includes under its first pillar the aim of raising money on capital markets that is specifically earmarked for climate action projects. The EIB pioneered the Green Bond market ten years ago by issuing the world's first Green Bond, branded "Climate Awareness Bond" in 2007. We have now issued over EUR 16 billion in the format across 11 currencies, which makes EIB the world's largest issuer of Green Bonds to date.

The EIB provides best-practice examples for impact reporting and external review in the Green Bond market. Last year, auditor KPMG delivered an Independent Reasonable Assurance Report on our Green Bond programme. We also contribute to the market development through the Green Bond Principles, a forum that provides voluntary guidelines promoting transparency and accountability. Transparency includes, of course, reporting on which projects have been financed with Green Bonds.

Another key area of the Paris agreement is scaling up investments to build resilience to the impacts of climate change. This is why the second pillar of EIB's climate strategy focuses on adaptation investments, which is particularly important in the least developed countries and small island states where efforts to promote sustainable development are often undermined by severe weather. Take the Cook Islands. Almost 90% of the combined territory is less than 5 meters above current sea level. The EIB has been providing technical assistance in the Cook Islands to assess options for relocating key infrastructure, such as the main airport's fuel storage, just between the runway and the ocean. The aim: to cut the potential impact of an extreme storm.

>>>

>>> The third pillar of our climate strategy focuses on integrating climate change across all EIB standards, methods and processes. One example is the EIB's introduction of an emissions performance standard, which was a first for an international financial institution. This means that the EIB can only lend to power generation projects where CO_2 emissions are below a clearly defined level (550g CO_2/kWh).

In addition, the EIB applies in its project appraisal work and projections an economic price for carbon dioxide of approximately EUR 33 per ton, rising to EUR 120 per ton in 2050, much higher than the current market price.

Whether it is helping to build one of the largest solar farms in the world, bringing sustainable transport to a megacity, or helping implement small-scale energy efficient and renewable energy projects in Kenya or Lebanon, the EU bank has made support for climate-friendly projects a priority. ●

Abyd Karmali

Managing Director, Climate Finance, Bank of America Merrill Lynch

How is private finance supporting global climate policy objectives?

Private finance is extensively engaged on the topic of climate change from both a risk and opportunity perspective. By focusing how to scale up and speed up investments in the low-carbon, new energy economy, private finance is helping to create new markets for corporate and institutional investor clients. Decarbonisation of the power sector, primarily through investment in renewable energy, combined with increased electrification in the transport, heat and industry sectors is one key dimension of the energy transition. Investment focused on achieving a structural increase in energy productivity improvement (i.e., 2-3 times faster than current annual rate) is a second dimension and one where new models of financing are needed. The following considerations concerning disclosure of climate risks, broader use of green securitisation, and an enabling integrated policy framework could help accelerate investment flows:

Putting the FSB Task Force Recommendations into Practice

The recommendations of the FSB Task Force on enhancing disclosure of climate-related financial risks, if adopted, will improve standardisation in disclosure and reporting of climate-related risks. This will enable investors to better identify, price and manage risks, and encourage a greater shift in capital from high to low-carbon. One recommendation made by the FSB Task Force is for organisations to use scenario analysis to guide disclosure of climate risks. Another recommendation is that preparers of reports should incorporate the principle of materiality into their disclosures. One way to make these two recommendations align is for each organisation to first determine materiality of climate risks based on an agreed and specified pathway for carbon prices, such as those being developed by the Carbon Pricing Corridors initiative. Where climate risk is shown to be material, scenario analysis (using a standard reference such as the IEA 450 ppm scenario) would then help guide the nature of the disclosures.

Enabling Broader Use of Green Securitisation

The Paris Agreement identified investment needs of approximately €200 billion/year for low-carbon and climate resilient infrastructure in the energy and transport >>>

>>> sectors alone. As the positive experience in the US capital markets with rooftop solar Asset-Backed Securities has shown, securitisation can be an effective tool for refinancing such infrastructure because it enables faster recycling of capital into new low-carbon investments, and allows a smooth transfer of risk from project sponsors to institutional investors, many of which are keen to increase their exposure to clean energy investments. The Capital Markets Union initiative, once implemented, should support structures that enable warehousing, pooling and securitisation of low-carbon assets. Large European projects such as offshore wind farms have the added benefit of long-term index-linked revenues that make them well-suited to securitisation.

Implementing an Integrated Policy Framework Linked to the EU's Nationally Determined Contribution

The EU Emissions Trading System commenced in 2005 and will shortly enter its 4th Phase. It is the centrepiece of the EU's Nationally Determined Contribution (the EU's strategy submitted as part of the Paris Agreement). Carbon pricing has shown itself to be essential but insufficient to drive decarbonisation. An integrated policy framework that combines industrial policy, power markets redesign, energy efficiency standards and regulations, improved transport system and urban design as well as a strong carbon price signal will help mobilise more private finance from institutional investors.

Bank of America Merrill Lynch has insights from each of these areas in low-carbon finance through our 10-year, $125 billion environmental business commitment, and from a track record of several completed transactions under our Catalytic Finance Initiative – which is now a two-year partnership that includes other commercial banks, Development Finance Institutions and asset managers. We look forward to sharing these insights with other interested stakeholders. ●

Daniel Calleja Crespo

Director General, DG Environment, European Commission

Green Finance is much more than investment

I strongly believe that Green Finance is more than investment related to climate. Public and private finance are both needed to build a more sustainable and inclusive European society.

The Sustainable Development Goals (SDGs), the Agenda 2030 and the Paris Agreement on Climate Change (COP21) are international milestones showing the path towards a more global sustainable development.

The financing needed to achieve the set targets is extremely important, having been estimated at some USD 90 trillion over the next 15 years[1]. Public budgets, though important, will not be sufficient. Therefore capital markets and private finance will play a key role.

For this, I believe we need a better alignment of the financial system, with clear and decisive policies to foster sustainable growth. We need to invest in clean technologies and their deployment; to develop a green bond market and to incorporate environmental considerations into financial risk management strategies. >>>

>>> WHAT INITIATIVES HAVE BEEN TAKEN BY THE EUROPEAN COMMISSION?

Public investments

The EU has committed to spend at least 20% of its 2014-2020 budget – as much as €180 billion – on climate change-related action[2], as well as 60% of the EU's research and development budget (Horizon 2020)[3] on projects promoting sustainable development. In addition, we have put in place several other funding programmes, such as LIFE[4], COSME[5] and the European structural and investment funds (ESIFs)[6].

European Fund for Strategic Investment

Green finance has received an extra incentive of at least €315 billion in additional investment over the period 2015-2018 from the Juncker Plan through the European Fund for Strategic Investments (EFSI)[7] aiming at overcoming market failures by mobilising private and public investment. The European Commission intends to extend EFSI until 2020 and focus it more on sustainable investments across sectors to increase our chances of meeting the Paris Agreement targets and help the transition to a resource efficient, circular and zero carbon economy.

Circular Economy Finance Support Platform and Biodiversity financing

Building on the momentum, the Commission launched the Circular Economy Finance Support Platform[8]. Together with the European Investment Bank (EIB), it aims at enhancing the link between existing instruments and to raise awareness to circular economy investment opportunities and promote best practices.

The European Commission also established the Natural Capital Financing Facility (NCFF)[9] whereby the EIB can provide loans and investments to support projects promoting the preservation of natural capital.

Through the European Business and Biodiversity (B@B) Platform[10] the Commission is engaging the private sector in exploring innovative financing mechanisms for biodiversity-related business activities. It also promotes the uptake of best practices in integrating biodiversity and natural capital into mainstream financial activities and fostering investments in natural capital as a new asset class.

WHAT IS THE ROLE OF THE HIGH LEVEL GROUP ON SUSTAINABLE FINANCE?

The European Commission established the High Level Expert Group on sustainable finance[11] as part of the Capital Markets Union.

The Group first met on 24 January 2017 to establish its work streams. It will examine the potential of green bond finance for resource-efficient investments[12] and resource efficiency and fiduciary duties of investors contracted by the European Commission. A report is expected by the end of December 2017, with operational recommendations for integrating sustainability considerations into the EU's rules for the financial sector. It will be of enormous valuable to shape the future of our Green Finance Strategy, and to succeed in meeting the challenges of our Sustainable Development and Climate Agenda. ●

1. http://unepinquiry.org/wp-content/uploads/2016/09/The_Financial_System_We_Need_From_Momentum_to_Transformation_Summary_EN.pdf.
2. https://ec.europa.eu/clima/policies/budget_en
3. http://ec.europa.eu/programmes/horizon2020/en/area/environment-climate-action
4. http://ec.europa.eu/environment/life/
5. https://ec.europa.eu/easme/en/cosme
6. http://www.eib.europa.eu/products/blending/esif/index.htm
7. https://ec.europa.eu/priorities/jobs-growth-and-investment/investment-plan_en
8. http://ec.europa.eu/environment/circular-economy/index_en.htm
9. http://ec.europa.eu/environment/life/funding/financial_instruments/ncff.htm
10. http://ec.europa.eu/environment/biodiversity/business/workstreams/workstream3-access-to-finance-and-innovative-finance-mechanisms/index_en.htm
11. http://ec.europa.eu/finance/capital-markets-union/docs/20161028-decision_en.pdf
12. http://ec.europa.eu/environment/enveco/pdf/potential-green-bond.pdf
http://ec.europa.eu/environment/enveco/resource_efficiency/pdf/FiduciaryDuties.pdf

Gerassimos Thomas

Deputy Director-General for Energy, European Commission

Initiatives to finance clean energy for all Europeans and beyond

On November 30th, the Commission presented regulatory proposals and facilitating measures that aim to consolidate and accelerate the EU economy's clean energy transition. This is a concrete response to Europe's COP 21 and Energy Union commitments. Similar objectives are set in the EU's neighbourhood and external action where climate mitigation and adaptation are at the core of our priorities.

The energy sector employs close to 2.2 million people, spread over 90,000 enterprises in the EU. The development of renewable energy sources, energy efficiency products and services has led to new business models and job creation across Europe. This transformation requires both a shift from carbon-intensive to low-carbon projects and a substantial increase in investments. We estimate investment needs of at least €150 bn annually over the 2020-2030 period.

Most of these investments will have to come from the private sector. The Commission creates a regulatory framework that sends the right signals to the market and increases investor confidence. Our "Clean energy for all Europeans" package covers (a) a new electricity market design proposal to facilitate the integration of renewables into the grid and achieve scarcity pricing, (b) energy efficiency and building performance standards and measures, (c) a new framework for the development of renewables as a mainstream energy source and (d) a governance system that permits a fair planning, reporting and monitoring system by Member States so as to achieve aggregated EU targets.

A reform proposal for the EU Emissions Trading System (ETS) is also central to our efforts to achieve: (a) more ambitious linear reduction factor for GHG emissions, (b) new rules for free allocation and carbon leakage and (c) provisions for funding innovation and modernisation. This will improve the commercial viability for mature energy efficiency and renewable projects, while these specific funds can give an extra boost to innovation in the energy sector.

Nevertheless, many project developers still face uncertainties and obstacles in raising up-front finance for their projects. In addition, the small-size of certain investments and the lack of sufficient capacity and skills to structure bankable projects keep finance demand low.

This is why, next to setting the right regulatory framework, the Commission identified a need for complementary financing support actions and has reinforced the sustainable finance dimension of the Capital Markets Union. Within the framework of the European Structural and Investment Funds (ESIF) Member States have pledged €38 bn in climate action related projects including €17 bn in energy efficiency. However the majority of these funds are planned to be spent in grant support thereby achieving low leverage. The European Fund for Strategic Investments (EFSI) on the other hand mobilizes private financing for energy efficiency and small scale renewables at a greater scale. As of January 31st, approved EFSI projects are expected to raise € 38.8 bn for energy out of a total investment of €168.8 bn. The better combination of structural funds with EFSI will be a key driver in the success of our clean energy and climate action policies going forward. The smart financing for smart buildings initiative will support the development of investment platforms and facilitate the deployment of new financing products and reinforced technical assistance.

At the same time, the EU is scaling up climate finance to help the most vulnerable countries mitigate and adapt to climate change. In addition, the EU's Global Climate Change Alliance initiative provides technical and financial support to developing countries to integrate climate change into their policies and budgets, and contributes its fair share to making available $100 bn per year by 2020 to these countries. ●

Isabelle Mateos y Lago

Chief Multi-Asset Strategist, BlackRock Investment Institute

The role of private capital in meeting the challenge of climate change

"Climate change is a complex problem that requires a holistic policymaking approach."

- ISABELLE MATEOS Y LAGO

From an investment standpoint, private capital can and should play an important part in helping meet the funding needs associated with the COP 21 goals. But addressing climate change is a complex problem that requires a holistic policymaking approach. >>>

>>> Mobilising new capital investment is rightly a focus of many policymakers; e.g. incentivising investment in renewable energy infrastructure or promoting green bonds. But capital is only one side of the equation, and indeed investor appetite for quality investment projects tends to outpace the supply of investable opportunities.

Beyond new investments or asset classes, perhaps a greater focus should be on creating an environment where investors are encouraged to take into account sustainability when making investments across their entire investment portfolios.

For example, the French Energy Transitions Law requires investors to disclose how they take into account ESG considerations and to disclose the carbon impact of their investment portfolios. This means these asset owners must at least consider and disclose how they will incorporate non-financial concerns into their investment behaviour, an important step.

