

Amsterdam 2016

EXECUTIVE SUMMARY

Highlights of the seminar

EXECUTIVE SUMMARY

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Resilience
Digitalisation
Growth challenges

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BNY MELLON



1. ECONOMIC AND MONETARY CHALLENGES IN THE EU AND THE EUROZONE

Growth prospects: how to reinforce investment and growth in the EU?

KEY ISSUES | Governor Knot opened the Eurofi seminar with a keynote speech on growth prospects in Europe. Below is a summary of this speech, which is reproduced in full further down in this report.

European Union in a difficult phase

Today, the European Union is going through a difficult phase. Geopolitical tensions at the borders, large migration inflows and threats from terrorism touch upon issues like solidarity and security. And the United Kingdom is even questioning its EU-membership in an upcoming referendum. In the wake of the financial crisis, the contribution that the European Union can make to higher living standards is in doubt. Many EU countries are struggling to find sustainable growth after the crisis. Unemployment is estimated at 9% in the European Union as a whole this year, and even at 10,5% in the euro area. From this perspective the skepticism is understandable. Sustainable economic growth is therefore urgently needed.

The European convergence machine needs fixing

The majority of member states that joined the EU in 2005 and 2007 are doing quite well, even though they started at much lower income levels. Since 1999 their annual per capita GDP grew by 3.4% on average. In stark contrast, the 12 countries that originally joined the monetary union when it was formed in 1999 are now lagging behind. Annual GDP per capita grew by only 0.8% on average in these 12 countries. The hope also that the monetary union would contribute to convergence of living standards did not materialize in this group. Quite the contrary. The countries that entered EMU with a relatively low GDP per capita, such as Greece, Italy, Portugal and Spain, only fell further behind. Their relative GDP per capita decreased from 97% of the EU average in 1999 to 82% in 2015.

It is obvious that the situation needs to improve. European countries need better economic performance, while new member states should ensure that their performance can

continue. In other words: the European convergence machine needs fixing.

Explanations for low growth in Europe

Part of the explanation is related to the imbalances that developed before the crisis, such as housing market bubbles, eroded price competitiveness, current account deficits and high public and private debt.

Second, some reasons for low growth may be related to the design flaws in the monetary union, which were exposed during the European sovereign debt crisis. Examples of this are the negligence of imbalances within EMU. It was erroneously thought, for instance, that current account imbalances would be irrelevant in a monetary union.

Another flaw is the lack of compliance with the stability and growth pact. During the period 1999-2014, Luxembourg was the only country of the current 19 euro area Member States that managed to keep its budget deficit below 3% of GDP. Seven countries have failed to achieve this in over half of these 16 years. And out of all 19 euro area countries, only one, Belgium, managed to lower its public debt between 1999 and 2014.

Third and finally, an important part of the growth problem is structural. Many EU countries simply have very low potential growth rates. The European Commission projects potential growth in the euro area at only 1.1% per year. Partly, this very moderate growth potential is the result of structural headwinds, which many developed countries inside and outside the EU are facing. These include ageing populations and a gradual decrease in the growth of labour productivity. Also, some economists fear that new technological innovations will not yield the same productivity gains as past innovations. Yet another part of the explanation for low growth is more >>>

>>> policy-related, as several countries have failed to adapt their economies to the changes in the economic environment in recent decades. While structural convergence was clearly what was needed, structural differences between euro area countries only widened.

The most effective way to raise economic growth are structural reforms

Central banks can buy time, but cannot solve structural problems. Obviously, additional measures are required. Unfortunately, budgetary leeway is limited in most EU countries. Public debt ratios remain high at 94% of GDP on average, and Europe needs to preserve the credibility of its fiscal rules. So the most effective way by far to increase growth are structural reforms. Reforms would have a number of important benefits. First, they would increase the resilience and adaptability of EU member states, especially after crises. The OECD estimates that moving towards best practices in Europe via reforms could raise GDP in member states by 4-7%. Possible measures include product market reform, as well as liberalization of the service sector and of regulated professions.

Another priority should be to stimulate innovation, R&D and the application of ICT (Information and Communication Technologies).

It would also be very helpful to increase the ease of doing business and to improve the investment climate. It should for instance become easier to start a company in Europe, and easier for small firms to grow further.

Finally, the quality of institutions could be improved, leading for instance to higher efficiency of the judiciary system in protecting property rights. One priority in

this context is harmonization and modernization of insolvency laws. This would allow Europe to free itself from the millstone of non-performing loans, thereby making room for economic growth.

How to implement reforms: Europe or member states?

Having explored what course of action we should take, we can now ask how these reforms should be implemented. First and foremost, reforms are the responsibility of member states, because they reap most of their benefits and bear most of their political costs.

Still, difficult measures are often only taken once their urgency can no longer be ignored. This is why Europe should also stimulate reforms. Mechanisms like Europe 2020 and the Macroeconomic Imbalances Procedure (MIP) aim to achieve this. Unfortunately, the implementation of policy recommendations remains incomplete so far.

Of the 158 recommendations within the framework of the MIP issued by the European Commission to Member States in 2012-2014, substantial or full progress had only been made for 5%, some progress had been made for 54% and no progress had been made for 41%. Obviously, European coordination may need to become more binding in the future.

Strict compliance with the rules is necessary to reduce existing vulnerabilities more quickly, and to better prevent new ones. That would also reduce the probability of future calls on public risk sharing schemes like the European Stability Mechanism. The shared responsibility for risks should go hand in hand with better control of these risks. ●

Monetary policy: How are monetary developments impacting the financial sector and the economy?

KEY ISSUES | *Many leaders of the industry stressed that lasting ultra-low interest rates were causing negative effects on the economy of the euro area. Indeed banks' profits are significantly reduced due to ultra-ease monetary policy and prudential banking regulations and this leads to a reduction of lending. In other words, in such circumstances, the transmission mechanism – through the banking sector – of the ECB's monetary policy is significantly weakened.*

This low interest rates environment fails to reduce household and corporate sight-deposits

In theory, a decrease in interest rates encourages savers to reduce the amount of their remunerated savings, as their opportunity cost decreases, and it

prompts borrowers, on the other hand, to increase their indebtedness, as it reduces their financial burden.

In practice, however, things at the moment are a little more complicated. We are indeed in >>>

>>> an environment of weak economic growth, which makes households feel uncertain about their jobs, and non-financial corporations feel unsure about their ability to sell their products to customers. As a result, the increasing economic uncertainty leads savers to increase their savings, rather than decreasing them, for precautionary purposes, and they invest less in riskier asset classes as they become more risk-averse. It makes borrowers less reactive to a decline in interest rates, as their commercial prospects are decreasing. When the yields fall or, sometimes even disappear, because of monetary policy, the shift of repressed financial savings to consumption doesn't seem to work in Europe. Indeed, one observes that a significant number of savers are trying to offset lower returns by more savings.

As a consequence, this low-interest-rate environment has translated into higher household- and corporate-sight deposits, as well as a decline of the money multiplier; hence, the monetary policy is not that well transmitted to the real economy.

Low interest rates have a negative impact on retail-deposit banks profitability and a positive effect on specialised financing activities

A representative of the banking industry stressed that low interest rates have a negative impact on retail-deposit banks in particular, because their business consists of maturity transformation between costless short term deposits, and long-term loans. Quite understandably, the interest margin depends on the interest-rate levels of those long-term loans. When interest rates go lower and lower for a prolonged period of time, back-book loans are progressively replaced by lower-yielding loans in the banking book.

Conversely, the same low-interest-rate environment is positive for many specialised financing activities such as factoring, leasing, consumer loans and long-term car rentals, as those businesses usually fund themselves at market rates, without any transformation. For them, then, client and funding rates decline in parallel, and margins remain stable, with a benefit from the demand increase brought by lower rates.

Corporate and institutional banking and market activities are more or less rate-neutral because all loans and deposits are indexed to floating rates in that business.

Clearly, the ongoing decline in interest rates and the significant flattening of the yield curve weigh on the profits of retail deposit banks that traditionally benefit from maturity transformational activities. Even more than the back book maturing and being

replaced by lower-yielding loans, the non-maturing back book is also endangered by the renegotiation of rates, because clients are asking for lower rates on their current loans. For commercial reasons, very often in several eurozone countries, banks are obliged to accept, which rapidly reduces the average rate of the loan book.

On the liabilities side, banks can lower interest rates on interest-bearing deposits, but only to a certain extent, because, of course, interest rates generally have a zero floor. As we are already there now, there is not much more to do than what has been done already. The margin pressure from low interest rates, then, forces retail networks to cut costs and to look at how to charge for services. This is a big question and a big problem, especially for pure retail deposit banks, which are clearly the most impacted.

The persisting divergence between the cost of capital and the profitability of EU banks

Another leader of the industry highlighted the persisting divergence between the cost of capital for European banks and their profitability. Indeed, the cost of capital remained at the level of 10% while profitability for the European banking sector as a whole remains quite low, at around 5% approximately. One of the key factors which explains the elevated cost of capital in Europe is that, despite all the efforts undertaken, some buckets of risks that are associated with certain banks and certain countries continue to persist (high level of Non-Performing Loans...). This discrepancy between the cost of capital and profitability in Europe is also triggered by the uncertainty surrounding banking regulations.

The consequences of the decline of the profitability of the banks of the euro area are manifold. The first consequence is that there are much fewer incentives for investors to buy bank shares, which is reflected in the relatively low price-to-book ratios in the banking sector, especially if you take into consideration the regulatory uncertainties such as the gold-plating of the supervisory authorities, which is unpredictable and may create some new surprises, as well as the upcoming Basel IV regulation, which is also frightening for any investor.

The result, then, is that they invest much less in bank shares and require an increase in dividends, since they consider that it is less value-destructive for banks to give back equity rather than trying to invest further in insufficiently profitable banking activities; hence, it is very difficult for banks to further strengthen their equity while the regulator keeps asking for more and is determined to really increase banking capital above current requirements year after year. >>>

>>> There is, then, a Catch 22 situation, which imposes to lend less and to further deleverage, retrench and reduce the size of the bank.

The new regulatory frameworks have also negatively impacted the profitability of EU banks which reduced European banks' lending capacity

Both monetary policy and regulatory policy are weighing on bank profits. Banks are in Europe the indispensable transmission belt of monetary policy: if banks are not profitable, they will not lend more. Clearly, the new Basel 3 regulatory frameworks reduced European banks' lending capacity, and banks were no longer really in a position to fund big corporates according to different leaders of the industry. They were not even able to be market makers in corporate securities; while securitisation has been shown as a solution, you need market makers. Clearly, banks' securities inventories decreased by more than 40% between 2008 and 2015; hence, it was difficult to have a liquid market for those debts.

