Suggesting key priorities for the forthcoming EU Commission

This document was drafted by Eurofi with input from its members. It does not engage in any way the EU Greek Presidency nor the Greek Financial Authorities.

Executive Summary

Since July 2007, the world has faced, and continues to face, the most serious and disruptive financial, economic and social crisis since 1929. The very existence of the Euro was under threat between the spring of 2010 and the summer of 2012, due to the repercussions of a crisis that originated in the United States, but also and above all due to the fiscal imbalances and the insufficient competitiveness of several Member States and the links between banks and their sovereigns[1].

Much has been achieved during the last four years to prevent future crises.

In 2010, there were no arrangements in place to deal with Member States losing market access. This absence created major uncertainty in markets about the way forward.

With the European Supervisory Mechanism (ESM) and the two-pack, a permanent funding instrument and a governance framework have both been created. This has been a major step forward and will ensure that in the future, the euro area is better prepared to respond to such crises.

Europe has also been working on implementing the G20 agenda, the aim of which is to ensure that all financial activities and players are well regulated and effectively supervised in order to prevent the development of systemic risks. During the four past years, the EU Commission has indeed proposed 28 legislative texts (including CRDIV, Mifid 2 / MiFIR, EMIR, AIFMD, Solvency 2…) in that respect.

The new EU supervisory authorities were also set up following the de Larosière report and played a key role in addressing the consequences of the crisis and ensuring a consistent transposition of directives and regulations across the EU. The introduction of simple majority (or, in some cases, qualified) voting rules providing the European Authorities with the means to make decisions, is also a significant step forward.

The Banking Union which is probably the biggest project since the Euro itself and which the EU Institutions are close to finalizing is another major improvement. The Banking Union has the potential to significantly contribute to the re-integration of financial markets in Europe and is fully consistent with the objectives of the Single Market. It will also ensure that investors - and no more taxpayers - will assume the burden of paying for failing - or risking tofail - banks.

[1]The more sovereigns were downgraded by the markets, the more they called on their banks to finance their debt. And that, in turn, reverberated negatively on banks. Banks had to be rescued by their sovereigns, which then damaged further these states' public finances

After years spent developing common rules for the EU financial services sector the monetary union is now badly fragmented following the sovereign debt crisis.

After 10 years of economic deviations, the sovereign debt crisis hit the Eurozone in 2009-2010. It has abolished years of efforts since the introduction of the Euro to further integrate EU financial markets. This crisis has indeed created a deep fragmentation across the Eurozone financial markets. In a monetary union there should indeed be one single set of interest rates in all parts of the Union, but this has no longer been the case since 2010.

In addition to the lasting spreads on sovereign securities between the periphery countries and other Eurozone countries such as Germany and France, banks have focused their sovereign exposure on their own domestic sovereign bonds in which they have heavily invested. Moreover EU banks have diminished their cross-border activities. National authorities have also sought to protect their domestic economies and national taxpayers by ring-fencing banks' capital and liquidity positions to protect them from hindering the activity of cross border banks and the freedom of capital movements.

In parallel the integration of retail markets is at a standstill. Yet building a more unified EU financial market is the only way for Europe to achieve the scale needed for providing appropriate financing conditions and products for its enterprises, citizens and states.

The next five years ahead – towards restoring the Single Market and completing the Union

Euro area citizens are still suffering from the inevitable adjustment process following years of accumulated imbalances. Unemployment remains unacceptably high. The years to come are therefore about creating a more perfect Union that caters to these objectives.

The time has come for Europe to define a fresh conception of its financial services markets. It is absolutely essential to re-launch an integration of the internal market and together to invest in projects for the future. Europe must also equip itself with the means of remaining a key player on the international scene.

The achievement of an integrated European market would indeed stimulate innovation, intensify competition in banking services, widen consumer choice and reduce the costs of intermediation, which are all needed to improve the performance of EU financial services and their contribution to the economy. Such an evolution will offer economic players improved financing and investment conditions, boost capital productivity and ensure a better allocation of assets, thereby fostering a proper match between savings and investment.