There is growing data to support the idea that companies that score highly on ESG metrics provide more value in the long term than those that do not. The market is already beginning to reward ESG behaviours – but to really catalyse a wider focus on ESG, disclosure must improve.

In order to enable asset owners (and asset managers acting on their behalf) to make investment decisions that can accurately incorporate ESG concerns, there must be a framework for consistent and comprehensive disclosure standards by issuers.

Underpinning all these approaches is the fact that capital cannot, on its own, lead the way; to commit capital, asset owners need a clear policy framework, and an even clearer set of investable opportunities that can provide financial returns.

This means that to meet the COP 21 goals, policymakers and corporate leaders must play a central role in making resource allocation decisions towards sustainable projects that create opportunities for private capital. ●

Michael Leinwand

Chief Investment Officer,
Zurich Group Germany

Green 'ROI': Risk, Opportunity and Impact (and the barriers we face)

Green finance is often equated with investments in renewable energy. But that is just one part of the story. To transition towards a more sustainable economy, a holistic approach is needed. At Zurich, we have three distinct, but complementary, perspectives on climate change, but are faced with barriers in each:

1. Risk – Better Disclosure

Almost every investment is likely to be affected by climate change one way or another: through regulation, technological change, changing consumer behavior or, ultimately, physical risk. To pick winners from losers we rely on a process to integrate climate risk, alongside other environmental, social and governance considerations, into the way individual investments are selected. But that process is predicated on disclosure of relevant data which, today, is mostly insufficient. The EU Non-Financial Reporting Directive and the FSB (draft) recommendations on disclosure of climate-related risks are steps in the right direction, but it remains to be seen if they will result in widespread and meaningful adoption beyond boiler-plate language.

2. Opportunity – Constrained Supply

Financing the transition to a green economy also presents opportunities to investors. As an insurance investor, we are particularly attracted to assets that generate stable cash flows over long-periods of time and reward our ability to invest a portion of our money in less liquid investments. Loans to infrastructure projects are a good example, and in fact our biggest such loan is to an offshore windfarm. But we have also invested in private equity funds that seek to exploit opportunities around environmental technologies. In our experience, there is no lack of demand for such investments. In fact, we have to pass on some of them because pricing is bid up too high. The real barrier here is insufficient supply of attractive projects, and that cannot be overcome by capital markets regulation or Solvency II.

"Green finance is often equated with investments in renewable energy. But that is just one part of the story. "

- MICHAEL LEINWAND

Those tools should not be used for climate policy. What's required is incentives to bring projects online: stable energy market policy; tax incentives for firms; public spending; etc.

3. Impact – Measure What's Green

Whatever the investment, for a given return investors should always favor the more sustainable – the greener – option. That's what we aim to do, for instance by having invested USD 1.5 billion in green bonds. Generally accepted frameworks to define green projects and measure their positive impacts would be a great help for issuers of green securities and investors alike. ●

Mark Lewis

Managing Director,
Equities Research, Barclays

Driving decarbonization and sustainable growth in the EU: the role of the finance sector

The EU has an ambitious long-term decarbonisation and sustainable-growth plan out to 2050, with intermediate targets for 2030 in three key areas: reducing GHG emissions; renewable energy; and energy efficiency.

Achieving these targets will require strong support of the EU financial system, as significant amounts of capital will need to flow into low-carbon infrastructure and energy-saving measures between now and 2030 if these targets are to be achieved. Two critical areas of investment are technological innovation and large scale infrastructure development, both of which are currently challenging for banks.

We support the formation of the high-level group on sustainable finance, whose objective is to provide recommendations by the end of 2017 for an overarching EU strategy on sustainable finance. The Commission will take the expert group's recommendations as a basis for determining how sustainability issues can best be integrated into the EU's policy framework and the rule-book for the financial sector.

More tangibly, the Commission has proposed rules as part of its CRR/CRDIV amendment package to make it easier for banks to lend to infrastructure projects and thereby to support investments. The proposal is to lay down a more risk-sensitive regulatory environment able to promote infrastructure projects and reduce risks for investors. In particular, capital charges for exposures to infrastructure projects will be reduced, provided those projects comply with a set of criteria capable to lower their risk profile and enhance the predictability of their cash flows. These criteria will need to be carefully calibrated so as to balance the policy goal of increasing investment into sustainable infrastructure projects with the need to ensure a robust capital framework which promotes financial stability. The proposal appears to be a positive step for climate related and sustainable growth policies, though the devil will no doubt be in the detail. ●

Blockchain and Fintech in capital markets

Contributors

Marc Bayle

Director General, Market Infrastructure and Payments,
European Central Bank (ECB)

Central banks and distributed ledger technology

The internet has led to networks all across the world becoming connected, resulting in an unprecedented level of global and instant communication. It has worked its way into our daily lives, fundamentally changing how we communicate, shop and store information.

But this period of change is only just beginning and new technologies continue to emerge. Could these new technologies help us, not only to communicate but also to move and record financial assets across networks in a more efficient and transparent way? Can they help us find solutions to some of the prevailing problems in the financial sector?

Financial market infrastructure – change ahead?

Exploring technological innovation is high on the ECB's strategic agenda. We are always on the lookout for ways to improve the efficiency of our market infrastructure and lower its costs. We also consider how best to respond to and take advantage of technological innovation and meet new user needs, while staying ahead of evolving risks.

In this vein, the Eurosystem has launched strategic reflections on the future of the Eurosystem market infrastructure. Investigative work has started in three key areas: (i) consolidating TARGET2 and T2S; (ii) settlement services to support instant payments; and (iii) a Eurosystem collateral management system. Work in these three areas is closely interconnected. It revolves around making liquidity management more efficient in the fields of payment transfers, securities settlement and Eurosystem collateral management.

Potential use of DLT in market infrastructure

With a fully digital market infrastructure the speed of technological innovation cannot be overlooked. The potential of distributed ledger technology (DLT) is therefore also an essential part of our reflections.

A range of DLT models are currently under development. Although they differ in many ways, they all have question marks over their implementation. There are substantial functional, operational, governance and legal aspects that need to be weighed very carefully before thinking about possible mass adoption in the field of market infrastructure services.

However, we continue to assess whether advances in DLT-based solutions could lead to service levels on a par with, or maybe even higher than, TARGET2 and T2S. We are currently focusing on concrete questions regarding the practical uses of DLT, such as the possibility of offering liquidity-saving features for payment settlement through smart contracts.

A standardised approach

With various DLT solutions emerging, there is a risk that this could lead to fragmentation, with new silos being established. Therefore, it must be ensured that any services developed are interoperable, not only by ensuring standardisation at the technical level but also by harmonising the business and legal domains.

At the ECB, we have established a DLT task force as part of the post-trade harmonisation agenda within the T2S governance framework. Its objective is to assess the potential impact of DLT on harmonisation, from both the T2S perspective and the wider >>>

>>> European perspective. Proactive collaboration with the market must take place to facilitate functional harmonisation, which will allow innovation to bring benefits without harming market integration.

Conclusion

New technologies could have a profound impact on financial markets. The time is right to understand and experiment with these technologies to explore their potential. We conduct such work against the backdrop of our main objective – that tomorrow's market infrastructure is efficient and innovative while remaining safe and resilient. ●

Larry Thompson

Vice Chairman, The Depository Trust & Clearing Corporation (DTCC)

Towards a modernization of market infrastructure: Making the best use of Fintech

It is no longer a question of if distributed ledger technologies ("DLT") will bring improvements in the post-trade area, but rather when and to what extent these changes may occur. Fintech developments including DLT, cloud computing, robotics and artificial intelligence are well positioned to modernize the current post-trade process and streamline the siloed design of the financial industry infrastructure. However, the timing and final application of these technologies are yet to be determined.

DLT has garnered significant attention due to its potential to further mitigate risk and reduce costs in the processes of clearing, settlement and payments in financial transactions as well as its potential application in derivative data processing. However, the financial services industry needs to evaluate where this technology may provide the greatest benefits and overcome potential limitations. Use of DLT does not necessarily guarantee efficiencies and costs savings for all post-trade processing. For example, The Depository Trust & Clearing Corporation ("DTCC") does not see near-term benefits of employing DLT for clearing and settlement of U.S. markets for equities and most fixed-income. However, by integrating DLT in certain areas of the post-trade environment where automation is limited or non-existent the technology could provide benefits over existing processes, especially when coupled with industry-wide coordination.

As a provider of risk management and data/transparency services to the industry globally, DTCC continues to closely examine emerging innovation. To this end, we recently announced plans to replatform DTCC's Trade Information Warehouse – a repository for credit default swap ("CDS") contracts – from its current mainframe application to a DLT network. This follows an earlier proof of concept which demonstrated that complex post-trade events inherent to CDS can be managed efficiently with DLT in a permissioned, peer-to-peer network. DTCC is also working with Digital Asset Holdings, a blockchain developer for financial services, to develop a DLT-based system for clearing and settlement of U.S. government securities repurchase agreements.

Wide scale adoption of DLT is possible, provided that challenges are addressed at the onset. It is important to note that the benefits of employing fintech in the current post-trade process should not frustrate key policy goals established globally. The mitigation of systemic risk, preservation of market integrity and enhanced transparency are long-standing policy goals that must remain at the forefront of any financial innovation experiment and implementation. >>>

>>> Industry and regulatory collaboration are necessary to ensure required standards and governance models are developed effectively. Industry participants and policymakers alike need to continue advance preparations for emerging innovation in securities markets and post-trade infrastructures. ●

Tom Casteleyn

Head of Product Management for Custody, Cash and Foreign Exchange, BNY Mellon

Blockchain challenges – Identifying the potential – the USC Project

Blockchain technology has the potential to transform our businesses.

BNY Mellon is currently working on numerous use cases, several of which have been presented to regulators, including the Fintech Task Force of the European Commission.

From a BNY Mellon perspective, we see in particular great opportunity in the Utility Settlement Coin (USC) project. USC is an asset which can be held by coded applications, enabling autonomous Payment versus Payment (PvP) and Delivery versus Payment (DvP) processing, as well as self-servicing instruments, and new business opportunities such as machine to machine payments based on the 'Internet of Things'

USC is a consortium effort comprising 5 current partners (BNY Mellon, Deutsche Bank, ICAP, Santander and UBS), with the aim of expanding the bank membership further in future phases. This is in line with the vision of USC being built as a market utility.

The core deliverable of USC project is to develop an asset backed, multi-currency, digital cash asset on distributed ledger technology.

BNY Mellon views this project as integral to our blockchain strategy given that digital cash is a core component of any future financial market fabric based on blockchain. USC will be designed to support the cash leg of any blockchain transaction, providing for exchange of USC digital cash versus digital assets.

The ultimate promise of blockchain technology within financial markets is to bring new efficiencies to payment, clearing and settlement processes. At this stage, central banks have clearly stated that the issuance of central bank digital currency is some way off. Equally, e-money presents problems in the context of financial markets, as it has very specific regulatory requirements, including regulatory capital treatment, and counterparty risk which makes it unfavourable for large scale use at the institutional level.

USC seeks to bridge this gap and provide an alternative which will provide significant benefits in clearing and settlement between institutions including reduced counterparty risk.

USC seeks to bring fiat currency to the blockchain, and as a result will be asset backed by paired real world currency at a central bank. Of course, such an undertaking will require the explicit authorisation of the regulators for each jurisdiction in which USC is deployed, and the consortium aims for continued active dialogue with the regulators and central banks to ensure the USC is built on robust and compliant foundations.

The efforts of the consortium partners have focused on building the financial model specifications and legal structuring of the USC concept, along with developing market integration proposals. Clearmatics, as technology partner have been building out the platform to test and prove some of the theories behind USC before production deployment. ●

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

ESMA sees potential benefits and challenges in DLT; regulatory action is premature

The Distributed Ledger Technology (DLT) is often cited as one of the potentially most disruptive innovations of the last decades, which could save billions of costs for payment, clearing, settlement and other related financial services, while at the same time making the financial system more secure.

ESMA has a more nuanced view of this new technology. Indeed, we believe that DLT could bring about a number of benefits to financial markets, including more efficient post-trade services, enhanced reporting capabilities for risk management or supervisory purposes and reduced costs. However, important challenges concerning for instance interoperability, governance and privacy, will need to be addressed before these benefits materialise. Although there have been a number of compelling 'proof of concepts' and some targeted applications, the technology is still in its infancy. >>>

>>> Also and unless proper safeguards are put in place, DLT may create or exacerbate some risks, e.g., by facilitating access to potentially sensitive information recorded by other market participants, although the exact nature and level of those risks is difficult to assess at this stage.

"Regulatory action would be premature at this stage, given that the technology is still at an early stage."

- VERENA ROSS

On 7 February 2017, ESMA published a report, which outlines our stance towards the technology. The report builds on the feedback to our June 2016 Discussion Paper. It highlights that any regulatory action would be premature at this stage, given that the technology is still at an early stage and practical applications are limited both in number and scope. We do not believe that the existing EU regulatory framework represents an obstacle to the emergence of DLT. Yet, a number of concepts or principles, such as the legal certainty attached to DLT records or settlement finality, may require clarification in due course. In addition, ESMA realises that beyond pure financial regulation, broader legal issues, such as corporate law, contract law, insolvency law or competition law, may ultimately affect the deployment of DLT.