Market makers would however be substituted by the ECB, which will buy some of those bonds via its quantitative-easing policy, as it does already for sovereign bonds. For large corporates, a solution has been found: they issue bonds in the market, which

are then bought from Institutional Investors by the ECB, so large corporates are going to be funded by the ECB. The latter becomes a lender of first resort, which will allow central banks to avoid being the lender of last resort.

A greater concern comes, however, from SMEs because their financing relies almost exclusively on banks. They do not have easy access to financial markets. These loans are further at stake because of the very significant capital requirement increases that will be induced by the introduction of Basel IV, which is currently under discussion. In that context, in order to preserve the financing of SMEs, we may see, according to a leader of the industry, a new step in quantitative easing in the future, with the ECB purchasing loans to SMEs. That may be the solution for the future.

Nonetheless, if the measures envisaged by the Basel Committee, notably to tighten the risk weighting process, were all decided by the end of 2016, European banks would see their capital requirements jump, on average, from 12% to 15% (or even 16%). The return on equity achieved in 2015 would fall to around 3%. This would not allow a large number of banks to cover their costs and thus to carry out their intermediation role. ●

Integration and disintegration: what trends in the EU and potential impacts for the EU financial sector?

KEY ISSUES | *The objective of this session was to discuss fragmentation trends in the EU, their potential impact of on the EU single financial market, the EU financial industry and the funding of the EU economy and also to define the priority actions that should be implemented to minimize the impact of such fragmentation on the financial system and the EU economies.*

Fragmentation Risks

A 'perfect storm' of challenges now existed, including the situation of Greece, the suspension of Schengen and control-free borders, the high level of unemployment and public indebtedness in some Member States, and the Brexit referendum on 23 June. This posed dangers to Europe's main achievements: the single market, the single currency and the single border. The European Union itself might not be close to disintegration, but a huge amount of fragmentation had already been witnessed. Although the European Commission and the other European institutions were in the process of tackling these problems, the vast number of legacy problems inherited from financial crisis complicated matters.

The EU had been proving itself to possess sufficient capacity, flexibility and political wisdom to deal with the challenges it faced, as could be seen from the example of the UK settlement. However, in coming years, questions of integration would need to be addressed, and this meant not just having multiple speeds, but also multiple directions of travel, with some countries opting for less integration and some opting for more.

Impacts of Fragmentation

Fragmentation was distinct from disintegration: the former might be a temporary consequence of the need to address certain problems where appropriate means to do so did not exist at European level. However, >>>

>>> these kinds of solutions would not provide a stable long-term solution to the problems that Europe faced, and would likely introduce more segmentation if they were to become the default approach. Whether the United Kingdom voted to remain within the European Union or leave it, the likely closeness of the vote should act as a 'wake-up call' to Europe, demonstrating that the union that had existed between the 12 pre 1994 member states could not be replicated with 28.

The United Kingdom not voting to leave the European Union would not necessarily resolve the issue on a permanent basis; another referendum could always be held in some years' time. However, if Britain decided to leave, it was not clear whether or not Europe and Britain would be able to amicably conduct negotiations to reduce the impact of Brexit, and what impact this would have on integration within the rest of the EU. A confrontational outcome and no further integration would drive risk premiums up. To mitigate risks, EU member states would also need to stop using the EU as a 'scapegoat' when things went wrong.

Necessary Priority Actions

Deepening the Monetary Union without undermining the single market

The work carried out by the European Council suggested that deeper monetary union might be necessary, such as via banking union; however, if this were to take place, Europe would need to be careful not to introduce any kind of discrimination against those who were not in the euro and who were not part of banking union. The 19 member states that had joined the euro had done for differing reasons, and this would need to be borne in mind.

Combining fiscal discipline with growth-enhancing measures is also important. According to a Panellist, the EU was in the process of finding a way to combine the need for discipline with growth-enhancing measures. The flexibility debate was complex and difficult, but the European Commission was moving in the right direction.

Europe should be more present in the monitoring and in the accompaniment of national structural measures

Given the persistent low growth environment specific emphasis, priority should be given to the implementation of structural reforms which have been the main way forward to boost potential output and productivity growth and to reduce unemployment. It was specified that the EU needed to address the problem of achieving stronger convergence in its structural reforms or economic policy with a stronger enforcement mechanism that contained an element of incentive, which could combine with this new, synchronised fiscal stimulus.

Completing the Banking Union

The Single Supervisory Mechanism and the Single Resolution Mechanism had been very important, but the third pillar on banking union, the European Deposit Insurance Scheme, was extremely difficult for the partner institution to work with. The envisioned end point was a fully mutualised Eurozone fund, which was a goal that remained controversial. Unless progress was made in improving the adequacy of the prudential standards with which bank exposures to sovereigns were treated, and a common view was reached, a political consensus emerging around mutualising debt was difficult to envision.

A speaker stressed that there were a number of important issues with which Europe would soon need to deal, including risk-weighted asset homogenisation, TLAC and MREL, and how global standards could be contributed to and implemented at European level. While doing all of this work, the need to have a proper balance between stability and sustainability of measures would need to be borne in mind; Europe was presently moving in this direction. TLAC and MREL would be approached in an intelligent way, and the European Union, in general, could learn from its mistakes, as had been seen recently in relation to the minimum distributable amount and the Pillar 2 issues recently in SREP. The speaker remained relatively confident that – despite the size of the challenges that the EU currently faced – the resilience, flexibility and internal intelligence that existed within Europe would prevail, taking into account Europe's particular political rhythm and dynamic.

Developing contractual arrangements

Given the diversity that existed within the European Union, contractual arrangements were very important, but had not been used sufficiently. These had been used within Schengen, but a lot more of those contractual arrangements could be created; these helped differentiate those who wanted to sign up from those who did not. There were many areas of the European Union; those who had a common currency had entirely different integration needs, and members of the Union differed on whether they regarded themselves as members of a free-trade arrangement or members of a capital market. People's views on what kind of arrangement they were in needed to be more clearly spelled out, because both the speed and direction of travel were now visibly different.

Being more ambitious regarding the Capital Makers Union

One Panel member felt that while Europe had been overly ambitious regarding some issues, such as mutualisation of debt, it was not ambitious >>>

>>> enough about capital market union, concerning itself solely with eliminating internal barriers. Global capital markets were much more powerful, and needed to be harnessed; to drive this work forward, a European equivalent of the SEC would need to be made responsible for it. Another Panel member added that new European regulation had to be designed to produce more integration, rather than a loose framework that created more diversity. To promote further European integration, the narrative would need to be changed, and there would need to be clear leadership that emphasised the positive aspects of the European Union and the institution's achievements.

Political Approaches

Jacques Delors had referred to a two speed Europe; however, 'two speeds' implied a joint destination, and this was proving not to be the case. The European Union might want to consider offering two, or possibly three, different models of integration, with the goal of producing a higher degree of diversity and political legitimacy without jeopardising the advantages of the internal market, with monetary

union and a completed banking union at its core. All EU member states would hopefully be able to unite around the goal of retaining the existence of an internal market within a customs union, with free movement of persons, although the exact form that this would take could be debated. For the financial services industry, this meant having a robust framework for the 28 member states that allowed some states to become more deeply integrated than others.

2017 would be a critical year for the European Union. If the UK's referendum were to be won by the 'Remain' campaign, and strong pro-European majorities were elected in EU member states that were holding elections in the near future, the European Union would be well placed to implement bolder and more ambitious measures. A critical decision would eventually need to be taken by EU member states, probably during 2017, as to whether common tools that entailed some element of risk sharing should be introduced within the European Union, and for these to be implemented, the right political conditions would first need to be created. ●

EMU: what priorities and ambitions for deepening the EMU?

KEY ISSUES | *The objective of the session was to define the priority actions for making the euro viable and avoiding a situation where the risk of an exit country becomes real.*

This plenary session was devoted to discussing the conditions required to improve the economic governance of the euro area. Speakers were also invited to discuss how to encourage Member States to meet their fiscal and structural commitments.

The process of convergence needs to be restored

Monetary Union without a sufficient degree of convergence of economic policies is unlikely to be durable and could, in fact, be damaging to the European Community. According to a public decision maker, the question is how to re-launch that economic convergence, with both political steer and concrete support. According to him, the Five Presidents' Report provides good guidance. The first question is not one of revolutionary new steps, but of showing that what we have already agreed is working. 'Deepening by doing' - as the Five Presidents' Report describes the first stage - means fully implementing decisions taken. Advancing further within the existing legislative framework and streamlining its application where necessary.

Only consistent implementation of the decisions already taken can provide us with the necessary credibility to advance toward Stage 2 as proposed in the Five Presidents' Report where more far-reaching measures would be agreed upon to complete the EMU's economic and institutional architecture. This speaker explained that there are a number of issues which can be implemented at this stage and which do not need any institutional changes or treaty changes.

First, we need to set clear common reform priorities. This is why individual euro area member states recommendations includes a clear set of joint priorities on enhancing productivity, adjusting labour markets, addressing fiscal situations and talking about the financial sector and >>>

>>> working out non-performing loans. The Eurogroup is benchmarking the implementation of those priorities across member states and the EU Commission is supporting strongly this approach;

Secondly, we need the engagement of all stakeholders within member states. At the beginning, the European Semester co-ordination mechanism was perceived in Member States as some department in a finance ministry sending some papers to Brussels and nothing more. Of course, this approach does not really work so what we need is that the European Semester and our common decision making priorities to become part of the national political debate. That means strongly engaging with member states and not only with governments but with social partners and other stakeholders.

A member of the Ecofin Council stressed that we can perform much better in the area of country-specific policy recommendations to identify the main economic challenges for each EU Member State. If we are really committed to these recommendations, the EU's budget should support the respective member states to implement these recommendations. National projects which profit from financing by the European funds should be designed to implement the country-specific recommendations. The Commission needs to make this a precondition for the financing of national projects. An approach of this kind, which is based on the synergy effects between the implementation of the country-specific recommendations and the use of EU funds, would have a positive effect on the public image of the EU as an agent for active change - rather than an obstructionist. An integrated policy approach consisting of European money and structural policies would in addition facilitate clear communication of existing and future political priorities.

A “full coordination” institution in the euro area is required

A public decision maker explained why a “full coordination” of fiscal and structural policies was necessary and made the economic case for a stronger governance of the euro area. According to him, clearly monetary policy cannot be a substitute for economic policy coordination or the lack of reforms. And the absence of coordination has a genuine economic cost. Several studies pointed to a significant cost of non-coordination, in the order of 2 to 5% of GDP since the crisis.