This means in particular developing a new financing model for the EU economy and particularly for SMEs, midcaps and long term projects involving a greater role for market-intermediated financing. Priorities include building an EU securitization market to improve SME financing, developing bond and equity financing for midcaps (notably with an EU private placement market and an appropriate ecosystem for EU midcap equity markets) and a bond market to support long term financing.

Moreover achieving an effective single market requires a more consumer-friendly financial system (providing notably appropriate investor protection and a suitable mix of investment products) and a strengthened EU retail payments market. Enhancing the safety and efficiency of EU Financial Market Infrastructures (FMIs) with the implementation of on-going reforms (MiFID II / MiFIR, EMIR, CSDR), the launching of T2S and related harmonization efforts and an appropriate recovery and resolution framework for FMIs are key to EU securities and derivatives markets. Increasing the transparency and safety of securities financing transactions such as securities lending, repos and asset rehypothecation is also an important objective in order to mitigate the risks associated with such transactions which are necessary in particular to facilitate the management of collateral.

Reviewing the IORP directive in order to face up to pension needs are other key priorities to be considered. In addition, acquiring a stronger position on the international regulatory scene is also urgently needed for Europe in order for the specificities of EU financing mechanisms and the impacts on the EU economy to be better taken into account in the definition of global rules. Finally, improving governance within the EU financial sector is also necessary, as regulation is not a substitute for good governance.

Furthermore, Member States need to keep their promises to correct imbalances and to reform the structure of their economies. Debt burdens remain high in many countries and the deleveraging process continues to impede growth. Fiscal policies have to be brought effectively in line with the provisions of the Stability and Growth Pact and of the Fiscal Compact. This concerns all Member States, not just those who looked at some point into the abyss of losing market access. This concerns also the European institutions, which have to ensure that common rules are thoroughly and evenly applied. This is the only way for Europe to reduce gaps in its internal competitiveness.

Delivering on past commitments also means keeping the promise made by Heads of States or Governments in June 2012 to complete the Banking Union. It means a swift transposition of agreed directives into national law and a stringent application of the adopted regulatory framework. It also means that a Single Resolution Mechanism, which is a strong second pillar of the Banking Union, needs to be agreed before the end of this legislature.

Creating a more efficient Union also requires filling the remaining gaps in the architecture of the Economic and Monetary Union, which should remain the long term objective of the EU as outlined in the Four Presidents Report in 2012. This report was prepared by the President of the European Council in close cooperation with the Presidents of the Commission, the Eurogroup and the European Central Bank proposes to move, over the next decade, towards a stronger EMU architecture, based on integrated frameworks for the financial sector, for budgetary matters and for economic policy.

Detailed proposals

1. Implementing the Banking Union (SSM, SRM, BRRD, DGSD) to reverse fragmentation and resume financial integration

European banks have already made strenuous efforts to repair their balance sheets. The comprehensive assessment conducted by the ECB should increase significantly the level of transparency of Eurozone banks, repair their balance sheets and restore confidence by assuring stakeholders that banks are sound and trustworthy.

A successful review and subsequent restructuring of banks identified as too weak would probably start a gradual healing of Europe's banking system. If so, bank funding conditions could return to normal in the course of 2015.

Only a secure and credible EU financial regulatory and supervisory architecture can be expected to reverse the financial fragmentation within Europe and to provide for a resumption of Europe's progress toward creating a genuine single market. Establishing the Single Supervisory Mechanism, strengthening the nascent supervisory authorities (EBA, ESMA, EIOPA) to achieve a common rulebook and promote the Single Market and putting in place a Single Resolution Mechanism, credible and efficient, should indeed break the vicious link between sovereigns and banks.