ESMA will continue to actively engage with FinTech firms and incumbent financial intermediaries to monitor market developments around DLT. We recognise that technological developments are ongoing and that our analysis will need to be kept up to date. ●

Pēteris Zilgalvis

Head of Unit, Startups and Innovation, Co-Chair, Task Force on Financial Technology, Directorate General Communications Networks, Content and Technology, European Commission

The European Commission is assessing opportunities and challenges of Blockchain in the securities markets

Blockchain technologies promise to "bring financial markets into the 21st century". Securities markets may see profound impact resulting from the implementation of Blockchain and Distributed Ledger Technologies (DLT). A balanced approach is needed to consider the opportunities and challenges associated with the take-up of Blockchain/DLT.

Blockchain technologies have the potential to attract new capital, ease investments and expand the market for equities. They provide transparency for investors and broaden SME fund raising possibilities. Funderbeam is an European-based example: the platform uses blockchain to secure tokens issuing and trading, keeping track of investors, and offering for flexibility to invest / divest in companies–disintermediating lots of traditional third-party players. Crunchbase described it as the world's first primary and secondary marketplace for early-stage investments, secured by blockchain.

Trading and post-trading are possible areas where the use of DLT is the furthest advanced. Among the possible uses of the technology is allowing securities trading and settlement to take place at the same time, potentially rendering the Central Securities Depository function redundant and eliminating the need for a Central Counterparty (CCP) to act as a guarantor of trade settlement. For derivatives transactions, further research is ongoing, as derivatives are by nature, open for a period of time between execution and settlement. However it seems that Ethereum and smart contracts could be deployed to address this time lapse issue.

DLT solutions could also be used for the reporting directly to the regulator via direct access to the shared ledger, which could potentially disintermediate Trade Repositories and Approved Reporting Mechanisms, enabling real-time supervision and improving risk-assessment and management.

These opportunities come along with challenges and risks, which have to be carefully assessed and mitigated.

In May 2016, the EU Parliament issued a report on Virtual Currencies and Blockchain[1], asking the EU Commission to set-up a Task Force. Blockchain/DLT have been identified as a prominent part of the FinTech Task Force co-chaired by DG FISMA and DG CONNECT.

Some of the identified challenges concern the "entry" and "exit" points of Blockchain, where the technology comes into contact with existing regulatory and legal frameworks. A regulatory sandbox approach is one way that new approaches utilising blockchain can be tested, with individualised monitoring. The FinTech Task Force identified challenges such as identity verification, AML/KYC and EU Data Protection Regulation (GDPR) compliance, capacity to handle a large number of operations/scalability, legal integration into existing frameworks, legal recognition of immutability and proof of ownership, territoriality and liability issues, as well as interoperability challenges.

"Blockchain technologies have the potential to attract new capital, ease investments and expand the market for equities."

- PĒTERIS ZILGALVIS

The FinTech Task Force has been closely monitoring latest developments in financial services and will open a consultation on FinTech. The EU Commission will also directly engage in Blockchain, aiming to set-up an open and agile European centre of research and expertise on Blockchain challenges and uses.

A joint European Commission - European Parliament Conference on Blockchain will take place on the 11th of May in Brussels. ●

1. http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A8-2016-0168+0+DOC+XML+V0//EN

Bob Ferguson

Head of Department for Project Innovate, Financial Conduct Authority (FCA)

FinTech and innovation: a UK perspective

Innovation and technology have long been powerful drivers of the development of global capital markets. Whether screen-based trading replacing open-outcry floors, algorithmic trading, new platforms, quicker clearing and settlement, reporting and monitoring.... the list is long.

So are the increasing attention to innovation and developments like "blockchain" really anything new, or just the latest stage in the history of capital market transformation?

From our point of view – a bit of both.

The FCA has sought to create a new regulatory capacity to deal with what we see as a new and exciting stage in innovative developments in the financial services sector.

Two and a half years ago we launched Project Innovate, with the aim of providing innovators (whether large or small, new fintech start-ups or incumbent firms) with support to navigate the regulatory system; reducing barriers to innovation whilst maintaining standards of regulation and consumer protection. We have assisted over 350 firms.

Our cutting-edge 'Regulatory Sandbox' has also underlined for us the pace of innovation. We are proud of this first for regulators worldwide: to create a controlled, limited, space for firms to pilot new ideas at small scale without incurring disproportionate regulatory consequences - but still subject to the necessary consumer protections for their limited testing activity. Since the launch in May 2016, we have accepted 24 applications to develop towards testing; from sectors including retail banking, insurance, advice, issuance and payments. More will shortly follow.

> *"As with all new technology, how it might apply will adapt and change as research and experimentation continue."*
>
> - BOB FERGUSON

Sandbox applications also included blockchain firms. Although we do not view blockchain as a panacea (and it is still relatively new), the development of DLT has the potential to offer genuinely innovative solutions to financial services. As with all new technology, how it might apply will adapt and change as research and experimentation continue. So we will continue to monitor its development, while remaining alert to any future risks it may pose.

In such areas, as in our work with firms developing automated models to deliver lower cost advice, and our 'RegTech' initiative to apply technology creatively to improve our regulatory interactions with firms and markets, the FCA is committed to harnessing the power of innovation in the interests of consumers and to deliver better outcomes for the markets we regulate. ●

Eric J. Pan

Director, Office of International Affairs, U.S. Commodity Futures Trading Commission (CFTC)

Supporting Fintech development

The views expressed in this article are my own personal views and do not necessarily reflect the views of the Commissioners of the CFTC or any of the CFTC staff.

Fintech innovations such as distributed ledger technology (DLT) have the potential to transform global financial markets and, as a result, have garnered significant attention. For financial regulators this topic involves questions about how to encourage innovation, and, within that, how to balance concerns about safeguarding markets and market participants while providing fintech application developers appropriate room to develop.

The CFTC, like other U.S. regulators, is actively monitoring fintech developments and considering how to approach those developments that could impact derivatives markets from a policy and supervisory perspective. Acting CFTC Chairman Chris Giancarlo has described fintech as one of the great "mega-trends" that has the potential to transform global financial markets and has expressed a commitment to pursuing policies that encourage innovation.

In derivatives markets DLT is significant because it can reduce or eliminate the need for human intervention at different stages of financial transactions. Current projects being tested include using DLT to record aspects of credit default swap transactions and to fulfill a variety of post-trade functions such as repo settlement and interest-rate swap reporting. These initiatives involve unprecedented collaboration among financial firms, tech startups and industry experts to develop commercial applications for the financial services industry. Yet DLT is still evolving, and many projects are still in early stages of development.

In the bitcoin and cryptocurrency space we are observing actual >>>

>>> market activity. There has been a proliferation of bitcoin-specific startups, such as trading platforms and exchanges offering bitcoin derivatives in the United States. These new entrants may be unfamiliar with applicable regulations, and the CFTC has, in some cases, brought enforcement actions against them for failure to comply with CFTC rules. One relevant consequence of some of these cases was to classify cryptocurrencies as "commodities" under the CFTC's governing statute – the Commodities Exchange Act – for enforcement purposes and to bring firms offering derivatives based on such products within the CFTC's regulatory authority.

Acting Chairman Giancarlo has expressed the view that regulators should take positive steps to encourage fintech innovation. This plan is part of a broader, forward-looking agenda that he has advocated to modernize the CFTC's regulatory framework and bring it in line with the rapidly evolving, and now largely digital, markets that the CFTC oversees.

Engagement with industry is at the forefront of this approach. The CFTC has an inter-divisional team at the CFTC dedicated to fintech issues and developments. This group meets regularly with industry, including trade organizations, start-ups, clearinghouses, and exchanges, as these firms develop DLT applications.

"Acting Chairman Giancarlo has expressed the view that regulators should take positive steps to encourage fintech innovation."

- ERIC J. PAN

Regulatory coordination and collaboration is also key, mirroring the collaboration we are seeing in the private sector to move fintech innovations forward. The CFTC is engaged with domestic regulators in monitoring fintech developments and is involved in relevant work by the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board. Through IOSCO and the Committee on Payments and Market Infrastructures, CFTC staff participate in the Joint Working Group on Digital Innovation in Clearing and Settlement on fintech and clearing and settlement.

These efforts underscore the importance of fintech and DLT to financial regulators from a policy perspective. Given that various applications of these technologies are still being developed and tested, much of the CFTC's current work rests on listening to, and learning from, fintech innovators, as well as fellow regulators, to formulate an appropriate policy framework. At the CFTC, the tone set by Acting Chairman Giancarlo is one of optimism and positive action to embrace fintech, so that the CFTC can help the industry develop and more fully realize the benefits of these new technologies. ●

EUROFI PRESIDENT // David Wright
SECRETARY GENERAL & PUBLISHER // Didier Cahen
ASSOCIATE PUBLISHERS // Jean-Marie Andrès and Marc Truchet

EDITORIAL COORDINATORS // Virginie Denis, Cristian Matei and Jean-Philippe Pisianas
GRAPHIC STUDIO // Initial Production - www.initialproduction.be

NEXT EUROFI EVENT

The Eurofi Financial Forum 2017

13, 14 & 15 September

Forum organised in association
with the Estonian EU Council Presidency

Tallinn - **Estonia**

Digitalisation and the single retail banking market

Contributors

Gertrude Tumpel-Gugerell

Supervisory Board Member, Commerzbank

The future of the financial market in Europe: integrated and digital

For over a decade the European Commission, the Eurosystem and market players have been working towards transforming a very fragmented financial market in Europe into a more integrated one. Important achievements in the field of harmonizing regulation and building up integrated market infrastructures have been reached. Through the successful implementation of the Single Europe Payments Area an EU-wide, integrated market for electronic retail payments in euro was created. Furthermore the Eurosystem operates with TARGET2 and TARGET2Securities pan-European platforms for the settlement of payments and securities in central bank money.

Right now the financial sector faces fundamental change due to the digital revolution. The internet, mobile phones and tablets have fundamentally changed the way we live and the way we use financial services. Several years ago Bill Gates formulated the famous sentence "Banking is necessary, banks are not". While banks still exist recent developments have shown that FinTechs are capable of providing financial services as well. In Europe the Second Directive on Payments Services (PSD2) will accelerate this process. The PSD2 regulates new services and market players and opens bank systems for third party providers. It seems that in the digital age FinTechs meet the needs of the coming generation in a better way than banks: they have the flexibility, the innovation power and the financial backing by investors. Data shows that funding of FinTechs faces rapid growth in Europe. As banks and FinTechs can benefit from each other they should seek for collaboration.

There are many challenges for policy makers and regulators in the field of financial services in the age if digitalization. Ensuring cyber security and data protection are key to guarantee the confidence of consumers in new products. As consumers are always online the acceleration of payments processing is currently investigated by European policy makers. Payments will then be processed in real time, 24 hours a day, 365 days a year. For European authorities it is important to carefully monitor the changing market environment and respond to new and different types of risks. The question is whether we should follow the maxim "same business, same risk, same rules" or a more "laissez faire" approach in order to encourage growth. The creation of a so called FinTech sandbox, which would let companies experiment with new financial services without immediately having to apply for authorisation is one of the idea in this regard.

To conclude, during the past few years important milestones towards greater integration of the market for retail financial services in Europe have been reached, but there are still some challenges ahead. ●

Antoine Saintoyant

Deputy Assistant Secretary, French Treasury

Deepening the EU retail financial services single market thanks to digitalization

Digital innovations have emerged as a potentially transformative force in the financial EU ecosystem. Technological developments have given rise to the emergence of a range of complementary services in recent years, which offer interesting opportunities for the deepening of the EU single market for retail financial services. Entailed decentralization and disintermediation contribute to expanding crossborder access to financial services. That said a number of challenges remain to achieve a truly integrated EU retail financial services market, as consumers habit remain local. Key policy initiatives should be dedicated to strengthening the trust of consumers in a harmonized financial market.

Digitalisatised services offer a low-cost solution for both merchants and consumers, and provide consumers with a possibility to choose cheaper retail financial services. Technically enabled innovations or new digital technologies have the potential to contribute positively to consumer welfare, innovation and economic development.

In the field of payments, new services have helped creating software bridges – sometime cross borders – between the online banking platform of the payer and the website of the merchant. The Payment services Directive 2015/2366 will undoubtedly act as a catalyzer in the field of EU single market payment services. Among the new digital comers are the payment account information providers, which bring significant opportunities across many financial industries, as they provide a renewed access to financial data.

Tomorrow will also see the coming of payment initiation services, which will enhance consumer services, thanks to easier payments. Such cross-border services remain limited today, but the Payment services Directive provides for equivalent operating conditions. Aggregated online information could play a key role in enhancing the consumers' choice, through an easier access to banking services, in several countries, especially if consolidated information is provided beyond payment accounts.

From a regulator point of view, we believe transparent, early-adopted and lasting rules contribute to the development of soon-to-grow Payment Fintechs. That is the reason why we aim at finishing earlier the introduction of this directive into our Law, so as to provide a clear legal environment to incumbents as well as new-comers.

Crowdfunding is another digital service which can play a significant role in serving creditworthy borrowers and businesses in need of capital. In France, we have been willing to provide appropriate conditions for the flourishment of this service, given that it can greatly improve in our view the access to safe, affordable and fair capital to individuals and small businesses. Although crowdfunding remains largely national, we believe crowdfunding could be one of the areas with significant cross border potential.