To take the debate forward, he proposed to make three principled choices: first: making parallel progress on both domestic reforms and European coordination. This is the cornerstone of any French German agreement: to be fair, the French call for Germany to support coordination, and the German

doubt about French reforms, have been and are still well-founded. This requires overcoming distrust between countries and putting both aspects under the same umbrella, namely a common institution.

Moreover, it must be recognized that institutions with a mandate are superior to rules without institutions. To bolster policy consistency and coordination, the rules of the Growth and Stability Pact should be supported by strong institutions with discretionary powers. This is why there is room for an intermediate level of integration. The speaker called it “full coordination of national policies”, a presently missing link between integration, as we have for monetary policy decision-making, and rule-based surveillance, such as it is currently the case for national fiscal policies in Europe and which is clearly lacking teeth. The highest level of policy integration would logically involve building a genuine fiscal union, as well as completing the Single Market; but that would surely require more ex ante convergence and resolution of legacies from the past. In addition to the completion of banking union, the most urgently needed part of EMU reform is to set up a strong institution to fully coordinate national fiscal and structural policies.

This approach would help to make the Euro area more than the sum of its parts. Jean Monnet famously declared that “nothing is possible without men, but nothing lasts without institutions.” The mandate of this decision-making institution must be to achieve the strongest, sustainable and balanced growth, through a decisive progress in terms of national macroeconomic policy coordination. To that effect this public decision maker shared with the audience some thoughts regarding the tasks a Finance Minister of the Euro area would have.

The tasks for a Euro Area Finance Minister

First, the Minister would be in charge of preparing the euro area-wide collective strategy to fulfil its sustainable growth mandate. It would be essential for the euro area to collectively agree on overall economic policy objectives, and on the division of tasks through the setting of individual performance targets for Member States. Nobody seriously contests that a collective strategy adding more structural reforms in some countries including France, and more fiscal expansion in others including Germany would make for a better policy mix for sustainable growth and employment in Europe.

Second, the Finance Minister would be responsible for supervising the implementation of the collective strategy, using adequate instruments to provide symmetric incentives. Third, the Finance Minister would be responsible for implementing centralized crisis management. A Finance Minister for >>>

>>> the euro area would naturally be in charge of overseeing European Stability Mechanism operations.

Last, while moving towards further integration, the Minister could be given the authority for managing a euro area Convergence Fund, evolving towards a Euro budget. We are touching here on the issue of a common fiscal capacity, promoted recently by Pier Carlo Padoan. As successfully done in the past, it could be built in three stages. In the first stage, Member States would be free to join. In a second stage, this budget could become a stabilisation instrument, centralising a well-defined set of policy instruments, such as a European layer of unemployment insurance. The third and final stage of fiscal integration would only be achieved if agreement can be found both on financing (direct revenue-raising capacity and common debt issuance) and on the desirable level of business cycle synchronization. This perspective would be a powerful incentive for national discipline and commitment as shown during the march to the Euro.

Further integration and democratic accountability should progress together. These institutional changes require a new Treaty. In such a context, a legitimacy-enhancing appointment process is required. In addition this euro area Finance Minister would need to be backed by a genuine Treasury administration. Last, a stronger democratic control over euro area affairs would be required. To this end, it would be appropriate to consider institutionalising a euro area format of the European Parliament. Relationships between euro area MPs and national parliaments would also need to be enhanced, through an inter-institutional agreement, or by creating dedicated commissions.

A member of the Ecofin Council stated that the first priority for Euro area Member States would be to

implement their domestic homework in terms of fiscal and structural policies which is essential for economic growth and financial stability. But this is not enough. He supported fiscal integration but the priority in this respect is to agree on its content. He stressed that Fiscal sustainability and macro economic stabilisation are not mutually exclusive but rather complementary objectives to stabilise a prosperous economic environment. More is needed to protect EU economies in cases where national fiscal stabilisers are not enough to cope with asymmetric shocks, and also when the monetary policy is limited. This is particularly important when countries are making efforts to reach their fiscal targets and therefore do not have much room to use national fiscal policies for stabilisation. This is why some were advocating a fiscal capacity and a common unemployment insurance scheme. This tool would be something quite visible and understandable for others. However this tool cannot resolve all the problems. He stressed that the key priority was the homework which must be done at a national level.

Another speaker of the public authorities agreed on the fact that deepening the EMU is a necessary objective, which will become credible once a broad consensus among Member States on a way forward has been built. This the reason why the economic case to explain the need for a Euro Finance Minister has to be clearly established. He also stated that the EU Commission was currently in a broad process of consultation in the first half of this year, running events and gathering views from member states and from stakeholders in all member states. Then the Commission will summarise the feedback getting from the member states through an expert group with a view to preparing a Commission-wide paper in spring 2017 outlining the steps for Stage 2 on completing the European economic and monetary union. ●

Ageing population: key challenges posed for the financial sector

KEY ISSUES | *This plenary session was devoted to discussing the economic challenges and the impacts on existing pension systems posed by the ageing population. The session also addressed the contribution of the financial industry to these issues.*

The character of the problem

Significant changes in the age structure projected in the EU

In order to understand the nature of the problem, it was important to define what an 'ageing population'

was. Here the source was low fertility rates, the retirement of the baby boom, and improvements in life expectancy. The other impact had been that the low fertility rate in most OECD countries was quite below the substitution rate, meaning there would continue to be a reduction in the population. >>>

>>> The primary factor, though, was improved life expectancy. On an individual level, people would spend longer in retirement than previously, but the number of years saving for retirement was not increasing.

This ageing affects the solvency of DB and DC funded pensions

The impact of population ageing and the micro and macro impacts differed depending on whether the subject was defined benefit (DB) pay-as-you-go pensions, DB funded pensions or defined contribution (DC) funded pensions. In DB systems the question was whether there would be enough money. If the ratio of people paying into the system moved to 4:1 to 2:1, then there would not be sufficient money, as pension benefits were paid with current contributions. In DC systems, the macro aspect was more important, as people would live longer and accumulate the same amount or less to finance longer in retirement.

The fiscal and economic challenges will be substantial in many Euro area countries

Ageing would mean that more people would withdraw from the labour force. Employment in the working population might decline, and pension expenditure was expected to remain the same until 2060. However, pension expenditure was only one element, alongside healthcare and long-term care, which was expected to grow by 2% by 2060. The current migrant crisis had benefits in the medium term, helping economies address severe ageing problems, but it also posed a challenge to EU governance. There was agreement about the need for people to work longer, to provide the income for later security, but that security needed protection in the present as well.

Demographic trends would impact the creditworthiness of sovereigns. Simulations showed that the US would reach sub-investment grade by 2050, the UK, France and Germany would be at BBB during most of the period. Since the simulations a number of countries had taken steps to address demographic change, by reforming their social security systems and reducing their budget deficits. However, real and nominal growth prospects had been lowered, as inflation had been all but absent. Median net general government debt in the advanced-market economies would be 134% of GDP by 2050, up from 52% currently.

The Regulatory Challenge and the political responses

Across Europe, questions needed to be asked as to whether entities were sufficiently solvent and able

to deliver on promises. In that respect there was also pressure from the low-interest environment which diminished returns. If the situation remained unchanged, benefits would need to be reduced and people would need to work longer. There were two political responses: the populist, where politicians sought refuge in Pillar I, and the reformist, where better collaboration between the three pillars was sought. It was important for pension providers to be able to deal with consistent regulators and rules.

Public Awareness and Understanding of the Problem

Public Awareness

There was general agreement that people needed to work longer. Some people, however, lacked the proper understanding of changes being made in their own interests. Many of people's beliefs about economics were untrue. Even when people understood, it did not mean that everybody acted appropriately. Similar to climate change or other hugely long-term challenges, there was a perception gap between long-term realities and short-term actions. Even if a person had the best intentions and started saving with a promise to save for the next 35 years, there might be incidents such as divorce, children or tragic events which caused the promise to be broken and the money to be taken out.

It was suggested that, while perhaps awareness was there on a conceptual level, it was not clear how many were fully aware of their own pension situation. Research had shown that most people thought the chance of their being unable to reach their pension without disability or a period of unemployment was smaller than 10%, when in reality it was 25%. In summary, understanding the problem was easy: people needed to work longer. The implementation, however, was less easy, and this was where the problem lay.

Government Awareness

The awareness was already present at a government level, as shown by the number of reforms which had passed in the last few years, such as automatic linking of benefits or retirement to life expectancy, or automatic stabilisers within the system. Three EU member states now had automatic balancing systems, eight had links between benefits and life expectancy, and seven had links between retirement age and life expectancy. As a result of this, predictions made only three years previously had proved pessimistic. Estimates suggested recent reforms in Italy would increase GDP by 2.5% and employment by 2.2% by 2030. >>>

>>> EU mechanisms had been introduced help governments to maintain awareness and to provide incentives for affecting those reforms, and the OECD message had always been to diversify sources in order to finance retirement. Private systems should be complementary to their public counterparts. In most countries, the solutions being pursued were to promote more and more DC schemes. The key thing was that benefits would be determined by the assets accumulated.

Addressing the Problems of Awareness and Understanding

Everybody recognised that life expectancy was increasing, but did they understand that they needed to save more? The savings opportunities and returns at present were not very exciting, owing to monetary and growth policies. One dimension so far unmentioned was the rise in inequality. When these very complex issues were considered, a response had to be articulated that addressed the inequality aspect of recent trends. It was important to recognise that large parts of the European population would never be able to save for their pensions. It was important to help people to budget and allow them to save more.

With changes in the law in the UK, employers could no longer set a retirement age in pension schemes, so good pensions were needed to encourage employees to retire. Auto-enrolment had been introduced, which had been a very important first step.

The Solutions

Delaying Retirement and Greater Contributions

Although it had been said that people could not contribute more and contributing more led to lower returns, it seemed that lower returns resulted from higher life expectancy and lower growth. The only way to achieve what somebody who retired in the 1970s did was to contribute more and for longer. Many countries, such as Sweden, had done this by linking statutory age of retirement to improvements in mortality and life expectancy. This was fine, but care needed to be taken, as not everybody reaching retirement age had the same life expectancy. Many countries were linking statutory age of retirement to improvements in mortality and life expectancy, but care needed to be taken around socio-economic factors. The other suggestion was that the ratio of years contributing to years in retirement was important.