Shifting some recapitalization needs and the supervisory functions to the center of the Union would be an additional important step forward to establish an effective confidence in the banking sector of the Eurozone. Without such a fiscal backstop banks would, in the event that bail-in and the resolution fund are insufficient, continue to depend on the strength of their respective sovereigns. In order for such a backstop to be credible, decisions about its use should be taken at the European level, and it should be available as soon as the SRM becomes operational. It would help restore an integrated financial market[2] and foster long term growth in Europe.

But, of course, this objective can only be effectively achieved if the States pursue vigorously their own adjustment efforts and the Union makes determined steps towards fiscal and political solidarity. As long as a lingering doubt remains in the minds of many investors on the sustainability of the Union (and it is that doubt that explains the high yields of the periphery), the system will be fragile. The Banking Union is not a panacea and cannot be a substitute for good policies, but it can help to strengthen the process and to move towards a true monetary Union as long as it is convincing and well-conceived.

Improving the EU macro prudential framework is also a necessity. Some might argue that with the upcoming Banking Union, there is no need for an EU-wide macro-prudential organization. The ECB could perform that role for the members of the Banking Union, and other members would do it nationally. That would be a grave mistake. Europe needs, as a Union and a powerful single financial market, a “sailor at the top of the mast “who looks at possible systemic dangers. Europe needs an independent body that looks beyond its borders and is also concerned by possible contagious effects of national policies. Thus subsidiarity would be preserved, and a clear division of responsibilities would be defined with Central Banks and National Regulators (see the keynote speech of Jacques de Larosière, “Financial Supervision in the EU, Brussels, May 2013).

2. Developing a new financing model for the European economy

Further developing market-based financing mechanisms

As expressed by M. Madelain in the Eurofi Athens newsletter, “over the long term, stability and growth may be complementary. Over the shorter term, with recovery in sight, policymakers’ choices on banking, insurance and financial services regulation will affect the real economy”.

Resuming growth in Europe requires providing adequate sources of financing for EU enterprises and households. However, with the implementation of international capital and liquidity requirements the cost of credit will increase and its availability will diminish in particular for longer maturities due to liquidity constraints. In addition, the insufficient profitability of many E.U. banks is reducing their access to market financing sources needed to increase their capital and therefore their lending capacity.

[2] See speech by Vitor Constancio, Vice President of the ECB at the BAFT-IFSA 2013 Forum – 29 January 2013 – Frankfurt: The project “aims at addressing the « financial trilemma » which can be defined as the impossibility of achieving at the same time financial stability, financial integration and maintaining national financial policies in an integrated market”.

In parallel specific actions to improve the profitability and the financial soundness of SMEs seems a prerequisite in many EU countries.

Larger companies and mid-caps, which have access to capital markets have anticipated this evolution by diversifying their financing resources, but this is not the case of SMEs, which are very reliant on bank financing due to the lack of data and the proximity relationship needed to assess their risks. The same is true for households.
Providing rapidly additional or more cost effective sources of financing through market-based mechanisms should be one of the top priorities of the next legislature provided such mechanisms do not create additional systemic risk or investor protection issues.

Building an EU securitization market to improve SME financing in the EU.

Developing an E.U. securitisation market seems necessary in order to refinance SME loans and alleviate SME financing constraints for banks.

Relaunching EU securitisation markets on a sound basis seems feasible but requires overcoming several obstacles in the short term, such as the sharp increases in capital requirements for securitisation exposures mandated in Basel III and Solvency II, the current low margins of bank loans and the absence of standardised and easily accessible information on SME loans.
Given the urgent need to step up lending in the EU, solutions involving the intervention of the ECB and national central banks (in order to impose appropriate quality standards based on the current criteria used for accepting SME loans as eligible collateral in central bank refinancing, support the emergence of securitisation conduits and purchase eligible loans temporarily, if needed, to foster the launching of the market) and the EIB and national public banks (in order to offer some guarantees for the securities issued) are proposed to help revitalise the EU securitisation market in a relatively short timeframe.