As stressed by the consultation launched by the Commission in 2016 on retail financial services, the appetite for firms to provide cross border retail financial services >>>

>>> or for consumers to buy cross border financial services is not only linked to regulation. Several other factors should be taken into account, especially the consumers' willingness to have face to face meetings with their financial services provider.
In that context, our key challenge is to nurture the consumers' confidence as regards cross border financial products and services. It implies improving access to information, for example by encouraging the development of financial services comparison websites at European level. It also requires to facilitate switching from one provider to the other as regards retail financial services such as saving accounts, including development of data portability. Finally, the deepening of the EU single market for retail financial services should be linked to financial inclusion and education.

In this regard, the Payment Accounts Directive (2014/97/UE), adopted in 2014, ensures that payment accounts with basic features are available to the widest possible range of consumers in Europe and facilitates the ability of payment service providers to offer their services on a cross-border basis. Such access to a basic bank account was already ensured by the French law, recently completed by the obligation for the banks to propose a specific offer for the most vulnerable and the set-up of a financial inclusion observatory. ●

Pēteris Zilgalvis

Head of Unit, Startups and Innovation, Co-Chair, Task Force on Financial Technology, Directorate General Communications Networks, Content and Technology, European Commission

EU Commission to tackle Fintech in 2017

Technological innovation in finance is revolutionising the way financial services are delivered and used. Innovations brought about by Fintech can bring many benefits to the European economy and its citizens, such as easier and increased access to improved banking services or opportunities to create new businesses. Technological changes are removing barriers and a vibrant European Fintech ecosystem has emerged.

Disruptive new digital technologies underpin these trends, driven by innovators and startups throughout the world. These new players – many of whom are European – develop and exploit successful solutions for instant and free mobile payments, robo-advisory services, peer-to-peer lending, investment crowdfunding etc. Further revolutions are around the corner with artificial intelligence, big data, machine learning and blockchain.

"The challenge is to innovate within a safe regulatory framework, while ensuring that regulation is technology-neutral and future-proofed."

- PĒTERIS ZILGALVIS

European citizens have much to gain from a true Single Market in financial services. Enabling fully digital processes and customer relationships can reinforce the European financial sector's competitiveness. However, different legislation and supervisory practices can limit innovation and hinder cross border transactions. Both traditional institutions and new firms are wondering: How can new services and business models fit into existing regulations? Indeed, some >>>

>>> barriers do need to be removed to overcome market fragmentation.

To support innovation, the European Commission is reviewing its regulatory framework, while keeping in mind the need to preserve payment security, consumer and investor protection, data protection and systemic stability. The challenge is to innovate within a safe regulatory framework, while ensuring that regulation is technology-neutral and future-proofed. In its Communication on Europe's next leaders: the Start-up and Scale-up Initiative, the European Commission stated that it intends to explore an enabling framework for regulatory sandboxes, and this is an area that is currently under discussion with the aim of envisioning ways of adapting to, and adopting, new technologies in our regulatory frameworks in order to support innovation and new business models demonstrating consumer benefits.

The Commission has already tackled a series of regulatory obstacles and financial technology is expected to pull down further barriers, provided adequate safeguards are in place. For example, the EU Regulation on electronic identification (eIDAS) will allow opening a bank account online while meeting the strong requirements for customer identity proofing and verification for Know-Your-Customer or customer due diligence (CDD) purposes thanks to electronic identity schemes. Moreover, qualified eSignatures will enhance the security of electronic transactions across borders and across sectors. The 4th Anti-Money Laundering Directive and proposed amendments accept these electronic identification means to meet CDD requirements. Other initiatives such as its Action Plan for building a deeper Single Market for retail financial services and the multi-disciplinary Task Force on Financial Technology - FinTech will be instrumental for the Commission to continue to support digital innovation in the financial services. ●

John Dye

Executive Vice President, General Counsel and Secretary, Western Union

Making FinTech work for consumers: Europe's innovation challenge

The European Commission is to be commended on setting up a Task Force looking at the regulatory and policy implications of FinTech.

The financial services industry is going through a radical transformation. One of the most important drivers of this change is new technologies. This is leading to changes in consumer expectations.

There are many ways to define FinTech. What these definitions have in common is the recognition that new technologies reduce barriers to entry. Payment services are a good example of this. Technology can also accelerate decision making through the introduction of automation. New technologies also create opportunities for the financial services industry to streamline its internal processes. If supported by the regulators this should help reduce costs for the end consumer.

Payment services have led the way when it comes to FinTech. I would argue that the E-Money and Payment Services Directives are first examples of 'so called' activities-based regulation. These Directives create a tailored regulatory and supervisory regime for innovative non-bank payment providers. The rules reflect the specific risks of the non-bank payment sector while granting these companies a European passport. Since the implementation of the PSD in 2009 we have seen a rise of EU authorised payment institutions. These represent a diverse range of business models, from remittance companies to card issuers, e-wallets to payment initiation services. In total, we count nine different business models. The PSD has not only been highly successful in fostering competition; it has also been technology neutral in its application.

The European Commission's Task Force is very much focussing on the needs of the consumer and the needs of small- and medium-sized companies. These are the drivers of European growth. We welcome this approach.

Looking at our own customers, more and more of our business in now conducted online. The EU's current regulatory and supervisory framework was developed at a time when much of the customer interaction was still face-to-face. We welcome the final RTS on Strong Customer Authentication and Secure Communications under the PSD2 as the text strives to find a balance between online security and customer convenience.

"E-identification will help address one of the biggest challenges in the online environment."

- JOHN DYE

Another policy priority for the European Commission is e-identification. If introduced, e-identification will help address one of the biggest challenges in the online environment, namely how to address the growth in online business with the non face to face interaction between the supplier and the customer that this entails.

By dealing with the challenges of a non face to face environment, the European Commission will be promoting the growth of the online world while also taking the necessary steps to prevent money laundering and terrorist financing. A proposal on E-identification could enable European businesses to thrive to an ever greater extent in this FinTech era. ●

Santiago Fernández de Lis

Head of Financial Systems and Regulation
Banco Bilbao Vizcaya Argentaria (BBVA)

Building an EU single market for financial services through digitisation

New digital technologies are at the heart of an economic and social transformation affecting all the agents of society. Their good use provides economic growth and big benefits in health, transport, energy, education and finance. Moreover, they have the power to reduce inequalities and improve the supply of goods and services to citizens.

Following this spirit, Europe is committed to building a Digital Society, starting by the creation of a borderless Digital Single Market (DSM) to expand the chances of growth for European companies and promote digital transformation of productive sectors.

Banks can play a key role in the development of this DSM, as main sources of finance, providers of payments infrastructure and by investing in technology and partnering with startups to improve customer offering. But we are still far from this vision in which consumers and providers buy and sell financial solutions regardless of their location. Technology is a powerful transformation lever that now allows banks to digitally reach new geographies in a cost-efficient manner. However, regulatory differences between member states still prevent financial institutions from offering services across the EU.

Regulatory harmonisation, especially regarding consumer protection and AML/CFT (digital real-time identity verification) is needed. This harmonised regulatory framework ought to be designed in a holistic way, covering the financial and technological perspectives; and future-proof, to avoid becoming outdated by rapidly evolving technologies and business models.

In this sense, two regulations (PSD2 and GDPR) are requiring remarkable efforts from the industry to deliver harmonised access and utilization of one of our most valuable assets: data. Their combined effects will undoubtedly give shape to a whole new landscape in European digital financial services. Thus, 2017 will be critical for regulators to fine-tune these regulations, and for banks not only to comply with them, but most importantly to prepare their business models to thrive in this new competitive market.

A DSM for financial services also requires a level playing field based on the principle "same activities, same risks, same rules", irrespective of the type of player. A European framework for regulatory sandboxes would contribute significantly to this vision, facilitating the launch of innovative, customer-oriented projects.

"Should make 2017 the year for the Commission to help overcome the hurdles."

- TEPPO PAAVOLA

The European Commission's Action Plan on retail financial services will tackle the existing barriers to cross-border activity. Besides, during 2016, the industry, together with the Commission, has identified key areas of regulation that are hindering the digital transformation of European financial services. As a result, a Financial Technology Task Force (FTTF) has been launched as a joint initiative from different services within the Commission.

The Action Plan, along with the works of the FTTF, should make 2017 the year for the Commission to help overcome the hurdles and start building an innovation-enabling level playing field in a constantly evolving environment. Otherwise, the effective integration of the digital market for financial services will be delayed yet again, with harmful consequences for Europe. ●

Florence Lustman

Chief Financial Officer, La Banque Postale

Can digitalisation accelerate the implementation of a single retail banking market?

While in many sectors, since 1986, a single market with broad competition and common quality standards has emerged (telecom, food, labor market, etc.), little can be seen regarding banking. What would that be? It would mean the possibility for any customer to open an account, use it for transactions, request a loan, be offered savings/investment solutions, anywhere in Europe regardless of banks' registration country.

Recent improvements have happened in Europe, mostly about supervision and capital rules, building up confidence and offering a level playing field. It still isn't enough to create a marketplace where supply can meet demand at the European scale. The 2015 Commission's action plan for a Single Capital Market does not entail any initiative regarding retail banking.

Harmonization is far from achieved in almost every dimension. Home loans market is as diverse as possibly >>>

>>> imaginable (fixed vs variable rates, legally fixed vs actuarial prepayment option premia, national guarantee scheme vs homes as loan collateral), as goes for savings as well (some countries having specific regulated savings schemes).

Achieving free circulation of services is harder than for goods. Most services remain locally operated, due to legislation and need for physical contact. This is where digitalization intervenes: changes in both customer approach to banking, and banks' capacity to establish contact and deliver services, are now happening. This could foster the development of a single retail banking market: all banking services can be affected, online payments, mobile banking, digital security... Anywhere in Europe, new technologies can provide standardized products in a "seamless" manner, as well as tailor made solutions adapted to customers, through analytics (Big Data) and computerized advice. This change of model is embraced by banks, but has to be controlled in order to allow a peaceful transition, for the benefit of customers.

"Authorities have to anticipate consequences, so that disruption doesn't turn into destruction. "

- FLORENCE LUSTMAN

First, convergence of national models, eg regarding mortgages, savings products, or consumer finance, has to be promoted. Then, authorities have to ensure that new actors comply with equivalent rules regarding solvency, customer protection, etc. Nobody wants digital pure players to start offering auto loans as it is done in the US.

Secondly, trust and security have to be a priority for a digital banking market. Fintech have to protect clients' data from leaks, identity theft and cybercrime, as banks do, for the sake of public confidence.

Finally, European authorities should pay attention to potential contradictory objectives of different rules: eg, faster access to e-services vs anti-laundering/fraud rules (requiring customer knowledge), or over-indebtedness management vs credit profiling restrictions: a larger, more fragmented market will make assessing clients' overall situation harder.

Opportunities offered by digitalization are formidable. However, Authorities have to anticipate consequences, so that disruption doesn't turn into destruction. ●

Jean Allix

Special Adviser, The European Consumer Organisation (BEUC)

Consumers, digitalisation and payment services

Payments were the first sector in retail financial services to have been transformed by digitalisation. The use of a simple piece of plastic with a magnetic stripe to withdraw cash at an Automatic Teller Machine (ATM) was the first digital transaction without the intervention of a bank staff member.

A lot of changes have happened since. Now we see waves of innovations based on digital technologies in all fields of payment, except cash (for the time being?). Digitalisation is changing the way consumers are using finance and, in particular, payments. It should create new competition in the sector, improve efficiency and drive innovation to the benefit of the consumer.

Fintech are new technologies applied to financial services. By creating the statute of Payment Institution, the Directive on Payment Services (PSD) has put an end to the idea that the payment business is a bank monopoly. This has been reinforced by PSD2 that open the door to many Application Programme Interfaces (API) Payments are the first sector where the legislation has already been adapted for fintechs.

Nevertheless, many issues will need to be solved in the consumer perspective.

Financial and non-financial companies strive to collect more and more consumer data. Digitalisation and the use of consumer data may contribute to improving the quality of services, but also create undesirable developments and potential consumer detriment. It must be clear that the consumer remain the owner of his data.

Secondly, it is increasingly difficult to stay offline and be anonymous. This raises the issue of cash as, for the time being, no payment instrument is really anonymous.

Thirdly, the development of competition and the implementation of new legislation should favour financial inclusion. Nevertheless innovation is based on instruments such as computers or smartphones that some, in particular the elderly, are not able to manage. These people should not be excluded.

Finally, fraud is probably the main issue when it comes to going digital. In November 2016 we have seen the first e-robbery in the history of payments (Tesco-UK). Fight against fraud will be a major issue for consumers in the digital world. ●

Post comments and questions
malta2017.eurofi.net


malta2017.eurofi.net

Key vulnerabilities in the EU financial system

Content

Issues at stake

Much progress has been made since the financial crisis to mitigate systemic risks in the financial sector. As the G20 commitments to reducing the systemic risks posed by banking and derivative activities are being implemented, increasing attention is being paid to vulnerabilities from non-banking activities both at the EU and global levels. The proposed EU framework for managing the recovery and resolution of a failing CCP will complete efforts undertaken with EMIR to ensure the resilience of these infrastructures. The measures for tackling potential systemic risks associated with asset management and insurance activities are also being examined, as are growing cyber-risks.

The world is however at a crossroads with increasing risks of protectionism and nationalism creating much uncertainty both at the economic and regulatory levels.

Emerging risks

Contributors

José Viñals

Chairman, Standard Chartered Bank

Averting the risk of global fragmentation

Following several decades of globalisation of trade and finance, the world is at a crossroads where there are growing risks of trade protectionism and of undermining global regulatory standards. If these risks were to materialise, there will be material consequences in terms of trade and financial fragmentation that will negatively affect the still weak global economic recovery.