Increasing Participation

Increasing participation rates could address not only the ageing problem, but the growth problem

more broadly. Improving participation rates of ages 55 to 64 could increase GDP by 3%, and, by improving participation rates of ages 65 to 75, the projected dependency ratio in 2060 fell from 2:1 to 3:1.

Increasing Productivity

In principle, you can borrow more, earn more or spend less to tackle such challenges. Borrowing more is, for the moment, out of the question, because debt is already very high, so we are left with either earning more or spending less. There, one can see that there is potential for spending less or at least spending better – there is potential for efficiency that could be tackled. Health costs can be reduced by 25% efficiency savings.

Then there is the better option, which is to earn more. Earning more with a lower population is more difficult and requires much more productivity. Improving productivity requires open markets within and outside the European Union. Entry costs and tax distortions which might create segmented markets would need to be removed. At the same time the quality of capital and labour needed to be improved, so more research and development was needed in innovation and more and better skills.

This was feasible, because, if one looked at the gap between the current situation and the best performing countries, it could be calculated that GDP could increase by around 11% in 20 years in the EU, though it varied from country to country. Additionally, if the reforms were implemented jointly by several or all member states, the dividend could increase to 12%. As a result, budget positions would improve, and so would employment. Once there was some sort of mechanism to remind governments of these benefits and entice them to make the reforms necessary to reach those dividends and communicate that information to the public. It was also important to create opportunities for older people to work on a part-time basis. This would require certain tax incentives and societal levies, to not disincentivise people working 10 to 15 hours from topping up their pensions.

Public/Private Co-operation

Pillar I would provide only a basic level of financial support for elderly people, and would need to be supported out of general taxation. Pillar II would need to be strengthened with more auto-enrolment, with a move to DC rather than DB pensions. This pillar was a combination of public requirements managed in a private fashion. Pillar III would then serve as more of a top-up to safeguard the standards of living for those who could not afford it. >>>

>>> In terms of auto-enrolment, the next step within Pillar II schemes would be auto-escalation. Employees received a 3% wage increase, 1% of which went into their pension. This could be done without legislation, and it was important that employers started to think about it.

Decumulation

Decumulation would also be more and more important. The insurance world could not provide the guarantees needed, so co-operation was needed. Following recent changes, the UK was a test-bed

for examination of the different options. Mistakes would be made, but could be learnt from.

Other solutions

Other solutions included moves to transfer risk to the individual, with capital backed savings, so that people would contribute more. Financial markets had a very important role, because of the need for drawdown programmes and annuity markets, and insurance companies and pension funds both needed financial instruments to hedge longevity risk. ●

Retirement products: what products for answering retirement needs in the EU?

KEY ISSUES | *This session focused on the role that EU institutions can play beyond domestic arrangements, in providing appropriate products / vehicles for answering retirement savings needs and the related EU regulatory frameworks (e.g. Pan-European Pension Product) that may be needed.*

Speakers were also invited to discuss the role that financial players can play to develop EU products in order to encourage and support citizens to save for their retirement.

The roles of public, occupational and personal pension vehicles in each of the 28 Member States diverge significantly. The need for EU products to answer retirement needs was obvious when considering the immense demographic challenges in Europe, current economic uncertainties, and low interest rates. Those factors aggravated conditions for retirement provisions of European citizens, which was a concern to European policy makers. The industry had to adapt.

The Current State of Pensions

The issue was of how to achieve adequate pensions for citizens. Within the pensions framework, the first pillar desperately needed reform. The inevitably unpopular reality was that if a more sustainable first pillar were to be attained with public finances, they would need to lower first pillar pensions. The retirement age also needed to move up. With the ageing population came growth in interest in pensions and retirement, which increased the difficulty of making adjustments to pensions.

The second pillar had various issues, not least that very few countries had it; there were therefore

few employers ensuring that their employees had pensions. Additional considerations were made regarding changes in the labour market's behaviour. Historically, employees would have worked under one employer for their entire lives. That was no longer the case, and the current system was not optimised for the new trend towards many short and small contributions to pension pots.

The third pillar was completely insufficient, fragmented due notably to varying approaches to pension provisions, tax differences and in most cases did not give consumers value for money.

To make the pension gap sustainable they needed more second and third pillar solutions. Although there had been steps towards reforming the sustainability of first pillar regimes, the same was not true for the second and third pillars, and awareness of the problems of future retirement pension revenues was gathering pace. Therefore incentives for good second and third pillar pension provision were essential. Europe could help with all three pillars, in rulemaking, implementation, and reform. >>>

>>> Fear was thought to be at the heart of discussions on all three pillars. People wanted to save, but were unsure. That was in part due to awareness of the low interest rate environment, but also because of lingering distrust in the financial services sector. The widespread fear was thought to be driving customers' decision making; although that was disputable.

However, it was noted that fear was a positive force if acted upon. The industry had an opportunity to attempt to push the energy and awareness behind the fear towards positive outcomes, and to aid their customers in their long term plans. Another asset to consider was that recent studies had indicated that employees trusted their employers. Therefore early engagement with employers was one route of action to consider.

Insurers had the potential to strengthen confidence in the industry through two routes. First was through transparency. The second was through provision of evidence that they would remain solvent in the long term. Insurance could offer guarantees, and that was a route to restoring confidence that was simple from a consumer's perspective. Movements towards transparency and education for citizens were strongly supported.

The Relationship between Citizens and Pensions

The widespread European perspective was that people believed that the Government had a responsibility to take care of them. As such, a reasonable measure was to increase financial education and citizens' understanding that, where possible, they had to take care of themselves. Although it was accepted that there were challenges to individuals being able to do so: some people had insufficient income; the first pillar was insufficient to provide adequate pension income for a good lifestyle; and in countries with a large ageing population, it was not easy to declare that there was no money left and people had to take responsibility for themselves.

Personal pension products were one way for individuals to look after themselves, but the question of how to motivate people to use them remained. The EIOPA had made commendable efforts towards solving the problem of motivation and had suggested that if they wanted people to buy personal pension products, then there had to be guarantees of their reasonableness offered. PEPPs were a viable starting solution, but not a final cure. In order to really motivate people to take care of themselves they had to develop a portfolio of pilot products that met certain investment rules and were properly supervised, and then introduce them on a level playing field.

Furthermore, encouraging people to save was not the final answer. Instead they needed to change the dynamics of the market by engaging people, giving them advice, and encouraging them to think long term. Those that planned for the long term also became more confident in their financial futures because they were more engaged. Therefore early engagement was essential.

Development of Long Term Investment

There was widespread agreement that the industry needed to do more in considering how to bring long termism back into the pension regime. They needed to build on what had already been done. Pensions were fit candidates for long term investment, but work needed to be done in collaboration with companies to refocus the long term approach. Both society and individual savers had much to benefit from that refocus because they were currently missing out on long term gains, which negatively impacted both innovation and wealth.

The immense demographic challenge had been considered, but the challenge should have been systematically linked with the challenge of investment within the European economy. The need for long term investment was substantial, and was a particular issue in Europe.

An additional point to consider was that pension funds were not the only way of channelling long term savings towards retirement or otherwise long term investment. There were many products available that offered similar outcomes, and thus there was scepticism on the need to generalise the pension fund or create a pan European one. The current expectation upon the European Union was for them to analyse the characteristics of long term investment and design a new regime dedicated to long term saving and investment.

Whilst it was possible to build products that would provide value for money for customers whilst allowing more long term investment in infrastructures, a warning was given: customers had to understand that they could not have all of the benefits they wanted. People had a preference for liquidity and were understandably risk averse, but businesses were advised not to try to offer long term guarantees in conjunction with short term liquidity. The economic reality was that it was too costly to do so. However, there was room to do better than they currently did.

The best service that the financial services industry could offer was to provide a money-collection product that would maintain a reasonable level of volatility, whilst protecting consumers from hyper-volatility. >>>

The Beginning of PEPP

EU institutions were advancing and preparing regulation for the PEPP. Work had been developed on the PEPP because the industry believed that Europe could add value. Regarding PEPP and the three pillars, work needed to be done on the second and third pillars to improve both efficiency and overall value for money. In many countries the products used for private pension provision were not true retirement saving products; that was problematic because pension investments differed greatly from short term investments. In order for the PEPP to realise its potential, it had to be a true retirement product. More generally it had to be digitalised, simple, economic, and high quality.

Actions were advocated for a second regime that would come from a European perspective and work alongside different national regimes. The regime required a degree of simplicity and was thought to be possible in a more cost efficient and transparent way.

The building of a pan European product was an acknowledged possibility. The industry knew the characteristics that it needed. There was also potential for the introduction of a default product, in the interests of simplicity, alongside the choice from more flexible products.

The challenge of digitalisation also bore relevance in regard to the upcoming PEPP. Discussions on 21st century regulation needed to take place because that was where opportunities were. Europe had the potential to provide pensions in a modern and digitised format, and with greater transparency than previous products.

There were also savings to be made from encouraging individuals to engage digitally. It was further considered that if customers were spoken to in one consistent and transparent language across the industry, it would empower individuals and allow the PEPP much wider acceptance.

There were understandable obstacles to the success of the PEPP; political willingness was one. They were currently in the last hours of being able to make political decisions on the sustainability of the second and third pillars in Europe. In 15-20 years' time the ageing population would make pension discussions and reforms significantly more difficult.

A further obstacle to the PEPP was the lack of interest towards it. Banking and pension management were not considered exciting activities. In order to gather interest PEPP had to be simple, transparent, and standardised; and people needed to be educated on how to manage their pensions.

Establishing cross border pensions was a further difficulty. Insurance firms cooperated at the international level, but solutions were mostly national, which was potentially problematic. Further, when looking at new solutions, they had to consider the distribution costs.

A final obstacle was that DC still had scope for improvement with regards to long term investment potential, and portfolio diversification.

The FCA's post implementation analysis of the Retail Distribution Review would be a good framework for the EU to look at how they compartmentalised the earning and savings habits of individuals across the EU, which would greatly inform the debate on the applicability and usage of the PEPP.

Future Thoughts

It was clear that the EU had a role to play in ensuring retirement provision and pension coverage for EU citizens. It was recommended that the industry worked to clear existing obstacles and incentivise long term savings for the benefit of European citizens.

Further steps had already been taken. Eventually the work that had been done needed to give rise to pilot products. That had been suggested to the European Commission, and was pending a response; further help on that front was openly invited.

The ageing society had proved to be a substantial concern. Calls were made for more debate and analysis on how to adapt to the new demographic.

An amount of future thought was geared towards helping citizens. Citizens had to understand that they were personally responsible for their pensions. However, the industry also needed to develop a consistently simple framework for customers that was digitally accessible and kept costs down.