Building an EU private placement market and an appropriate ecosystem for EU midcap equity markets

Midcaps (turnover comprised between 50 Mio € and around 1 Bio €) have less difficulty in accessing market intermediated funding than SMEs (turnover < 50 Mio €), but developing EU level markets and instruments for such companies is necessary in order to facilitate their financing. A legal EU definition of such companies, the development of a European private placement regime (possibly expanding existing domestic frameworks), the expansion of EU high yield bond markets and efforts to improve the consistency of EU bond legislations are proposed, as well as actions to encourage equity financing and promote IPOs (e.g. rebuilding an appropriate

ecosystem, better balancing incentives for bond and equity financing[3], adapting rules for SME and midcap issuers).
Developing an overall perspective on the financing needs of SME / midcap issuers and investors is also put forward as a priority by many industry players, in order to achieve a general and consistent approach of the regulation of the different instruments available (i.e. equity, bonds, loans, securitised products…) and ensure their coherence.

<u>Making Europe more competitive globally by investing in long term projects</u>

If Europe wants to remain a leading global player in some sectors, we urgently need to launch three genuine strategies, as explained by Michel Barnier in his speech "Shaping a new competitive Europe" (Bilbao, 3 March 2014). We need a fresh start for a competitive European industrial sector. This requires new common investments to support strategic sectors such as nanotechnologies, micro and nano-electronics, advanced materials and industrial biotechnology. We also need cheaper energy supplies through a common energy policy. Europeans indeed pay three times more for their natural gas than Americans. Energy is therefore a natural candidate for new, common, investments to secure European future competitiveness. Third, we need Europe to be a digital continent as far as the digital economy is a real driver for growth and jobs.

These policies require significant investments and therefore appropriate financings.

<u>Developing an EU capital/bond market to support long term financing</u>

Banks are by far the main source of external financing for infrastructure projects in the EU but long term loans are expected to be more expensive or scarcer with the implementation of Basel III capital requirements and liquidity ratios. This explains why the transition from a bank- dependent financing of infrastructure to a more capital market has also to be achieved rapidly.

Long term investment has been a concept continuously repeated by political leaders and investors but little has been achieved concretely with the exception of the capital increase of the EIB (10bn euros). The long term-guarantees package that should be adopted by the EU Commission in the coming weeks is of paramount importance in that respect in order not to discourage insurance companies from investing in long term investments.

Building an efficient EU financial market for EU infrastructure projects needs additional regulatory or EU public initiatives in two key areas: infrastructure project procurement processes should become market and investors friendly and cost effective. It is also important to reduce the information asymmetry and the cost of due diligence and to inform over time on the economic and attractiveness and risk of EU infrastructure securities and loans.

3. Ensuring the safety and the efficiency of EU Financial Market Infrastructures

Trading venues and post-trading infrastructures are key elements of the functioning of EU securities and derivatives markets.

The implementation of on-going regulations (MiFID II / MiFIR, EMIR, CSDR) aiming to enhance the safety and efficiency of EU Financial Market Infrastructures and the implementation of T2S and related harmonization efforts which should improve the cost effectiveness of cross-border settlement are essential reforms for the EU capital markets.

The outcome of these reforms which will foster greater competition in the market among infrastructures and between infrastructures and custodians will however need to be closely monitored. Some observers are concerned that such changes may trigger more fragmentation among service providers in the short term and potentially blur the delineation between market infrastructures and intermediaries and the scope of application of regulations. Others believe that the CSDR and T2S might not provide sufficient harmonization for cross-border settlement to develop significantly. The need for a common framework for securities (the project of an EU Securities Law Legislation) in order to enhance the consistency of securities laws, beyond the harmonization efforts under way (e.g. in the area of corporate actions) will need to be examined.

Lastly, defining an appropriate recovery and resolution framework for Financial Market Infrastructures is the main forthcoming challenge following the adoption of EMIR and CSDR. CCPs will concentrate a large part of risks related to derivatives transactions with the implementation of the clearing obligations of EMIR by the end of 2014. The failure of a CCP may have extremely high consequences for the market. This is why the Commission should rapidly publish a proposal for the recovery and resolution of CCPs.