One of the great achievements of the global response to the 2008 financial crisis was avoiding the erection of beggar-thy-neighbour trade barriers that deepened the Great Depression in the 1930s. Nevertheless, evidence compiled by the Global Trade Alert shows that this trend turned around and protectionist measures have been rising slowly since 2012, while global trade has been slowing. Protectionism could further increase as a result of the negative headwinds blowing from the United States, where the introduction of an "import tax" is being contemplated. If followed by widespread retaliations, this would seriously undermine global free trade.

In the field of financial services, protectionism is often a collateral damage caused by different solutions to the same problem and lack of cooperation or mutual recognition. It results in regulatory fragmentation and the erosion of cross-border service provision. I am a strong supporter of efforts to harmonise international standards while recognising the right of countries to pursue exceptions and national rules where appropriate. In this spirit, let me highlight some current issues that risk driving financial fragmentation.

At the global level, as a result of recent political developments in the US, the finalisation of the Basel reforms risks being delayed further and thus extending regulatory uncertainty. I strongly support the Basel Committee and the Governors and Heads of Supervision's efforts to finalise the reforms as soon as possible. However, arbitrary deadlines should not drive the process. Instead, the focus should be on achieving a robust, risk-sensitive regulatory capital framework which ensures credible risk weights whilst enabling banks to support economic growth, trade and investment. Without a good, balanced compromise we risk losing international regulatory consistency in the calculation of prudential capital requirements, which will drive fragmentation of capital flows and liquidity.

The global approach to recovery and resolution planning developed by the Financial Stability Board, which is founded on the need for close cooperation amongst national authorities, is also under threat by recent developments in the US which seek to propose an alternative, more domestically focused approach. Banking is a global business and needs international regulatory and supervisory standards and approaches to be effective in supporting financial stability.

At the EU level, care should be taken to avoid banking rules that hamper the ability of European banks to finance international trade. For instance, BRRD Article 55 requires the inclusion of EU bail-in powers in contingent trade finance liabilities linked to trade finance contracts. This may not be consistent with globally accepted standard documentary rules of trade finance set by international bodies such as the International Chamber of Commerce.

An ongoing issue in the EU where the industry has been calling for a rethink is equivalence assessments. This is the process that allows the European Commission to decide whether third-country rules are equivalent with EU regulation of financial services. It is encouraging to see reports that the European Commission is reviewing the existing framework of equivalence. While the review is welcome, I hope it will >>>

>>> drive a more, not less, open EU market and help build more cooperation between regulators. Recent initiatives like the EU Intermediary Holding Company rule have sent a message of mistrust to Asian regulators and risks similar requirements spreading around the world, with the dangers of additional financial fragmentation. In this regard, I find the EU-Asia-Pacific Forum on Financial Regulation that took place for the first time last year an encouraging initiative that brings regulators together and builds trust.

Nine years after the start of the global financial crisis, the world has still much to do to strengthen the global economic recovery. But the first thing to do is to avoid undermining the global free trade system and financial globalisation. Now more than ever, global norms, standards and multilateralism remain part of the solution. ●

Luiz Awazu Pereira da Silva

Deputy General Manager and **Előd Takáts** - Senior Economist, Monetary and Economic Department, Bank for International Settlements (BIS)[1]

The risk of complacency and self-delusion

There are many recognised short-term risks in today's global economy: new financial crises in highly indebted emerging market economies (EMEs), a bond yield snapback in advanced economies (AEs) or old and new geo-political tensions. There are also long-term important issues such as climate change. But perhaps the most significant risk for financial markets now is complacency and self-delusion, partly related to markets' hope that short-term policies at odds with well-established economic principles are sustainable, partly related to markets' bet that muddling through policies in increasingly fractured societies without undertaking serious structural reforms can still produce interesting short-term returns.

Policy uncertainty and threats to trade, financial integration and international cooperation that benefited both AEs and EME are increasing. We knew this well in EMEs but they appear now in AEs: discontent in large pockets of society can create blocking coalitions and paralyse economic reforms. Surely globalisation and technological change can produce inequality, as structural transformations always have distributional consequences. The key is how the economy can adapt and how to make benefits greater than costs with more inclusive policies and retraining. In any event, we have to defend the net positive effects of global integration and also the actions taken by policymakers, especially central banks, during the global financial crisis.

Naturally, after electoral "surprises" in the United States and in Europe, markets are tempted to see mainly the positive side and forget the downside risks. In the United States, markets are pricing in the positive impact of a fiscal stimulus, deregulation and some tax cuts. Business confidence has strengthened with expected infrastructure spending. Yet there are downside risks. As the US is close to full employment, a fiscal stimulus might increase inflation. Trade sanctions can disrupt global value chains, which could spill back to the US economy. And the deeper problems of the weakening of the middle class and political polarisation pose further risks.

In Europe too, there are positive developments. The ECB successfully eased monetary conditions through various programmes and pronouncements, including the famous "whatever it takes" speech, to contain the pressures of the sovereign debt crisis. The establishment of the Single Supervisory Mechanism and the move towards banking union has made the banking system safer. Yet the downside risks have not disappeared. Profound structural problems, such as low productivity growth and difficulties to reform, remain. Monetary policy can >>>

>>> buy time, but unfortunately, it is not enough to undertake the necessary structural reforms. As political will fell short, monetary policy became "the only game in town". And public discontent that is shifting electorates to various forms of "populism" could pose further risks to social and economic stability. Risks are also present in the European financial system. Low and negative interest rates put banks' and insurance firms' profits under pressure. The task of adjusting business models to this environment has only just started. Non-performing loans remain high in some countries, weighing on banks' balance sheets. Banks' need cost-efficient cleaning of their balance sheets with the removal of legal obstacles and where needed, reduction of excess capacity. And regulatory reforms need to be finalised to ensure that internationally active banks are safe and operating on a level playing field.

Many commentators recognise the difficulties of euro zone politics and point to working towards completing the common currency area with a common budget framework, proper institutions with authority to decide on fair and efficient fiscal transfers, and enforcing banking rules and common supervision mechanisms. All this should strengthen and simplify the euro zone decision-making process for the common good.

Undertaking the above requires hard work. It is tempting to focus on short-term returns and disregard the potential downside risks. Thus, markets' leaning towards complacency and short-termism might be the most significant risk today: self-delusion will not get us very far. Some exuberance today cannot replace the need to fix our economies, increasing productivity and mending the social fabric toward more inclusion and fairness. It is with markets' cooperation and alertness that policy-makers will be more capable to act for the common good. ●

1. The views expressed here are our own and do not necessarily represent those of the Bank for International Settlements

Andrei Magasiner

Corporate Treasurer, Bank of America

Managing the balance sheet through uncertainty

As Bank of America's Corporate Treasurer, managing the balance sheet through uncertainty in its many forms is part of my day job. Within our Enterprise Risk Framework, tools such as scenario analysis and stress testing are important in helping us identify and quantify these uncertainties, and how they relate to balance sheet risk.

The balance sheets of the largest internationally active banks are much more resilient to risk than pre-crisis. According to the Basel Committee, average CET1 capital ratios and leverage ratios of these banks reached new highs in 2016 at 11.9% and 5.6% respectively. Banks' resolvability has also improved. But business models are still adjusting. Profitability has struggled in a prolonged period of low growth and low interest rates, and legacy overhangs in some cases.

The adjustment of business models is complex and take multiple years to execute involving difficult strategic choices. These choices will never be made with certainty but narrowing down the range of potential outcomes supports execution to reach steady-state. So what are some of the uncertainties that industry is facing today?

Regulatory uncertainty

Regulation creates uncertainty in two ways. The first is what the future regulatory regime will look like. The second is how new regulation will be applied across different jurisdictions.

While banks are still adapting to Basel 3, Basel 4 is on its way. Basel 4 is a fundamental reform to how banks compute RWAs. At time of writing, the Basel Committee has >>>

>>> not yet agreed final reforms to credit and operational risk approaches (including the proposal for a capital floor). In Europe, these two risks combined consume over 90% of banks' capital. The Committee has committed to avoid further increases to regulatory capital requirements, but until the final design and calibration is agreed, there remains scope for different outcomes.

The other uncertainty stems from how and when Basel 4 will be adopted in the EU and US. As we saw with Basel 3, both the EU and US made significant adjustments to the internationally agreed rules. In the US, the timeline for Basel 4 implementation and the overall direction of bank regulation remains unclear as is the cost of implementation.

Political uncertainty
It's fair to say that the political environment has become less predictable. Last year, markets had to digest the UK's vote to leave the European Union and the outcome of the US presidential election. This year, markets will focus on elections in the Netherlands, France, Germany and possibly Italy. Greece's debt negotiations continue. Managing financial resources and planning for resolution across borders through this political ambiguity creates significant execution risk.

Economic uncertainty
After a lacklustre outturn in 2016, the IMF now projects economic activity to pick up pace in 2017 and 2018, especially in emerging market and developing economies. However, the IMF believe that there is a wide dispersion of possible outcomes around their projections, given the political uncertainties mentioned above.. This complicates matters for central banks trying to calibrate and time their monetary policy interventions. In turn, this leads to a wider distribution of possible scenarios across key risks (credit, interest rate) that bank treasuries have to manage capital and liquidity against.

To conclude, managing the balance sheet through uncertainty makes my job both interesting and challenging. But, clarity is needed quickly, especially on the regulatory framework as it is key in helping manage whatever political or economic uncertainties come our way. The industry also needs cooperation and trust between authorities in cross-border supervision and resolution planning. In this way, banks can continue to support customers in the economies and markets in which they operate. ●

Francesco Mazzaferro

Head of the ESRB Secretariat,
European Systemic Risk Board (ESRB)

Systemic Risk analysis at the ESRB

The analysis of risks constitutes the backbone of the General Board meetings of the European Systemic Risk Board (ESRB), and is strongly supported by the European Central Bank – as hosting institution – as well as by several national and European institutions as regular contributors.

As part of its mission, the ESRB regularly reviews vulnerabilities which have, by nature, a possibility to cause systemic damage to the economy of the European Union or its Member States. In November 2016, for instance, the ESRB published warnings to the authorities of 8 Member States concerning medium-term vulnerabilities which may be triggered by the residential real estate market. These warnings intend to document the impact of residential real estate on the financial strength of banks and borrowers and the medium-term sustainability of property valuation. >>>

>>> A triad of intertwined vulnerabilities has been at the center of ESRB risk discussions over the last year: the possibility of a reappraisal of risks (which has, in fact, already partially materialised in the course of the last months), the weakness of the business models of banks, insurers and other financial institutions, and, finally, the questions of the sustainability of public and private debt. Some overarching concerns have further aggravated these three vulnerabilities: first, until a few months ago, economic growth was moderate and, although there have been improvements, it remains subject to uncertainty; second, the very low level of interest rate has created concerns for the long-term profitability of the financial sector and other structural weaknesses of the economy; third, the increase in size and complexity of the so-called shadow banking sector hints towards the potential for a new accumulation of risks in the financial sector, which might be further aggravated by the impact of technology.

On the positive side, of course, the financial sector has revealed signs of improved resilience to a number of shocks – whether specifically economic or more of a geopolitical nature – which materialised during the second part of 2016. This may reflect confidence for an improved growth scenario of the EU economy, and may also reflect a positive impact of the several rounds of measures taken by supervisors and macroprudential authorities to strengthen the financial sector.

It is the duty of a macroprudential authority to show the maximum degree of prudence in two respects. First, the financial sector has not reached an equilibrium which precludes the emergence of systemic risks. The banking sector remains weak, and in some cases is confronted with asset quality problems which will require great determination to resolve. Second, the aggravating factors (low growth, low level of interest rate, impact of technology on the financial sector, excessive size of the banking sector) are very structural in nature, have a broader geographical scope than the European Union itself and would call, more in general, for an overall reassessment of the role of the financial industry in our economies.

In conclusion, risk monitoring at the ESRB is increasingly supported by policy action, as proven by the recent warnings and by other initiatives documented in this text. ●

Stacey Schreft

Deputy Director, Office of Financial Research (OFR), U.S. Department of Treasury

The OFR's Assessment of U.S. financial stability

Researching threats to U.S. financial stability is a key part of the Office of Financial Research's mandate. Our assessment of potential threats to financial stability, weighed against our evaluation of the financial system's resilience, leads us to conclude these risks remain in a medium range.

Four themes characterize the risk today. First, disruptions in the global economy may affect U.S. financial stability. The United Kingdom (U.K.) vote to exit the European Union (EU) raised uncertainty about the U.K.'s future relationship with the EU and London's future as a financial capital. Greater uncertainty may prompt businesses to postpone investment, slowing growth and pushing U.K. inflation higher. The U.K. economy has remained resilient so far, but the impact of greater uncertainty can play out over a long period. Thus far, the vote has highlighted weaknesses in EU banks. Shocks could expose those vulnerabilities and spill over to banks and markets elsewhere.

Second, risk-taking amid low long-term interest rates globally remains a concern. Low long-term rates support economic growth. They also promote greater risk-taking by financial market participants. Since the middle of 2016, stronger economic growth globally and higher inflation and expected inflation rates have driven interest rates somewhat higher, though rates remain near historic lows.

Low borrowing costs have promoted the high level and rapid growth of U.S. nonfinancial corporate debt, including loans and securities. Investors are exposed to credit, duration, and liquidity risks in this $8 trillion market. Those risks could expose them to large losses in a severe downturn. Banks are the institutions most exposed, but nonbanks own more than 25 percent of that debt, primarily through bond holdings.