Further digitalisation was encouraged. The benefits to the industry were as yet untapped.

The future of the economy would largely depend on the ability to fill the investment gap. That was the highest priority. Meanwhile, all diagnoses indicated that long term investment was hampered by a series of regulations that had been implemented. It was advised that they looked seriously at the business model of long term investors, and that they took the necessary initiatives without delay. ●



2. NEW TRENDS IN THE FINANCIAL SECTOR

Digital financial services: what regulatory framework?

KEY ISSUES | *The session depicted how the EU Digital Single Market Strategy (DSMS) was unfolding in financial services. It clarified the challenges specific to existing and incoming players, assessed actual achievements in the EU and the difficulties posed to the DSMS by cybercriminality. The session also outlined relevant regulatory approaches.*

Key targets for an Appropriate European Policy

Making European policy was often about trade offs. Regarding notably the payment directive (PSD2) they had found a good trade off in terms of opening the market, and they also took into consideration the security of the system though it required consequently a great deal of monitoring and upgrading of expertise.

Attention to a level playing field was crucial for the framework that would be developed. However, it was not necessary right for regulators to just regulate things that overlapped with banking activities in the same way that they regulated banks. Flexibility and consistent implementation in particular across Member States, were important in regulation as well as standardisation. That could become an experimental area, possibly changing things afterward.

Finally, for both the innovating firms and the transformational experiments of established banks the regulatory sandbox would be crucial to enable innovation. However, building skyscrapers in a sandbox was not advisable.

Managing Digital Developments and Cybersecurity

There had been new efforts in the Digital Single Market in areas trying to stimulate fintech. Regtech and legaltech were also useful to respond to regulatory compliance duties. Organisations had also funded innovation in blockchain to investigate its development from the technological side. Associated publications had highlighted how data flow through cloud based standardisation could enable new approaches and simplify the regulators role in combating malpractice. Evidence gathering had been

launched to look at what would happen if there were problems with the algorithm, application, or software.

Some thought that they already had a seamless Digital Single Market, with digital platforms that had the potential to help both SMEs and large companies to move funding across borders. It was noted that the Digital Single Market was one of the top 10 political priorities of the Juncker presidency of the European Commission. Some thought it should have ranked higher, and that the potential of the network benefits for Europe was enormous. Others agreed and said that in addition to a legal or paralegal solution they needed a framework for the development of the connection. In addition, two obvious developments to accompany that were instant payments and mobile payments.

One issue was the balance of responsibilities between the traditional financial services industry, new entrants, and consumers. It was acknowledged that consumers had to accept accountability for themselves; however, the industry also had to provide some of the protection that consumers wanted.

Cybersecurity was a significant issue. There was a dangerous presumption that technology was safe and secure. The industry had to ensure that sensitive information stored on digital platforms was secure. There was also the question on the extent to which the big data challenge for privacy would become more nightmarish than it already was. It was stated some consumers were not capable of making complex financial decisions, regardless of the level of education provided.

Thus interesting opportunities were arising around new risk pools. The internet had brought >>>

>>> opportunities, risks and threats from the global connectedness it provided.

It was outlined that current cyber crime costed around \$445 billion globally. A lot came from beyond individual regional boundaries, which was something that both regulators and the industry needed to be aware of; the insurance industry certainly was.

A further issue was how the market rewarded people that did well. Comparison and review sites had received very good consumer responses, which served to encourage certain behaviours; however, they were a form of self regulation and not standard regulation.

There was still an issue around resolving disputes, in which the market could not be relied upon to provide a solution. They recognised that technology and innovation always had positives and negatives, but they had no immediate response to the dispute resolution issue. One way to answer that question was to investigate what incentives there were for protecting people.

The industry was working with regulators and national security agencies to find a balance between privacy and security. They had to be aware that information had to be shared with national security agencies and that self protection involved recognition of the trade off between security and privacy. It was agreed that regulators needed to improve their coordination and cooperation on security and cyber crime. Regulators needed more sophisticated ways of stress testing. It was also agreed that, prior to regulation, they needed strategy.

Regulatory challenges

It was clear that the panellists wanted an efficient Capital Markets Union and seamless flowing of markets. However, the panellists were talking about a moving target. The challenge was in knowing which tools could be utilised to achieve that end and allowing the best technology to win. Precautionary regulation would likely stifle innovation. Instead, some advocated an approach to wait and see. When required, regulators would be able to act swiftly. Regulators had also to distinguish between official standards and de facto standards as in current technology, the de facto usually won.

The regulators were rather far behind, and unless some innovative thought occurred in the Commission and other bodies, they would struggle to keep up.

Digital Developments in Retail Finance and Big Data

Retail finance was still bottom in terms of consumer satisfaction, and so changes were welcome. However, the impact of fintech on the average

consumer was currently not large. Of the 315 million European internet users only 15% had completed any cross border trade, therefore there was opportunity for development. The panellists were also beginning to see the UK as frontrunner in digital innovation.

Some struggled to accept that robo advice and processes could model the challenges that people would face over a five to seven-year period. However, they accepted that perhaps they just did not understand the algorithms used.

Some trends were identified in the digital environment. First was the increasing number of products bought online; second was the movement towards 24/7 availability. However, it was highlighted that when buying financial products online it was easy to buy a toxic investment product, and redress then had to be considered.

In order to reap the benefits of digitalisation they needed a digital upgrade to financial consumer protection. It was thought that the majority of consumers had a generic profile and could have had more standardised products. However, they required safeguards; not all European countries had robust protection agencies and standards, which presented a danger of regulatory arbitrage.

One challenge was the volume of transactions in fintech; the question was how to ensure that the public authorities of the industry kept up with them. A second was how to ensure that there was a level playing field maintained between those who wanted to engage through digital and those that did not.

Transparency of costs was identified as one of the proficiencies of fintechs, and was something that was welcomed from new market entrants.

Big data was a concern for some. Consumers had the potential to profit from more aggregate information, but that came alongside privacy issues. It was highlighted that the big issues in the insurance industry regarding big data were on risk pricing, acquiring data, and developing products more appropriate for individuals' risk needs. Big data also helped to inform customers and served to influence behaviour.

Big data was also mentioned in relation to credit, where it had helped those that did not have a credit footprint. Big data would allow firms to make more personalised risk assessments, which gave rise to questions around what information would be used to inform credit and insurance areas.

There was uncertainty over the extent to which big data would be replaced by having better >>>

>>> access to micropayments, as well as the extent to which the big data challenge for privacy would become more challenging. The answer was unclear, but work needed to be completed in that area.

Used the wrong way, it was dangerous and so it was important that protections were available. However, it was also important that the protection was flexible. An ideal answer would have been one in which digital financial services contributed towards enhancing privacy.

Digital Trade and Consumer Confidence

Digitalisation also worked to break down national biases. It was plausible to have a platform, investor, and investment in three different regions. However, the key information for consumers in those cases was what protections they had and whose dispute resolution they could use if it went wrong.

There was uncertainty on whether the industry would need a cross border dispute settlement system, but they agreed that they needed to work on an answer before they started to build skyscrapers. It was agreed that confidence in the system needed to be developed. It was highlighted that the ombudsman service in the UK had worked well in the case of individual problems with individual products. A public authority intervention seemed to be a sensible response.

Few Europeans traded digitally across borders. That provided an opportunity, if executed well. There

were also opportunities, particularly with long term products, to communicate more effectively with customers. However, those opportunities came with inbuilt challenges that needed to be overcome through technology.

There was a question around whether they wanted to move towards encouraging uptake of security investment, to improve consumer confidence. There was a general fear of the unknown. People tended to migrate towards things that they were familiar with, which was a behavioural pattern seen beyond the financial services.

It was noted that firms were not obliged to adhere to out of court complaint systems when it came to redress.

Conclusion

There were opportunities in Europe, if handled correctly. They wanted an open and innovative environment and to encourage attention on cross border issues. They also had to be aware of the security issues and monitoring by regulators and supervisors needed to be adapted to the digital world. Other important areas of focus included stress testing, creating a level playing field, and building consumer confidence.

Addressing those issues in the right way would result in huge potential dividends for Europe in financial services, digital technologies, retail, and across the wider economic frame. ●

Fintech and blockchain: what prospects for improving efficiency in capital markets?

KEY ISSUES | *This roundtable concentrated on discussing the benefits that can be expected from the development of blockchain and Distributed Ledger Technology (DLT) solutions in the capital markets in terms of efficiency, the impact on the existing market structure and post-trading processes, as well as the operational, regulatory and supervisory conditions needed for the development of such solutions.*

Expected benefits and challenges of Blockchain technology

Potential savings and efficiencies were widespread and easily identifiable particularly for Blockchain and Distributed Ledger Technology (DLT) applications and in the securities post-trading area. Financial technology could lead to new business models and

contribute to a significant growth of the industry via lower transaction costs, shorter delays, greater convenience, thus facilitating access to capital markets. Potentially billions could be saved. Polls had shown that the expected benefits of Blockchain included transparency and easier tracking, reduced reconciliations and increased capital mobility. Blockchain was however not a silver bullet and >>>

>>> its actual impacts were still unclear, several speakers considered.

These evolutions had to be viewed in the wider context of digitalisation, which was nothing new in the financial sector. Dematerialisation and developments related to the internet for example had been expanding for many years. DLT was a further step of this development. Moreover DLT did not have a monopoly on distributed databases, which were already used but their development was expected to increase with DLT applications. The benefits of data distribution were not disputed, but there were constraints that needed to be addressed, such as issues of maintenance and access. DLT was therefore not the solution to all problems and it would have to be adapted depending on the strategy pursued.

The development of Blockchain would probably not be a big bang evolution

The complete overhaul of capital markets would not be seen for 15-20 years and applications to core clearing and settlement processes for blue chip stocks were still a remote objective, several speakers considered. Blockchain technology would probably first apply to small and discrete processes that surround the main settlement and clearing engines and provide incremental benefits.

It was still difficult to determine at present whether Blockchain would lead to disruption or incremental evolution, some speakers believed, because the securities industry was not known for radical shifts. Building integration with existing infrastructures in capital markets was an issue of importance and genuine infrastructural change would take many years. There were limited incentives to move away from the current functioning of the market, due to the huge investments needed and legal issues. There were also governance issues to be addressed regarding: the technology, who could participate in the network, the roles and responsibilities in the network and possible sanctions for misbehaviour. Moreover benefits may not be individual but shared with the entire network of players interacting in the capital markets.