4. Increasing the transparency and safety of securities financing transactions (SFT)

SFT such as securities lending, repo and asset rehypothecation transactions are key elements of secured financing operations and collateral management which are becoming fundamental to the functioning of the financial market with the implementation of Basel III and OTC derivatives rules and the increased risk-averseness in the market following the crisis. SFT indeed enable to

[3] Equity is penalized compared to debt by its tax treatment since interest paid for debt is tax deductible

optimize the use and circulation of good quality assets which are due to become scarcer with the higher demand for such assets and the persisting fragmentation of EU FMIs.

SFT however raise systemic risk concerns as they increase the interconnectedness within the financial system as well as safety issues when assets are re-used (if the ownership becomes difficult to track). Proposals were recently made by the EU Commission to help mitigating such risks by improving the monitoring and transparency of SFT. In addition the way to achieve greater consistency of rules governing collateral and SFT transactions in the different EU legislations (e.g. EMIR, UCITS V...) needs to be further assessed.

5. Some priorities for the integration of the EU retail financial market

Retail financial services play a major role in the everyday life of European Union citizens. In spite of some legislative initiatives that have been launched in the past years both in terms of consumer protection (Key Information Document for investment products) and EU integration(SEPA, basic payment account), retail financial markets however remain fragmented, and further efforts are needed before such services can be bought and sold across European Union borders without hindrance.

<u>Ensuring appropriate retail investor protection and providing a suitable mix of products in order to foster investment</u>

As stressed by S. Goulard in the Eurofi newsletter issued for the Athens seminar, "to make the financial system more consumer-friendly would enable it to attract more funds and to soften the near-dogmatic risk aversion which currently hangs in the air. Risk-free products do not cover the funding needs nor the expected return on investments of consumers. Diversification of funding, information, transparency and proportionate risks are a combination which needs to be focused on in order to fuel more funding".

At a time when investors are bearing increasing responsibility for their financial futures, not investing is simply not an option–both for the financial security of investors and the overall health of the global economy. As such, investors need a robust regulatory regime that protects their rights and fosters the efficient functioning of capital markets. Importantly, protecting investors does not mean prohibiting them from taking on investment risk. Rather, it means proper risk management and understandable disclosure.

Effective regulation to foster economic growth and build greater resilience to market volatility must take the needs of end-investors into account. Rather than focusing on whether investment in liquid or illiquid assets is the best way forward to drive economic growth, the focus should be on ensuring that investors can manage both long-term and short-term liabilities. Sustainable growth will come from capital markets which are consistently able to offer a suitable mix of instruments, from corporate bonds to infrastructure, to meet investors' needs.

<u>Strengthening the EU regulatory regime for retail payment services</u>

Payments are the "oil in the wheels of the Internal Market". It is of major importance that those wheels run smoothly and safely. The SEPA Regulation adopted in 2012, aims to create the reality of a European Single Market for retail payments. Credit transfers and direct debits in euro are now made under the same format: SEPA Credit Transfers and SEPA Direct Debits since the implementation of the SEPA regulation in February 2014.

In times of rapid technological advancements and related changing consumer behaviour it is important to adhere to guiding principles when refining the future regulatory regime for retail payments within the EU. Amongst these principles are legal certainty, consistency, proportionality, technological neutrality, the promotion of the Single Market and the fostering of financial inclusion.

As proposed by G. Angelini in the Eurofi Newsletter (March 2014) specific initiatives to strengthen the future EU retail payments market should include:

- Creating a common supervisory framework for non-bank payment providers. The competences of EBA and of the ESA Joint Committee should be enhanced in this respect.
- Giving the European Retail Payments Board (ERPB) political focus. The ERPB should ensure the consistency of policy objectives, promote legal certainty and evaluate whether the EU payment regulatory framework meets its objectives.
- Preparing for the increasing digitalization of commerce and payments. The rising digital economy needs adequate online identification procedures which are readily available to both account-holding as well as transactional Payment Service Providers (PSPs). EU-wide harmonized electronic identification and –authorization tools need to be developed to better support the growing field of digital non-face to face transactions.
- Defining a holistic approach to EU remittance regulation allowing for an increased but fair competition.