Third, financial institutions continue to face a number of risks. Malicious cyber activity aimed at financial firms has become more common and sophisticated. Financial stability risks related to cybersecurity come from a lack of substitutability for key financial services, a potential loss of confidence by customers, and a loss of data integrity.

The growing role of central counterparties (CCPs) improves transparency, but may also concentrate risks. Stress testing has shown CCPs to be fairly resilient, but more robust testing is needed, including improved systemwide testing.

Life insurers' exposure to duration and volatility risk has risen in the low interest rate environment. A large, common shock to all life insurers or the failure of a large and interconnected insurer could adversely impact U.S. financial stability.

The largest and most interconnected U.S. banks have become more resilient since the global financial crisis. Still, they remain a potential source of risk due to their size, complexity, and interconnectedness.

Fourth, challenges remain in the scope, quality, and accessibility of financial data. Data gaps prevent a full assessment of financial stability risks. The OFR has a core mandate to improve financial data. Examples of the OFR's data initiatives include its pilot data collection on bilateral repurchase agreements and securities lending and its U.S. Money Market Fund Monitor.

Such initiatives are critical not only to improve the official sector's supervision of the financial system, but also to improve market discipline. A healthy, self-regulating financial sector is fundamental to financial system resilience. The road to that end through better data must include gains in data reporting that reduce duplication and increase efficiency.

As we move forward, we also must look back and review the reforms that came out of the financial crisis: what works well and what could be improved. Such a review is going on internationally and is likely to intensify in the U.S. ●

Systemic risks associated with asset management

Contributors

Francesco Mazzaferro

Head of the ESRB Secretariat, European Systemic Risk Board (ESRB)

Investment fund risks – a macroprudential view

The European Systemic Risk Board (ESRB) has published a comprehensive strategy paper on macroprudential policy beyond banking in July 2016. We also published, in parallel, the first issue of an annual EU Shadow Banking Monitor, which is deemed to become a reference publication in terms of dissemination of data and identification of vulnerabilities and risks in the EU shadow banking system. Since then, work has advanced in terms of analysing vulnerabilities and reflecting on potential policy responses.

Certainly, asset management has very specific features and covers a broad universe of different fund-types. Moreover, risks from investment funds have not been at the very centre of the financial crisis since 2007. Nevertheless, an authority like ours, charged with identifying and mitigating systemic risk, should not refrain from asking questions about whether the resilience of the sector is also guaranteed for the future.

For instance, the prolonged phase of low interest rate globally may have led to enhanced risk taking, at least in some segments. The sheer increase of the market size also indicates that – while asset management is now increasingly popular, also because some asset managers have been a driver for financial innovation – possible market reversals might trigger significant risk reassessment within the industry, with a considerable impact on the economy in terms of volume. The investment fund industry may, therefore, be both a shock absorber, as well as a shock propagator.

This leads to a number of issues, which require careful examination. The first one is how to treat funds whose portfolio of assets is, by nature, relatively illiquid. When these funds are closed-end funds or subject to conditions restricting redemptions, they may help to strengthen specialised funding, for instance in the area of corporate bond finance. When, however, the funds offer the possibility to investors to redeem their investments on a daily (or high frequent) basis, this could trigger fire-sale type behaviour when funds are hit by large redemption shocks.

The recent events following the result of the Brexit referendum in the UK show that – to some extent – these risks are manageable, if funds have in place liquidity management tools which have been contractually agreed in fund rules. In this respect, swing pricing, redemption fees and gates, or, ultimately, a suspension of redemptions can help stabilise market conditions. These instruments are not commonly available across European countries and – even where these instruments exist – industry practices can differ widely.

Investment fund leverage also attracts the attention of the ESRB especially through its procyclical nature, including the risk of an abrupt deleveraging, causing spillovers to the wider financial system. While under the UCITS regime there are in-built restrictions on the use of leverage which have proven effective, the world of alternative investment funds is still left with rather general principles on risk management and self-regulation. >>>

>>> There is no doubt that good internal governance mechanisms are highly useful. In addition, the legal instruments on systemic risks foreseen in the AIFMD directive – in particular, the possibility for authorities to limit the use of leverage employed by alternative investment funds – will need to be operationalised, so that it should become more evident to all stakeholders in what conditions authorities would be willing to exercise their powers, when needed.

The data collected on alternative investment funds will enable authorities, ESMA and the ESRB to shed more light on activities which can be considered as risky, both in terms of liquidity and leverage. Data will be available on a quarterly basis for the largest industry participants. This will mark a new start in the monitoring of risks.

Those belonging to the ESRB institutional framework know that these considerations are no longer marginal in our life. In this respect, the ESRB is preparing to contribute to the review of the regulatory framework for the management of Alternative Investment Funds in Europe, proposing solutions which might become operational without the need of a fundamental overhaul of the existing legislation. ●

Benoît de Juvigny

Secretary General, Autorité des Marchés Financiers (AMF)

Stress tests in asset management: what makes sense?

While the Financial Stability Board has emphasized the potential impact of the asset management industry on financial stability and the need for asset managers to be prepared for possible market shocks, the AMF is convinced of the benefits of an efficient use of stress tests. But what types of stress tests and for what purpose? There are radically different understandings of the objectives and effectiveness of stress tests in asset management. Building on an already robust European framework and having conducted extensive engagement with the industry to identify best practices, the Autorité des marchés financiers (AMF) has issued detailed guidance to help managers frame and use stress tests as part of their risk management processes. Beyond that, the debate around system wide or "macro" stress tests continues.

"There are radically different understandings of the objectives and effectiveness of stress tests in asset management."

- BENOÎT DE JUVIGNY

Among the policy recommendations adopted by the Financial Stability Board in January 2017 to address the vulnerabilities of the asset management industry, stress tests have been identified as a critical measure: (i) for managers, to allow them to assess, at the individual fund level, the risks associated with their positions and their possible effects on the overall risk profile of their portfolios; (ii) for authorities, to explore the potential impact of the asset management industry on the financial system. These are two very different exercises.

With regard to fund level stress tests, both the UCITS and AIFM directives require asset management companies to perform periodic stress tests. Additional specific requirements apply for >>>

>>> the management of AIFs, where the scope of assets in which the fund may invest and the strategies implemented are broader. The AMF decided to complement existing requirements derived from EU legislation with additional guidance. We are convinced of the benefits of an efficient use of stress tests by managers for financial stability and investor protection purposes, provided such stress tests are tailored to the relevant features and risks of a portfolio. For example, regarding liquidity risk, both the asset and the liability sides of funds' balance sheets should be tested, using all the information available to managers, including to the extent possible, investor profile or redemption patterns. Also, crucial to this framework are the procedures according to which the results are channeled internally, and trigger adequate measures, for instance through a possible alert mechanism.

The scope of investment funds on which those stress tests are run may also play a role with a view to anticipate appropriately a situation of heightened stress (incl. reputational risk) and its consequences on one fund or interactions between different funds.

As for system wide stress tests, the FSB highlighted that a number of macro-prudential authorities and international institutions are seeking to incorporate investment funds in broader stress tests of the financial system and that these efforts are still at an exploratory stage. Although the AMF supports the ultimate goal, at this stage, we are particularly cautious in light of the difficulties in gathering relevant data and defining appropriate scenarios. That being said some initiatives can already provide useful insights[1]. Challenges in developing the robust methodologies and data collection needed for a meaningful implementation of macro stress tests, and in taking into account the interconnections among the sectors tested, mean that this field still remains largely an area for further research. ●

1. In France, where the Haut Conseil de Stabilité Financière (HCSF) had raised concerns on the commercial real estate, a first experience was launched at the end of 2016 to assess the resilience of the French financial system (banks, insurance companies and investment funds) to a significant fall in commercial real estate prices.

Joanna Cound

EMEA Head of Government Relations and Public Policy, BlackRock

Macroprudential policy in asset management increases - not decreases - systemic risk

Macroprudential policies originally designed for the banking sector are most effective when applied in the context intended. The transfer of these policies to asset management, with its very different industry structures and dynamics, is more likely to contribute to, not mitigate, systemic risk.

The data needed to perform meaningful and truly system-wide stress tests does not exist. While detailed data is available for mutual funds, it is scant for asset owners investing directly in markets and not via mutual funds. Stress testing across mutual funds alone is not a substitute: as mutual funds represent less than 20% of financial assets, the results would not reflect a system-wide stress test. And methodologies that don't differentiate the normal price fluctuations of well-functioning markets from systemic risks are also more likely to mislead than to inform policy decisions.

The use of macroprudential policy tools in asset management presents a number of challenges: (i) they are likely to encourage procyclical behavior by investors; (ii) they can hinder natural price adjustment processes that lead to distortions and asset price bubbles; and (iii) they raise fundamental fairness questions around who should bear the burden of losses during a crisis.

Where macroprudential policies breach risk management protocols, such as 'countercyclical' use of margin/haircuts, or run counter to investors' best interests, such as mandatory liquidity buffers, outcomes are likely to be procyclical rather than countercyclical as intended. Their application in stressed markets is likely to cause investors to retreat, when their participation might otherwise have a stabilizing effect. This could reduce a source of funding to the real economy and negatively impact businesses and households.

Prices convey important information about potential risks and rewards, and allow for better risk management and investment decisions. Macroprudential tools, such as capital flow management measures that prevent prices from accurately reflecting risks will create asset price bubbles and market distortions, rather than mitigate systemic risk. Concerns about the amplification of price changes within the financial system, due to losses that could be experienced by banks, are best addressed by ensuring there is sufficient capital and liquidity in the banking system.

Another tool subject to debate is the use of fund gates for macroprudential purposes. Preventing fund investors from liquidating assets, while permitting investors who own the same assets directly to sell, creates fundamental fairness questions, and imposes losses on certain market participants over others. While this may be seen as a means of avoiding taxpayer bailouts, in reality it is a bailout by another name, as individuals saving for retirement or other purposes will bear a cost.

The most effective way to reduce risk in asset management is to regulate at the product- and activity-level across the ecosystem. These efforts are already underway in multiple jurisdictions (including by the FSB and IOSCO). In many cases, existing regulation already mitigates systemic risk concerns. ●

Marianne Scicluna

Director General, Malta Financial Services Authority (MFSA)

A systemic perspective on the vulnerabilities in Asset Management: 'Diagnosis' risk and regulatory response

The diverse nature of asset management poses various risk identification challenges to regulators. In fact, in a systemic context, we are still debating basic questions, such as whether to regulate the fund manager as opposed to the fund itself. One side of the debate holds that size, herding, concentration, leverage and liquidity risks are vulnerabilities that need addressing at a systemic level, with the other cites the industry's track record and differences from banking.

"The diverse nature of asset management poses various risk identification challenges to regulators."

- MARIANNE SCICLUNA

Open-ended funds, including ETFs, are an increasingly significant source of growth for the asset management sector. The risks from liquidity illusion are undeniably present; although one has to acknowledge the existence of a whole range of tools designed to mitigate such vulnerabilities. As for some ETFs, their use of complex derivatives, synthetic leverage and investment in relatively less liquid underlying assets which are at times quite opaque to investors, are all potential risk areas. So is the disproportionate size of some ETFs compared to the market capitalisation of their underlying indices.

The space conceded by the banking sector in the aftermath of the financial crises has also provided asset management with new opportunities. A few big asset management companies are also venturing into securities lending programmes or offering indemnification to their clients' programmes. Albeit at budding stages, these are channels by which certain managers are crossing from the agent to the principal side of the equation.

Even though history stands on the side of the asset management sector, given the changing dynamics of the financial system, no potential systemic risk should be excluded a priori from a prudential point of view.

At this stage, the key regulatory response in the midst of such uncertainty is perhaps to resist the temptation of generating more rules and regulations and instead maximising the efficacy and consistency of our existing toolkit, supported by a robust but proportionate macro-prudential framework. ●

Dennis Gepp

Senior Vice President, Managing Director and Chief Investment Officer, Cash, Federated Investors (UK) LLP

Money Market (MMF) reform – has Europe got it right?

The completion of the reform of MMFs has proven that European policy makers can, despite long odds and at times polar opposite views, reach a successful compromise that not only enhances the safety and stability of all MMFs in Europe, but does so while preserving the utility of a critically important liquidity management vehicle.

Liquidity management is a serious challenge for European investors. In a period when banks are less and less able to accept short-term cash deposits and investors are less willing to take on credit risk, MMFs play a critical role in providing European investors with a properly diversified cash management vehicle. This fact was not lost on policy makers. This reform not only preserves the two-tiered MMF system which has successfully given European investors an option of investing in both Constant Net Asset Value (CNAV) and Variable (V)NAV MMFs, but goes further to expand the investable universe to include a brand new Low Volatility (LV)NAV MMF option, a product which has been designed by policy makers to be able to provide a constant value in normal market conditions.

"MMFs play a critical role in providing European investors with a properly diversified cash management vehicle."

- DENNIS GEPP

Policy makers were also able to address any perceived systemic risks and craft a reform that avoids the pitfalls of the US MMF reform debacle. Any such risk was mitigated by the requirement for all MMFs (CNAV, VNAV and LVNAVs) to maintain substantial amounts of daily and weekly liquidity; and the prohibition of sponsor support addresses not only the risk of contagion but also eliminates any perceived implicit guarantee in products normally providing stable pricing. Pitfalls have been avoided, as the European MMF reform will, (i) in normal markets, maintain a stable Prime MMF option for all investors, and (ii) key market participants will not find the cost of financing >>>

>>> materially increase due to massive outflows of investors from their preferred product type.