An outside-in movement triggered by third parties was possible but would require the whole industry to move which seemed unlikely in the short term without significant intervention from central authorities, a panellist suggested. Moreover changes in securities laws that may be required were a complex issue. The internet had previously brought many changes but the main market players had largely remained unchanged. First-movers are expected to propose new solutions but they will probably be peripheral to the core clearing and settlement processes. A panellist suggested that many firms had already decided to provide technology and know-how to incumbent companies, rather than

entering in direct competition with them due to high compliance costs in particular. Such collaborations could be a more efficient way of providing these technologies for society.

Significant transformation could however be expected over time. It was agreed that smart contracts would be a fast moving catalyst for change. There was no question that contracts could be reduced to an algorithm, and that algorithms would become a very powerful asset used in conjunction with other technologies, for both firms and regulators.

A significant amount has been invested in order to cover all relevant aspects of the evolution of financial technology. The approach was to identify opportunities, build solutions and learn from them. Learnings were both technical and non-technical, including issues related to the governance of the network. The main technical challenge of DLT was to build applications which could leverage the properties of the underlying ledgers.

However it was clear that electronification would not rule out risk in capital markets. Digital finance methods were still subject to possible manipulations and errors; and alongside the possibility for error would come a necessity for responsibility and a call for supervision in order to ensure sufficient trust. Finally technology could disturb the present capital markets ecosystem which was highly tuned with different levels of intermediation, thus potentially creating new risks.

Policy development and oversight strategies

Working out a strategy for policy development and supervision was a pressing issue given the uncertainty regarding the precise impact that technology might have on the financial services sector and related policy fields. Trade-offs between supporting innovation and prudence should be avoided, a regulator believed. At the same time, regulators should endeavour not to stifle innovation and treat it in a flexible manner. Moreover striving for artificial separations between traditional banking and digital finance was warned against, even if legal issues had to be adapted to digital contexts. Technology should be treated neutrally on a “same business, same risk, same rules” basis and a specific entity needed to be responsible for operational risk. They needed a level playing field with modernised rules that could ensure the efficiency and effectiveness of best market forces in the long-term.

The “First Do No Harm” regulatory approach used during the mid 1990s for the internet could be used as a source of inspiration, an official suggested. Evolutions such as Blockchain could not be decided by regulators, could not be held off and were going to happen. Moreover diverse and contradictory regulations should be avoided, as well as laborious ones which might kill off >>>

>>> innovative business models. Rules will need to be adapted to quickly evolving technology and the related data completed.

From a central bank perspective, there were three angles to consider: the impact of technology on regulatory and oversight capacities; the catalyst function to be played by the ECB in the further integration of financial markets: i.e. issues related to access to data and to its circulation, as well as standardising practices; and finally the perspective of an infrastructure operator such as TARGET2Securities (T2S) regarding the capacity for technology to increase efficiency safely. Cyber-resilience was also an issue and developing an appropriate IT stress testing framework was essential to ensure that technology was resilient.

Mechanisms such as regulatory sandboxes were useful for testing innovative products, services and business models but technology was quickly evolving and may have systemic relevance.

Regulators needed to anticipate changes and modernise their approach. The current ruleset needed to be rethought for the digital world, because it partly ignored digital realities and the fact that decisions would increasingly be made by artificial intelligence and algorithms rather than human interaction; legal issues had to be adapted to these changes. They also needed to ensure that digital technology developed in a way which allowed it the greatest utilisation by both industry and regulators.

It was further advised that a supervisor ultimately had to act on a clear legal basis, which was why it was essential

to ensure sufficient legal certainty. The availability of appropriate trading data at the global level was also an essential issue.

A culture clash was expected with the increasing development of Fintechs. It was suggested that firms in the post crisis era had become accustomed to seeking permission before acting, which differed from the culture of Fintech firms that never sought permission. There was however confidence that the world would unite and that a common development could be achieved although it may not happen in a straight line.

The importance of standards

The importance of standards for the development of technology in capital markets was emphasized. It had been the key issue for the T2S project. Standards would also be essential for moving things forward with regard to Fintech applications. However, it was emphasised that much time would pass before Blockchain would be ready. Many technologies rendered the same service, and it was as yet unclear which of those would be dominant, if any. A layer of standards was required to allow each service to do their job whilst offering consumers a space to build applications in confidence. Moreover a sandbox where practitioners, innovators and regulators could collaborate would be useful.

It was suggested that standardisation had five key areas that needed to be looked at: governance of access; the status of legal entities used for supervisory and reporting purposes; consistent data semantics; algorithms and their maintenance; and integration strategies between legacy systems and DLT. ●

Conduct and culture: what priorities in the financial services industry?

KEY ISSUES | *The objective of the session was to clarify the expectation of customers, policy makers and executives in the EU financial sector in the global context, regarding culture and conduct, and to outline the realistic benefits that can be expected in that respect.*

In addition, the participants were asked to assess the progress already achieved regarding this topic and to list political, managerial, supervisory, etc. success factors required to make a significant breakthrough toward sufficient improvements.

How to improve conduct and culture?

Conduct was acknowledged as one of the biggest risks faced by major financial institutions. The 25

largest banks had received combined fines and litigation costs of \$260 billion since 2009. This would increase by an additional \$65 billion by the end of 2017. >>>

>>> The first dimension of improving conduct and culture was trying to position sustainability ratings as similar in importance to financial ratings. This meant looking closely into product governance as well as strategic and treasury investments. Secondly, institutional clients needed to select conduct risk and culture as selection criteria for their asset management providers. Thirdly, conduct and culture needed to be extended to the retail franchise. If the quality was right, if it was made transparent, and if the product was suitable, then it would improve client outcomes. Finally, conduct and culture had to be part of capital planning, treating conduct and reputational risk as part of the business risk in terms of capital underpinning.

Change needed to be part of the management objectives. This was no longer about quantitative targets but about the ethics code and qualitative objectives, and was now part of the objective-setting, assessment and incentivisation of the team and the management. A financial institution should be run so that it was in everybody's DNA to ask whether something was right, rather than whether it was legal. If this was done correctly it could translate into more and better business.

Culture and governance of firms was seen as an important long-term focus. Culture shared values and norms within a firm that characterised the organisation and the mind-sets that drove the behaviours of the firm. Remuneration and promoting effective links between the risks run by the firm and individual reward could serve as a mechanism for discouraging excessive risk-taking and short-termism.

At a firm-level, there were three particular aspects where firms could benefit from an increased and continuing focus on culture. The first was an increasingly sustainable business model. The second was more effective risk management. The third was the ability to respond more effectively when things did go wrong.

People had moved past anger and denial, but the current mood still had to change. Middle management needed to be brought along, and those at the bottom needed to be listened to. Sometimes what was right was not clear, and people should be enabled to see the tools available to help with the grey areas, as a lot of what they dealt with was not black and white.

One of the big concerns was that the perception of the public would be that these fines were simply the cost of doing business. A culture of bad conduct put institutions and financial markets at risk. Conduct was not an asset class, and it did not stop at a border,

so regulators should be mindful of harmonising rules as much as possible. It should not be a tick-box exercise.

Progress made so far

There had been examples of direct ways to do this, such as the bankers' oath in the Netherlands, which would lead to conversations within organisations, though it went against the Anglo-Saxon culture. Another was the code of conduct for tax advisors in Denmark, making the expected norms and values for tax advisors very clear.

The Dutch supervisor, the Nederlandsche Bank, had since the crisis adopted a framework which analysed the board's effectiveness, the risk culture and the readiness for cultural change.

The ECB had launched a thematic review on internal governance called RIGA, covering both qualitative aspects of boards' functioning and risk appetite frameworks of banks. The ECB joint supervisory teams had gone in to look at the agendas into which the information had been flowing, but they had also observed meetings and taken part as observers to grasp the quality of debate. Composition of boards and their members' suitability was also verified. This had ultimately been a means to test the risk culture within the institution.

In the UK, the Fair and Effective Markets Review had looked into fixed income, credits and currency. Fines had served a purpose in flushing out the issue, but in the UK there had been a move towards the Senior Managers Regime, which continued the focus on individual accountability, to support the rebuilding of public trust. Culture was not something that only applied to client-facing staff, but was for everyone. This went to the point around subcultures: trading desks might feel loyalty to other trading desks rather than to the institution they worked for. Anyone raising an error or mistake needed to be supported through the process rather than being marginalised.

It was crucially important that an environment was created where regulators could share understanding and effectively discuss how better to move forward. There was no single right answer, but firms could learn from one another. The UK had introduced individual accountability for senior managers in banks, and were committed to extending accountability to other sectors. This was an approach that complemented the increased clarity of responsibility on senior managers.

Diversity was also a big help. The Dutch Central Bank had established a special division to >>>

>>> look at culture and conduct, introducing psychologists and anthropologists, where they had used to hire economists. The introduction of more colourful people had helped.

Different roles in culture change

Regulators needed to set an appropriate framework with incentives to get it right. Supervisors needed to effectively apply that framework with strong enforcement consistently across the single market. Businesses needed to assert a better control as to what was happening within firms and develop a sound culture in the area of values and ethics. A lot had been done from a regulatory standpoint in the EU, in the Markets in Financial Instruments Directive (MiFID II) framework. The entire relationship between the company and the investor had been addressed there: a true root-and-branch reform. In a few years, it would be clear whether there was a better regulatory framework to foster a more ethical approach within firms. Businesses needed to take the issue more seriously, which was not easy in a competitive environment.

The Commission wanted to see firmer focus and commitment to conduct supervision from European supervisors across the EU. The dialogue between supervisors and companies was extremely important; there were a lot of good developments coming from the private sector, but more would be needed going forward. A fair game required good rules, a good referee, but also fair play by the players.

Bad conduct was hard to define, but everyone knew it when they saw it. It was also important for regulators to work together to prevent bad apples moving from one jurisdiction or asset class to another. Bad apples could bring down institutions in terms of reputation. It was important to have the right incentives in place. There was not a choice between making money and doing good.

What was lacking on the industry side was a framework which linked risk culture across dimensions. It was not clear that conduct risk could be properly addressed without a proper risk culture framework. Since 2011, the EBA guidelines on internal governance had been available, covering six areas and around 30 principles. They offered an adequate ground for reviewing the internal governance structures of banks, and ensuring that the shortcomings to having a proper risk culture implemented are fully addressed. From the industry side, the question was why they should engage in cultural change. Addressing specific behaviours aligned with the core values and vision was the best starting option. There was a strong incentive to address the cultural issue as a trigger for innovation,

and an underlying sound risk culture at the end. This issue should be the main incentive and driver for the industry to engage or take culture seriously.