6. The IORP Directive review should also be a top priority for the European Commission

European society is ageing. Occupational pension funds are part of the solution for meeting the challenge of an ageing society and they are essential for long-term investment and thus European growth. Pension systems must adapt. The existing European Directive on occupational pension funds dates back to 2003. It aims to create a single market for occupational pension funds and to improve their functioning. However, those objectives have only been very partially achieved. The directive needs to be reviewed. There are three areas where improvements can be envisaged: solvency, governance and transparency.

For insurers, such high policyholder protection standards will result from the forthcoming Solvency II framework that will introduce a common European risk-based regulatory regime for insurance companies as of 2016. Solvency II will cover all activities of insurers, including in the occupational pensions area. Insurance companies are, like pension funds, important providers of occupational pensions. Both insurers and institutions for occupational retirement provision (IORPs) offer long-term guarantees and engage in long-term investments. It is therefore important that both types of providers are subject to appropriate rules, in order to guarantee a high degree of protection to policyholders.

7. Europe must acquire a stronger position on the international regulatory scene

The biggest challenge for the EU is to act in accordance with its global position. To do so the EU needs to realize that its weight (and therefore strength) comes from the fact that it is a common area. The EU needs to speak with a single voice in the global regulatory fora (Financial Stability Board, Basel Committee on Banking Supervision, IOSCO, IASB...). A scattered, rather than consistent and focused, approach is a waste of time, money and influence.

As explained by S. Goulard in the Eurofi Athens newsletter, "this has not yet been achieved, because for some inside the EU they consider that keeping their own few (remaining) powers matters more than increasing joint powers. National competent authorities still need to play a role, given their knowledge of the national markets, but they should be able to delegate the representation of the European interest completely to the appropriate level, in order to better influence the discussions in those global fora. One must not forget that the systems put in place build on the expertise of national systems to increase tenfold at the EU level and recognize that the relevant level for decision making in this sphere is the EU level".

In March 2013, the EU Commissioner for Internal Market and Services, Michel Barnier, mandated Philippe Maystadt to examine ways of reinforcing the EU's contribution to International Financial Reporting Standards and improving the governance of the European bodies involved in developing these standards. In this respect Mr Maystadt's final report published on 12 November 2013 recommends, as a favoured option, reorganising the current EFRAG with a view to increasing its legitimacy and representativeness. The report is part of a broader debate on accounting standards, which also takes into consideration international developments in this field and the evaluation of the Regulation on the application of the IFRS, planned for the end of 2014.

8. Regulation is not a substitute for good governance

An excess of regulations creates a false sense of security and ignores the critical importance of governance, culture and behaviours. Financial regulations generally cover quantitative criteria, but these are no substitute for safe and sound corporate governance and appropriate behaviours.

Yet, qualitative criteria must be taken into account to help restore financial stability. As mentioned by Etienne Boris in the Eurofi Athens newsletter "Experience, Competencies, Courage and Diversity that are crucial for good governance need to be assessed by supervisors".

Regulatory stability is needed while more focus is put on reinforcing the importance of quality-governance, culture and behaviours. Recognizing the crucial importance of such qualitative soft criteria for financial stability and assessing them implies that supervisors must take responsibility for making such judgments. That goes beyond assessing compliance with the rules and is a challenge not to be underestimated. The architects of the EU single supervisory mechanism must fully recognize this, as the closeness required to make sound judgments will be naturally challenged. "In a context of general sense of de-responsabilization characterizing our modern society, this clearly is a gauntlet we collectively need to pick up" Mr Boris writes.