All that remains is the facilitation of a smooth transition from Prime CNAV to Prime LVNAV and the continued provision of excellent portfolio management by the MMF industry. ●

Michael Rüdiger

Chief Executive Officer, DekaBank Deutsche Girozentrale

Systemic risk in asset management industry: European legislator has already done his homework

In view of the significant increase in the importance of the asset management industry, it is key to get a common and better understanding of asset managers' business models and to identify potential structural vulnerabilities from their activities that may pose risks to financial stability.

The most discussed potential risk is liquidity risk, that large fund outflows cannot be met by liquidity holdings or asset sales especially driven by the herding-effect.

However, it is essential to highlight that the European legislator has already adopted new very strict legal requirements in the asset management sector. In particular following the two updates of the UCITS Directive since the global financial crisis and the adoption of the new AIFMD in 2011, strong legal requirements for asset managers with focus on protection of the interests of investors apply in Europe. Strict standards are also set in the field of liquidity management and leverage limits as potential structural vulnerabilities of investment funds.

These requirements are intended to enhance the prudential resilience of asset managers and their funds under management, thereby removing or materially reducing the possibility of any of them posing risks to financial stability, as well as protecting fund investors. Thus, the European legislator has already done his homework. Also the industry employs already a broad set of measures against these risks such as increased liquidity quotas and launching funds especially designed for long term investors (e.g. maturity funds).

Moreover, one of the important issues is the need at least to agree on global non-bank data reporting and exchange standards with the industry to enable better regulation and supervision. A threatening jungle of different data standards and formats presents a huge burden for cross border activities of asset managers. An improved cross border data exchange mechanism should lead to a common and global understanding of systemic risks in order to mitigate them on a global basis. ●

CCP resilience, recovery and resolution

Contributors

Ugo Bassi

Director, Financial Markets Directorate, European Commission

EC proposal on CCP recovery and resolution: the final piece of the jigsaw

As a result of the G20's commitment to clear standardised over-the-counter derivatives through central counterparties ('CCPs'), made in 2009, and the implementation of this commitment - in the EU through the European Market Infrastructure Regulation ('EMIR') - the systemic importance of CCPs has been increasing. While central clearing is good for transparency and reduces the overall risk inherent in the underlying transactions, the stronger reliance on CCPs makes it necessary to have a clear system in place to ensure that CCPs and authorities in Europe have the means to act decisively in a crisis scenario. To this end, on 28 November 2016 the European Commission adopted a legislative proposal for a Regulation on a framework for the recovery and resolution of CCPs. It will constitute the final piece of the jigsaw that the EU has been working on since 2009 and also complements the banking risk reduction proposals that the Commission put forward last November.

The proposal reflects the importance of having a single set of rules to manage CCP recovery and resolution. It clearly assigns the roles and responsibilities of the authorities involved in the crisis management of a CCP. The key elements of the proposal are:

- Prevention and preparation: Supervisory authorities and resolution authorities (in coordination with the resolution college established under the proposed Regulation) are required, respectively, to assess the recovery plans to be written by the CCPs and to draw up resolution plans for each CCP setting out how to deal with any form of financial distress which would exceed a CCP's default management and prudential resources. If resolution authorities, in coordination with the resolution college, identify obstacles to resolvability, they can, on a case-by-case basis, require a CCP to take appropriate measures including changes to its recovery plan, its operational or legal structure or to its pre-funded loss-absorbing resources to ensure that the CCP can be resolved with the available tools in a way that does not threaten financial stability and does not involve costs to taxpayers.

- Early intervention: Supervisory authorities have the powers to intervene at an early stage, i.e. before the problems become critical and the financial situation deteriorates irreparably, when a CCP is in breach of, or is about to breach, its prudential requirements under EMIR. These powers would complement those in EMIR, constituting specific supervisory options in these circumstances. Amongst others, competent authorities could require the CCP to undertake specific actions provided for in its recovery plan or to make changes to its business strategy or legal or operational structure.

- Resolution: The framework provides for a set of credible resolution tools. These tools should ensure that essential clearing functions and services are preserved without the need to bail out an ailing CCP, and that shareholders bear an appropriate part of the losses.

>>>

>>> The European Commission's legislative proposal is intended to transpose into EU law the international standards that were adopted in this area in October 2014 by the Committee on Payment and Market Infrastructures and the International Organisation of Securities Commissions ('CPMI-IOSCO') on recovery and by the Financial Stability Board ('FSB') on resolution. Further work is underway by these bodies to refine parts of these standards. On 1 February 2017 the FSB published a consultative document with draft guidance that covers a number of aspects of CCP resolution planning which authorities should consider when developing frameworks for resolving failing CCPs.

The guidance will be finalised in June 2017 in advance of the G20 Leaders' Summit. The European Commission's legislative proposal is fully in line with the current international guidance. Should the European co-legislators, the Council and the European Parliament, consider that the final international guidance points to a need to adjust any of the provisions proposed by the Commission, this could be taken up in the legislative process. ●

Sandra O'Connor

Chief Regulatory Affairs Officer, JP Morgan Chase & Co

Recovery & Resolution: Responsibility and accountability within CCPs is critical

Over the past two years, progress has been made towards enhancing CCP risk management standards to improve governance, ensure they have sufficient financial safeguards, and reduce the risk they pose to financial stability, but more needs to be done. CCPs play a crucial role in increasing transparency and reducing systemic risk by facilitating the netting and collateralization of exposures. The volume of transactions going through these institutions has increased significantly and will continue to do so with mandatory clearing rules in place. It is imperative that CCPs are high resilient and should a failure occur it is managed to limit market contagion, avoid pro-cyclicality, and ensure the continuity of critical financial market functions.

We welcome the European Commission's recently proposed CCP Recovery & Resolution Regulation which is a significant step in establishing an effective framework. Nevertheless, there are areas where further improvements are warranted to ensure that rules do not risk exacerbating market distress. Careful consideration needs to be given to 'loss and position allocation tools'. Tools like mandatory resolution authority cash calls, partial tear-up of contracts (PTU), and variation margin gains haircutting (VMGH), which force additional losses on market participants, undermine the risk mitigation function of the CCP in the market and can have an adverse impact. VMGH should only be used as a very last resort in resolution by authorities, while PTU, if used in recovery, should be under strict oversight and direction of the supervisory authorities. There should be a maximum of one cash call on members, that can be used either by the CCP in recovery, or by the authorities in resolution. Further cash calls in a stressed market would be destabilizing as exhaustion of one cash call suggests a market event in which more than 4 members have defaulted, accounting for ~40%[1] of the market in the majority of cases. >>>

>>> CCPs are generally not public utilities, but shareholder-owned corporations. It is crucial to ensure that recovery/ resolution regimes incentivize CCPs to manage risk effectively and not rely on taxpayers, or clearing members (banks) to cover losses incurred in an extraordinary tail event. If VMGH were to be used by resolution authorities, participants should receive compensation for any losses they bear. This compensation could come in the form of 'bail-in-able' instruments which would be converted into equity in a resolution. It is important that, if value is retained following resolution, these claims are paid in full before any distributions to the ownership (shareholders) of the CCP. The same approach should be used for losses incurred by participants in replacing trades torn up as a result of PTU. It is important that shareholders, management and creditors bear the consequences of a failure before their customers in order to reduce moral hazard.

The global nature of CCPs and products cleared makes a globally consistent and workable CCP regulatory framework imperative. Cross-border cooperation is absolutely critical. To this end, we support both CPMI-IOSCO's and FSB's efforts to review existing Resiliency/ Recovery standards and develop Resolution guidance respectively; EU policymakers should aim for consistency moving forward. We look forward to continuing to work with policymakers on these important initiatives for the market. ●

1. Per top 5 member concentrations in public quantitative disclosures published by CME, ICE, JSCC, LCH SA and ASX

Dr. Kay Swinburne

MEP, Co-Rapporteur – Recovery and Resolution of CCPs, Vice-Chairman Economic and Monetary Affairs Committee, & ECR Coordinator Economic and Monetary Affairs Committee, European Parliament

Recovery and Resolution of CCPs

The new draft regulation on CCP recovery and resolution is the last piece of a much broader framework of financial legislation that promotes greater financial stability. However, given the extreme circumstances which would trigger a CCP needing to be recovered, or worse, resolved, the primary requirement of this legislation is to provide for legal certainty whilst measures are taken to allow the systemically important functions to continue.

When the mandate from the G20 regarding central clearing of derivatives was fulfilled by national and supranational regulators globally it was clear that moving derivatives contracts into central clearing would only succeed in promoting financial stability if it was accompanied by sound regulation and supervision of the CCPs themselves.

EMIR put this system of supervision of CCPs in place in the EU, as well as setting out the default waterfall to be used should circumstances require action.

As a commercial entity, a CCP's main reason for being is to manage and mutualize risk. It is not analogous to a bank that takes risk as part of its everyday business and therefore CCP recovery and resolution should not mimic the BRRD framework. While it is important to avoid moral hazard and therefore that a bank be allowed to fail in an orderly fashion, the critical services of a CCP, on the other hand, must be maintained in order that the market can continue to function. The moral hazard issue in a CCP distressed scenario is that in order for the CCP to continue to work it should be in everyone's interest to fully participate in the default management procedures of the CCP as high up the chain as possible.

Should any participant think that they may be in a better situation by allowing the CCP to activate parts of its recovery plan, then incentives are misaligned and the recovery process will fail.

Therefore, every single recovery and resolution tool must be analyzed for what effect it might have on the incentive structure in order to better manage risk on a day-to-day basis.

Incentivizing clearing members to participate in auctions should be at the center of any default scenario - Should a clearing member be truly unable to participate or fulfill their contractual obligations around cash calls it is only then that the resolution authority should consider getting involved.

Clearly, CCPs themselves must also be incentivized to operate prudent and conservative risk management strategies. Knowing that their own capital is on the line and that their shareholders will be penalized if failure results due to either mis-margining of a product, or operational failure.

Legal certainty also applies to end users and so the clients of clearing members should be fully informed in advance, as to how their assets may be used should a clearing member or CCP get into difficulties. Choices that they make between more costly full account segregation and omnibus accounts should be made in the full knowledge of how this may affect future loss allocation.

If we focus on incentive structures then it follows that some resolution tools should only be considered for non-default scenarios, and it is in fact these scenarios that may require the use of a wider array of tools and ultimately more flexibility for the resolution authority.

CCP recovery and resolution legislation needs to ensure that incentives continue to be aligned throughout the process; that the tools used have adequate flexibility, especially for resolution authorities; and that safeguards for investors and clearing members are workable, whilst above all providing legal certainty at a point of huge market instability.

A well-designed recovery and resolution framework should mean it is never required. ●

Danuta Maria Hübner

MEP, Committee on Economic and Monetary Affairs & Chair of the Committee on Constitutional Affairs, European Parliament

Recovery and resolution of CCPs: advancing the financial stability agenda

It is only a few years ago that attention started to extend from the resilience of the banking sector and the ways of dealing with banking crises to the situation of financial market infrastructure.

Central Clearing Counterparties are, more than ever, crucial pieces to ensure financial stability. They have been the place where, through mandatory clearing, risk has migrated and concentrated. Therefore, there was a need to establish a regime that, as in the case of banks, could make sure that their critical functions would be preserved in a crisis. This would go hand in hand with, but beyond, ensuring the resilience of CCPs, a matter which began to be tackled earlier on.

This why international guidance on a regime for CCP recovery and resolution has been developed and is almost completed. It has been followed last autumn with a Commission's proposal to establish such a regime in the Union.

It is one of the main final touches needed to complete our financial stability agenda and make sure that the entities in charge of preserving this stability can do so at all times.

The future rules must take into account the many interactions of which CCPs are part.

There are geographical interactions. With derivative markets being global, with large members of CCPs being global banks and with CCPs being interconnected through their common members, a global approach is particularly necessary and the respect of global guidance is key. The Commission paid particular attention to this issue.

However, the fact that the Financial Stability Board listed a broad set of tools available to resolution authorities could prove over time challenging should jurisdictions make diverging choices and retain different subset of tools within this toolbox.

There are interactions with other sectors and regimes. The differences between banks and CCPs mean that the bank resolution regime cannot be wholly transposed to CCPs, although all the guiding principles and many tools can apply to both cases. One of the biggest challenges has been and will still be to identify where changes are needed.

"The future rules must take into account the many interactions of which CCPs are part."

- DANUTA MARIA HÜBNER

However, access to market infrastructure is key for banks in resolution. This means both resolution regime have to be consistent with each other. Above all, this means that, when implementing the legislation and facing future crises, authorities responsible for, respectively, the resolution of banks and of CCPs, will need to dialogue, cooperate and exchange information.

There are also interactions, within the CCP ecosystem, between clients, members and CCPs themselves. The alignment of incentives between them, and with the incentives of the supervisors and of resolution authorities, will be crucial. The tools used to deal with CCPs failures have to set the right incentives. The necessary flexibility for resolution authorities to act based on the actual scenarios they will encounter needs to be balanced with clear guiding principles and with appropriate flows of information between all authorities and stakeholders affected.

As so often in crisis management, proper governance and information sharing arrangements will be key in this regard. ●

Ulrich Karl

Director CCP, HSBC Bank plc

Are CCPs now safe and is resolution possible should they fail?