Everyone wanted to create and foster the conditions for positive ethical and cultural moves. The FCA should be applauded for stepping back from their cultural thematic review at the start of the year, and recognising it was more about engagement with firms. Market participants would appreciate benchmarking results being made visible and transparent.

Looking Ahead

Sanctions were only part of the solution, but they were an important part. Their imposition was not desirable; however, sanctions were needed which were a real deterrent, which meant they should be high enough to scare financial institutions, and required supervisors who were sufficiently strong and credible. Some supervisors were quite advanced in Europe, and a process whereby ideas on best practice could be exchanged was desirable. Supervisors also had a role in dealing proportionately with things that might go wrong; it was important that enforcement action continued to have a credible deterrent effect.

The industry would welcome a more harmonised approach to assessment of board members and key function holders. Rules varied from country to country. In the UK the senior managers' certification regime was very stringent, but elsewhere in Europe there was a lack of legislation. Clarity was also needed on the RIGA findings, and whether they would feed into the SREP process; this process was not solely about capital. On suitability, a peer review of fit and proper had been conducted, and the results had been embarrassing. It was difficult to make progress given the differing legislation.

The sector would be helped by increasing diversity on many levels, but it started at the board. People needed to feel engaged and invested in their business. ●

Climate change: what impacts on the financial sector?

KEY ISSUES | *The panellists were asked to clarify the diverse types of challenges posed by climate change to the financial sphere and the subsequent roles for the public and private sectors to address them appropriately.*

The session also tried to assess the sense of urgency that addressing the challenges related to the topic requires. The impact that the recent Treaty of Paris had on clarifying the issues, related stakes and the roles for public and private players was also commented.

Issues Faced by Financial Institutions resulting from Climate Change

Categories of Risk

There were several aspects of risk: the direct physical impacts of climate change; the the economic, regulatory and policy initiatives that were happening in consequence; the legal risks arising for those who are seen to have caused it, not mitigated it or who have insured against liability risks. Rating Agencies focussed on the first two categories but to date, physical risks had only a limited impact on most asset risk ratings. More of an impact was resulting from regulatory and policy initiatives in the areas of coal, oil and gas. One rating agency notably had reviewed its portfolio to assess the relevance of these risks across the sectors they covered, and had found that in 11 sectors, there was immediate and elevated risk coming out of either policy or regulatory initiatives; medium to longer term risk in 18 sectors; and lower risk in 57 sectors.

Financial stability risks affected the insurance industry most directly, because these had very long term assets matching very long term liabilities and others underwrite climate risk directly or indirectly. Prudential rules could not be easily adapted in order to mitigate climate change. The Bank of England was about to publish a staff working paper on how all of these issues affected central bank responsibilities notably via potential volatility in asset prices affecting financial stability. But also, volatility in energy and food prices would affect monetary stability.

Possible added value of financial institutions related to climate change

China alone required hundreds of billions of investment each year to support its transition to a greener economy. Beyond the discussion about

changing from fossil fuels to renewable and cleaner energy, more attention needed to be paid to how vulnerable economies would be helped to deal with the consequences of climate change. The 'V20' nations, consisting of 43 countries and around 1.6 billion people, were particularly vulnerable to catastrophic climate related risk. To address these kinds of risk, the reinsurance community, NDB community, private sector, the Green Climate Fund, and others would all need to work together. These countries were predominantly agrarian, and the risks posed by climate change in the agrarian community – including water supply and pollution control – needed to be borne in mind, with significant investment in mitigating them.

Actions Taken

The evidence for climate change was now incontrovertible and generally accepted, and appropriate policy actions needed to take place accordingly. The sooner the world took action to address climate change, the less extreme these measures would need to be.

The Financial Stability Board had set up a Task Force on Climate Related Financial Disclosures, which was due to report its final conclusions on how the landscape of existing measures could be simplified by the end of 2016. A G20 study group on Green Finance had also been set up, co-chaired by the People's Bank of China and the Bank of England, and would deliver a draft first report to ministers in July 2016.

Climate risk was now being factored into investment decisions globally. To make further progress, it would first be vital to improve information frameworks. Some progress had taken place in relation to this, but the standards were still too fragmented, and needed to be streamlined. The FSB task force would be examining the issue of disclosure frameworks, and financial benchmarks linked to climate >>>

>>> change needed to be developed. The rating agency sector was becoming increasingly focused on green finance, both in their day to day activities and in relation to investment processes and the availability of funding for green finance.

Policy-makers were trying to accelerate the transition towards green finance in other ways: for instance, France had passed a law that made the carbon footprint almost mandatory for asset owners.

Asset managers were also becoming increasingly active in the fight against climate change. They had invested in indexes such as MSCI, FTSE and S&P; new innovations had been developed that allowed polluting companies, or those with stranded assets, to reduce their climate change related risks without changing their market exposure in the short run. A platform was being developed under the rubric of the United Nations, which would allow investors to share knowledge in relation to climate change; 25 asset owners were now involved, who around COP 21 committed to the gradual decarbonisation of a total of USD 600 billion in Assets under Management. That was a sharp increase from USD 100 billion in just one year and showed that investors were moving into the right direction. Insurers aimed to both mobilise the supply of investable assets at the right price while avoiding price discontinuities, and determine what could be done in relation to risk mitigation: whatever happened some adaption risks would still need to be managed. One of the big challenges faced by the insurance sector was how to help identify long tail, unquantifiable risks through policy measures, consistent disclosures and consistent transparency, so that these could be priced into asset values. Pension providers were also adapting to the need for green finance, with one organisation having committed to a 25% reduction in the carbon footprint of its portfolio; earmarking €5 billion to invest in renewable energy; and doubling its commitment to highly sustainable investments from €29 billion to €58 billion. A number of banks had created partnerships with each other, with asset managers and super sovereigns to engage in creative financing to devise innovative new solutions, as had been seen with the financing of Meerwind.

Contributions of the Financial Sector and appropriate Policies

Roles of Public and Private Entities to mobilise private financing and inflect high Vs. low-carbon financing ratio

There were a number of estimates regarding how much money would be required to meet global green finance goals, from \$38 trillion between 2015 and 2030 to \$114 trillion between 2010 and 2030. The public sector alone would not be able to provide

this much money. However, roughly \$95 trillion of assets under management was held by asset owners; as such, convincing even small number of investors to take action meant a significant reallocation of capital or debt, which gave policy-makers options.

The proliferation of ESG ratings around assets under management was significant. Around 30% of global assets under management have a ESG rating, which represents a steep increase from around close to zero a decade ago. Banks needed investors to help them de risk their portfolios, to enable them to re lend into the green economy.

The issue of infrastructure financing represented a key problem that needed to be solved. There was not yet an industrialised, homogenised asset class, and governments would need to be involved in helping to create this; France and China, among others, were leading in this space. The role of multilaterals needed to be increased, with major NPBs encouraged to create a homogenised product that global investors could dip into, pricing for sovereign and credit risk.

Market Failures require long-term policies to avoid late pro-cyclical reactions

Both climate change and the policy measures designed to address it would have unpredictable consequences. Financial markets were forward looking, and asset prices would change suddenly in response to breaking news; this was likely to give rise to financial stability risks, which had already been seen in relation to the global oil price. Entities were also leaving themselves open to mispriced risks by failing to price for the likelihood of companies being fined for pollution or other climate changing activities; even when entities were aware that they had risks, they did not necessarily know when they would crystallise or how large they could be.

The world was only now admitting that climate change was a problem, and was struggling to adjust. Investors would need to determine both how they could invest proactively in mitigation activities, and how they could avoid the risks created by the lack of mitigation over the last 25 years. Individually, all of the initiatives that had been outlined would be insufficient to meet global warming targets; all of the players in this space would need to consider how they could work together more effectively, while avoiding 'knee jerk' policy reactions to sudden crises that would add to instability.

The Treaty of Paris had been a change of tack

The Paris agreement had demonstrated that public authorities around the world were firmly >>>

>>> committed to limiting global warming to well below 2°. Since this agreement had been signed, there had been a number of developments: climate risk was increasingly being seen as a challenging part of the investor portfolio, only hedgeable to a certain degree. Around 1,800 gigawatts of renewable energy had been committed to by countries by 2030; the Paris plans represented an overall acceleration of decarbonisation from about 1.3% per year to 3% per year, which did not get the planet to its 2° target, but still represented a significant opportunity that would need to be taken advantage of. However, investors would not be attracted to this opportunity unless liquidity, risk sharing, and scale were addressed. Reporting was also becoming a more standardised area of activity.

Pursuing New Initiatives

Mitigating risks could be best done via greater disclosure, to encourage smaller market fluctuations when these risks materialised, and more accurate pricing. Operating via large risk pool mechanisms was also a promising approach, and micro insurance would be heavily in demand in agricultural communities in V20 type countries, such as municipal bond issuance.

Supply-side factors would also need to be considered: the projects had to firstly be available to be invested in. Project management capacity in the public sector would need to be rebuilt, and there would need to be good sectoral and regulatory frameworks, conducive to sustainable investments.

To make the transition, the EU would need to invest an additional €270 billion (or on average 1.5% of its GDP annually) over the next 4 decades¹. These investments consisted in large part of small projects, worth €10 million to €20 million; to mitigate the problems caused by the higher unit costs of these projects, and challenges in relation to finance, some bundling would need to take place. Private money was not yet being channelled effectively to deal with climate change in developing countries; these projects were notably difficult to structure.

In the current low-return, low-interest rate, low growth environment, there was enormous demand for yielding assets that could be appropriately priced. Investing in green had moved from being an exclusion strategy to an inclusion strategy; however, efforts would need to take place to ensure that price discontinuities did not arise because of abrupt policy changes, and that the pricing of these risks could be done with as much information and as much consistency of information as possible. Banks could help in a number of areas, including harmonisation of projects in relation to the non financing reporting directive, green securitisation, and credit enhancement; they would also need to give thought to the question of what would happen if a climate related catastrophe occurred. The FSB's guidelines for disclosure would allow the buy side to exercise more discerning judgment about what they invested in, and the infrastructure hub that had been established globally could not be allowed to fail. ●

1. http://ec.europa.eu/clima/policies/strategies/2050/index_en.htm



3. DIVERSIFYING THE FINANCING OF THE EU ECONOMY

CMU: is it on the right track?