Over the past few years, good progress has been made with international CCP regulation. The newest guidance on CCP resilience is the most advanced yet, and has been welcomed by the industry. Keeping a CCP safe and resilient in BAU is vital to making recovery or even resolution as unlikely as possible.

A topic not covered in current rulemaking is clearing mandates. So far only liquid and vanilla instruments have been mandated for central clearing. Regulators need to be careful with future clearing mandates, and even when signing off clearing services for less vanilla products which can cause problems during default management.

Rules around resolution, be it the FSB guidance or the EU proposed regulation show that the discussion is still ongoing and offer a wide range of actions and discretion, for example in >>>

>>> terms of resolution triggers, use of tools or deviation from rulebook.

As clearing members we are glad that there seems to be consensus about the tool to be used: Variation Gains Haircutting for loss allocation and Partial Tear-Up for position allocation. It is also very welcome that the rules make clear that position allocation should not be a loss allocation tool. We are however worried that forced allocation is not excluded. Forced allocation is arbitrary and cannot be risk managed; and will likely violate pari-passu treatment of creditors. It would also not create the right incentives for participants clearing transactions that might be difficult to default manage.

Liquidity can become a large problem especially in stressed markets. We would welcome backstop liquidity provisions for CCPs in recovery and resolution.

An area where more work is required is calibrating which entities in the clearing ecosystem should carry which risks. At present the draft regulation puts too much burden on clearing members, for instance in loss and position allocation. The wider the burden of loss allocation is spread the smaller it will be for everyone. How to balance this loss absorbency between clients, clearing members and the CCPs is ultimately a regulatory call. Given the level of concentration in the clearing market, market mechanisms cannot be relied on to identify the optimal balance of loss absorbency.

"Keeping a CCP safe and resilient in BAU is vital to making recovery or even resolution as unlikely as possible."

- ULRICH KARL

When making such a call, regulators need to consider the incentives to all participants to do the right thing in support of default management, recovery and resolution.

Flexibility versus predictability is another open question in resolution. Clearing participants want predictability: The more participants (including buy-side) know what will happen in default management, recovery and resolution the more they will continue supporting the CCP's default management. If recovery or resolution is unpredictable, they will plan for the worst outcome and come likely to the conclusion that a run to the door is the best strategy for them. This is easier for clients than for clearing members. Again it is important to keep incentives in mind. Predictability is also important for appropriate risk management during a recovery/resolution situation.

We appreciate that there might be exceptional circumstances where flexibility is required. Deviating from a plan known ex-ante should however be the exception, and should put the resolution authority at risk to pay compensation if they deviate from No-Creditor-Worse-Off (NCWO). Designing the right NCWO counterfactual is paramount to make sure not only the system, but also the participants are protected.

In summary we believe that regulatory proposals have made progress in making CCPs safe. Recovery and resolution will require some more debate over the next months. ●

Andrew Gracie

Executive Director, Resolution, Bank of England

The EU CCP recovery and resolution proposal's consistency with international standards

Given CCPs' global membership and systemic importance, for resolution to be effective it is imperative that we have internationally consistent standards that avoid regulatory arbitrage, facilitate planning at international level and ensure cross-border enforceability of resolution actions.

The Commission proposal on CCP recovery and resolution, adopted in late 2016, is generally consistent with the FSB Key Attributes (KAs), which specify a range of tools to resolve a CCP in member default and other failure scenarios, in a way that losses are absorbed by the private sector. Further guidance is currently being developed by CPMI-IOSCO and the FSB, and it is crucial that the current alignment is maintained as that guidance is finalised.

An issue that is core to the impact of resolution is the 'no creditor worse off' (NCWO) safeguard. CCP rulebooks provide for comprehensive allocation of default losses and, broadly speaking, establish how those losses will be allocated in insolvency. Accordingly, deviation in resolution from those rules could put CCP participants in a worse position than they would have been if the resolution authority had not intervened. This difference is subject to the NCWO safeguard.

The NCWO safeguard in the EU proposal is consistent with the KAs and draft FSB guidance, and protects creditors by providing a right to compensation if their losses as a result of resolution actions are greater than they would have been in the counterfactual. It enables participants to predict the maximum losses they will bear in resolution - just as creditors of banks are able to do. That predictability supports financial stability: uncertainty about their eventual losses may lead participants to terminate positions in a way that exacerbates liquidity stresses on the CCP.

The safeguard is also important for cross-border clearing, where resolution

actions apply to foreign participants. The EU proposal strikes an appropriate balance between predictability about how losses will be allocated and flexibility to deviate from that agreed loss allocation where necessary. This balance depends on an effective NCWO safeguard: a weaker NCWO safeguard could undermine the protection for jurisdictions that rely on cross-border clearing. ●

Ivan Odonnat

Deputy DIrector General
for Financial Stability and Operations,
Banque de France

Brexit: a unique opportunity to implement a CCP location policy in the EU

We are faced with an unprecedented situation: Central Counterparties (CCPs) are at the heart of the financial markets and get further prominence as the clearing obligation of Over-The-Counter (OTC) derivatives is coming into force in the European Union (EU). Meanwhile, the vast majority of euro-denominated OTC swaps is cleared in London by UK-based CCPs and the upcoming Brexit implies that the Eurosystem and other Eurozone authorities are at risk of losing the influence - as modest as it is - they currently have on clearing activities which are of systemic importance for the Euro area, because EU regulations and supervisory arrangements will stop applying to the UK.

Recent history actually shows that the stability of the euro area debt markets served by off-shore CCPs receives only very little attention from off-shore supervisory authorities in general and even in crisis times. Against this background, the perspective of Brexit reinforces the need to impose the location of CCPs clearing EU currency denominated instruments in EU countries where such activity is significant.

This is especially a prerequisite for the Eurosystem and other competent authorities to be able to exercise efficiently their oversight of all CCPs clearing euro-denominated instruments. Besides, the equivalence regime for third countries must be substantially revised to account for the significance of offshore clearing activities and to ensure that prudential requirements for third country CCPs providing services in the EU are as stringent as for EU-based CCPs, so as to achieve a level-playing field.

"The location of CCPs clearing EU currency denominated instruments in EU countries."

- IVAN ODONNAT

All in all, as the EU regulatory framework for the recovery and resolution of CCPs is being finalised, EU cannot afford a situation where a substantial part of clearing activities denominated in an EU currency would escape to its direct supervision. ●

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

Stressing the resilience of EU CCPs to systemic risks

ESMA published in 2016 the first ever EU-wide stress test on CCPs and is now working on the second exercise. Supervisory stress tests are an important tool to monitor potential systemic risk; they complement the stress tests individual CCPs already run on a daily basis.

While individual CCPs' stress tests focus on their own environment, such as their participants, cleared products and business activity, the ESMA stress test looks at the entire system of EU CCPs by considering possible spill-over effects resulting from CCPs' interconnectedness. Although CCPs were set up to reduce systemic risk stemming from bilateral relationships, they are still counterparties to all their clearing members. Therefore, any shortcomings leading to a failure to mitigate risks could potentially invoke spill-over effects and exacerbate systemic risk. As it was verified in the first EU-wide stress exercise conducted by ESMA, the CCPs are also highly interconnected through common participants. Therefore, for CCPs the EU-wide picture is necessary to identify emerging systemic risks.

ESMA's first EU-wide stress test showed that European CCPs were overall well equipped to face the counterparty risk associated with the considered stress scenarios.

ESMA is committed to further evolve and improve the methodology of supervisory stress tests. A number of key changes are envisaged for the second exercise. ESMA, being globally the first supervisor to do so, will add liquidity stress to its exercise. Liquidity risk is an important risk that needs to be taken into account to assess CCP resilience. Additional changes in the methodology aim to improve the scenario design and implementation, with input from the ESRB, as well as to strengthen the validation process to increase the data quality assurance.

"For CCPs the EU-wide picture is necessary to identify emerging systemic risks."

- VERENA ROSS

The results of the exercise will provide supervisors, CCPs and other market participants with useful information on the resilience of the EU's CCPs to different market shocks. The exercise will also help identify any potential shortcomings in the CCPs' resilience, and if needed ESMA will issue recommendations for further action. ESMA expects to publish the final report in Q4 2017. ●

Larry Thompson

Vice Chairman, The Depository Trust & Clearing Corporation (DTCC)

Will the EU and international work on CCP recovery and resolution result in an appropriate framework to protect financial stability?

While there is universal agreement that resiliency of CCPs is of paramount importance, a universal approach to recovery and resolution planning is not advisable. A principal objective of R&R planning is to enable the continuity of critical CCP functions. However, CCPs are not uniform and varying resolution approaches and tools are required. A variety of resources with flexibility for when and how to utilize them are necessary for maintaining stability of CCPs and financial markets in general.

Differences among CCPs need to be considered as policymakers continue work on R&R frameworks. DTCC – a user-owned and –governed provider of cash equity and bond clearing – does not clear derivatives transactions while other CCP operators only clear swaps and additional derivative trades. The transactions that DTCC clears are fundamentally based on underlying US instruments, which is different from other transactions that are comparatively borderless. There are also differences between cash securities and derivatives clearing, in terms of the nature and duration of risks assumed by the CCPs that clear these transactions versus swaps or other complex derivatives. These differences are significant considerations as policymakers approach standards or rules.

Legislation should avoid implicitly or explicitly endorsing any single loss allocation rule or adopting a de facto one-size-fits-all approach. Determinations as to whether one or more loss allocation tools are inappropriate should be made by CCPs, in consultation with national supervisors and participants, and consider the unique market and regulatory environment in which a CCP operates.

CCPs must work with their members, regulators and boards of directors to develop default management structures best suited to the services they provide, the products they clear and their positions within the industry. While recommended R&R frameworks should be consistent at an international level in order to promote safety and soundness and avoid regulatory arbitrage, regulators should avoid being overly prescriptive and granular in terms of specific requirements and in prescribing or prohibiting particular tools. ●

Post comments and questions
malta2017.eurofi.net

Index of contributors

About EUROFI

The European Think Tank dedicated to Financial Services

- **A not-for-profit organization currently chaired by David Wright who succeeded Jacques de Larosière as Chairman in April 2016**
- **A platform for exchanges between the financial services industry and the public authorities addressing issues related to the evolution of financial regulation and supervision and the economic and monetary context impacting the EU financial sector**

MAIN ACTIVITIES

The main objectives of Eurofi are to help industry and public decision-makers reach a common understanding of possible evolutions required in the regulation and supervision of financial services and to open the way to legislative or industry-driven solutions that may enhance the safety and effectiveness of the EU financial sector and its contribution to economic growth.

Eurofi acts in a general interest perspective, facilitating exchanges of views between diverse financial industry players and the public authorities. These discussions are prepared by objective fact finding and issue analyses.

Eurofi has two main types of activities conducted by **Didier Cahen**, Secretary General of Eurofi, **Jean-Marie Andrès** and **Marc Truchet**, Senior Fellows:

Events and meetings:

- **Eurofi organizes annually two major international events (the High Level Seminar in March / April and the Financial Forum in September)** gathering industry leaders and EU and international public decision makers for discussions on the major on-going regulatory projects in the financial area and the role of the financial sector in fostering growth as well as the economic and monetary environment.
- These events are regularly organised in association with the EU Presidencies in parallel with informal ECOFIN councils and in some cases with the G20 Presidencies. They are organised with the support of **Virginie Denis** and her team.
- Additional workshops involving the members of Eurofi are set up to exchange views on regulatory issues. Bilateral meetings are also regularly organised with representatives of the public authorities and other stakeholders (e.g. end-users, experts) to fine-tune assessments and proposals.

MAIN TOPICS CURRENTLY ADDRESSED

- **Measures and instruments needed to ensure an appropriate financing of the EU economy:** impacts of Brexit on the financing of the EU, impact of on-going monetary actions, measures to support bank financing (securitisation), diversification of the financing of SMEs and infrastructure projects, proposals for developing a long term investment perspective, climate change agenda
- **Prospects of digitalisation and fintech:** digital transformation in the banking and insurance industries, fintech and blockchain applications in the capital markets and investment, related regulatory challenges
- **Prospects of further EU integration:** implementation of the Banking Union, priorities for implementing a Capital Markets Union, possible evolution towards a fiscal union and further economic integration in the Eurozone, evolution of the EU regulatory and supervisory authorities (ESRB, ESAs).
- **Optimizing the EU financial services internal market:** payments, review of the IORP directive, regulation of CRAs, prospects of further banking integration and of digital banking
- **Evolutions of the prudential and regulatory framework of banks and insurance companies:** fine-tuning and implementation of banking and insurance prudential frameworks, recovery and resolution of banks and non-banks, culture and conduct measures
- **Capital markets and investment product regulations:** Capital Markets Union, regulation of securities, derivatives and commodities markets and infrastructures, recovery and resolution of CCPs, cybersecurity, SFT and collateral requirements, asset management regulations, investor protection regulation (PRIPs, MiFID, IMD…), regulation of shadow banking
- **Financial regulation at the global level:** feasibility of bank crisis management at the global level, coordination of capital markets regulations at the global level, systemicity of non-banks non-insurers

The membership of Eurofi comprises many leading global and European financial institutions from different sectors of the industry (banking, insurance, market infrastructures, asset management, credit rating agencies…).

NEXT EUROFI EVENT

The Eurofi Financial Forum 2017

13, 14 & 15 September

Forum organised in association
with the Estonian EU Council Presidency

Tallinn - **Estonia**

EUROFI MEMBERS

eurofi

www.eurofi.net