KEY ISSUES | *This roundtable examined the progress made with the CMU action plan and whether the short term actions were likely to foster a significant diversification of financing and better opportunities for investors. The key longer term priorities of the CMU and the way to keep sufficient momentum over time were also discussed, as well as the need for a stronger focus on technology.*

The CMU, an ambitious project facing several challenges in the implementation phase

The importance of developing capital markets and of diversifying the financing of businesses in Europe that was intended with the CMU initiative was emphasised by the panel. At present EU capital markets were too fragmented and under-developed, they said, and did not allow a sufficient diversification of financial sources or an effective transformation of savings into investments across the EU. The CMU could also help to improve the stability of the financial system with a better diversification of financing. Moreover, thanks to the CMU, EU capital markets could be made more competitive and more transparent. The long term policy aim of the CMU was not to revive just individual segments of the market, but capital market financing as a whole; CMU should therefore be considered as a comprehensive undertaking.

Some speakers felt that there could be a stronger emphasis in the project on SMEs and the local financing ecosystems that were needed for them, as SMEs were the most likely to generate growth and employment. A stronger focus was also needed on measures to rebuild retail investor trust, such as investor protection measures, in order to encourage more investment.

Although it provided many opportunities, the CMU also contained significant challenges, some panellists considered. A poll conducted during the Eurofi seminar showed that 59% of participants felt that the CMU was 'not quite' or 'not at all' on the right track.

There was first a risk of loss of momentum with the four year timeframe of the CMU implementation

and the relatively high number of initiatives that the action plan comprised, that were somewhat difficult to promote and explain from a political perspective. Several speakers were in favour of accelerating the implementation as much as possible. A mid-term review is to be carried out by the European Commission (EC) in 2017, in order to review priorities and instil a new momentum. A speaker also felt that it should be acknowledged that the CMU was a complex project, deeply intertwined with national traditions and cultures, which thus required careful implementation in connection with the Member States. This would take time but was essential for the success of the CMU. Ultimately the CMU should be pursued in a determined manner without expecting immediate results, an official concluded.

A second challenge was related to the economic growth and job creation objectives associated with the CMU which might be difficult to achieve with the CMU action plan alone. The CMU was a necessary, but not a sufficient condition for achieving these objectives, a panellist emphasised. Some speakers considered that a broader and more holistic approach was needed, because the achievement of the CMU objectives was also dependent upon the economic conditions prevailing in Europe; in addition diversification in the sources of financing would only work if the overall variety of financing options, including traditional banking activities, was taken into account. Such a holistic approach should encompass also the Juncker Plan, the Banking Union and measures to enhance investor trust; this approach also needed to address the banking sector with measures relating to risk reduction, the expansion of lending capacity to the real economy and SMEs in particular and a capitalisation >>>

>>> on the links between banks and the capital markets, some speakers suggested.

The potential impediments that the ongoing bank prudential reforms could create for the development of capital markets, notably the measures targeting market making, were a further challenge, a panellist felt. There needed to be deep reflection on whether it was possible to meet Basel prudential objectives in a way that did not interfere excessively with the development of European capital markets and the financing of the economy e.g. with a possible re-calibration of certain requirements.

Progress made so far with the short term CMU actions

The implementation of the first phase of the CMU action plan was well underway with the proposals that had been made regarding securitisation and prospectuses, the recalibration of Solvency II capital requirements for investments into ELTIFs and infrastructure projects and actions conducted by the private sector regarding private placement. Several speakers however considered that the progress made so far was not sufficient and that the adoption of the pending legislative texts regarding securitisation and the prospectus review needed to be accelerated. Flexibility and adaptability also had to be built into these regulations, as capital markets evolved in a dynamic way, a panellist emphasised.

There were mixed perceptions regarding the STS (simple, transparent and standardised) securitisation proposal in particular. Securitisation was considered as the main short term initiative of the CMU, but the EU securitisation market was declining compared to covered bonds and the volumes were 8 times smaller than in the US. Even for the most liquid products, the inventory of broker dealers and trading were a small fraction of what they had been prior to the financial crisis, which made price discovery increasingly difficult and favoured volatility. There was also a reduction of transparency with increasing trading of loan portfolios instead of ABS and an increasing proportion of privately-placed transactions. There were different possible reasons for these trends, but some speakers considered that cumulative regulation played a significant part. Consideration would need to be given to the question of how to reverse these trends.

The STS initiative to revive the securitisation market on a sound basis had the potential to spur capital market financing and to support banks' capacity to lend. For this potential to be realised, however, appropriate capital charges needed to be adopted in particular for insurance investors, otherwise there would not be sufficient buyers, a speaker claimed; these prudential requirements and whether junior

tranches would be recognised as good securitisation still needed to be decided and transposed into law. In addition it should be determined whether the adjusted capital charges for banks, decided under the Basel provisions, went far enough.

Regarding infrastructure investments, the Juncker plan was regarded by one panel member as a 'good start', but it did not fundamentally change the capacity of large institutional investors to invest; the project pipeline had been increased, but mainly with small projects. A positive step forward had been made by EIOPA in defining specific capital charges for infrastructure investments, but there was still the risk that corporate infrastructure might be treated in a restrictive and rigid way.

The longer term action plan of the CMU

The longer term part of the CMU action plan concerned some of the core building blocks of the financial market and covered a number of difficult topics deeply embedded in aspects of Member State law, public administrative practice, and culture. These included insolvency and securities laws, domestic withholding tax procedures and accounting standards. Supervisory convergence was another important area of focus on which ESMA was working. Four areas related to the longer term actions of the CMU were emphasised by the panellists; these were areas where action was initiated in the short term but their full impact would only be felt in the longer term.

Forthcoming EU initiative on insolvency regimes

There was general support within the panel for the ongoing initiative of the EC regarding insolvency regimes. A consultation had been launched, with the aim of tabling a legislative proposal towards the end of the year. The EC did not intend to harmonise everything, but to focus on certain key elements. Benchmarking domestic regimes could also help to make sure that such regimes would become more efficient and predictable. Significant progress was for example being made in Italy in this regard.

The objective was to facilitate the risk assessments of cross-border investors and to reduce the time currently spent rescuing viable companies and also potentially lost with the ones that could not be rescued, all of which hindered the full achievement of the Banking Union in particular. Current EU processes were on average sub-standard compared to other OECD high income countries and excessively heterogeneous. According to AFME calculations, an increase in EU GDP by somewhere between 0.3% and 0.55% of GDP could be achieved with an improved insolvency framework. >>>

>>> Achieving a full harmonisation of insolvency frameworks seemed difficult, but was eventually necessary, some speakers considered, in order to obtain a full integration of EU capital markets; the approach proposed by the EC would be a first step towards this.

Capital market liquidity

Liquidity was important for the CMU. A policy-maker stressed that much care had been taken by the EC to evaluate and mitigate the potential impacts on market liquidity of ongoing regulatory initiatives such as MiFID II and Basel III and of developing asset management rules; work was also being done at FSB level on this issue. A comprehensive assessment was to be undertaken by the EC notably regarding corporate bond liquidity, the results of which would be available in 2017. Some speakers however emphasised it was a given fact that liquidity was a problem in European markets and that the situation needed to be urgently addressed, as it was not going to improve with the development of HFT and the intervention of the ECB. It was also felt that the harmonisation of tick sizes imposed by MiFID II could further impact the liquidity of SME markets, reducing the incentives for market makers to operate in this market.

Some other upcoming initiatives would have a major impact on capital markets, such as MiFID. It was felt that good work had been done in ensuring that the transparency regime in particular would strike the right balance between protecting investors and not undermining liquidity.

Taxation

Consideration would also need to be given to the issue of taxation in order to pursue the goals of market integration and greater efficiency, although this was a difficult subject to broach. Withholding tax was still a major problem in Europe; investors were often double taxed, and the EC aimed to devise proposals to address this. The differing tax treatment of equity and debt, and how this influenced issuance and investment behaviours was another issue. The current debt bias should be addressed through the EC's legislative proposal on the common consolidated corporate tax base. Creating a catalogue of best practices that had arisen in EU Member States (e.g. fiscal incentives for SME equity investment) could also help, a panellist suggested.

Post-trading infrastructure

Creating a more efficient post-trading infrastructure in Europe and reducing costs in this area was also

important for achieving the CMU objectives. Much had been done over the last few years, including EMIR, the regulation on CSDs, the SFTR legislation, and TARGET2 Securities. Next year, the EC aimed to evaluate what had already been done and what more was needed. Developing an appropriate framework for the recovery and resolution of CCP was a key issue in particular.

Technological innovation and fintech solutions: an important element of the CMU

The CMU and fintech were mutually reinforcing, several panellists stated and the importance of technology should not be underestimated by policymakers. The future of finance would be data driven, online, and heavily personalised. Fintech and technologies such as the distributed ledger, had the potential to make capital markets more efficient and broader and to develop cross-border investment, eliminating constraints related to geographic location and legacy processes and systems. Innovations, such as peer to peer lending and crowdfunding could also allow for closer ties between lenders and borrowers. In addition, data analytics and artificial intelligence used for example in robo-advice could potentially improve investor service and risk management.

However, the legal and regulatory barriers and the lack of standardisation that impeded unified capital markets would also hinder fintech development, some speakers believed. Moreover, technology created new challenges. The traditional financial sector players would need to balance the benefits of these new business opportunities against the risks of being disintermediated, and against those linked with sunk costs for obsolete ICT investments. Fintech would also lead to the loss of jobs in the financial sector, foster algo trading and the related disruption risks, and increase cyber-risks. ●

Output of the call for evidence: what key issues to be addressed in EU financial regulation?

KEY ISSUES | *The session highlighted the main themes and the supporting evidence emerging from the EU Commission consultation launched to understand if the legislation has struck the right balance between reducing risk and enabling growth, avoiding creating barriers. Attention had also been paid to the interactions between the different regulatory pieces and related possible unintended consequences. The influence on this review of the current economic and monetary environment was also be examined.*

The call for evidence has generated a great deal of interest.

The call for evidence was launched a few months ago. Around 300 responses had been received with something like 600 documents of supported evidence.

The panellists largely shared the view that the call for evidence was not about re-writing the legislative and regulatory rule book but about fine-tuning it where necessary. Stakeholders do not question the rationale of the reforms and the big picture as all the legislation responded to weakness in the run up to the crisis or during the crisis. It was not disputed that the core elements of the regulatory framework needed to be in place as it was part of the G20 commitments made after the financial crisis.

A policy maker explained that respondents provided very clear examples and descriptions of where rules are perceived to be inconsistent, overlapping and duplicative, notably in the area of reporting requirements. But he also stressed that there were a certain number of reasoning but generally a lack of quantitative evidence on the markets impact of the different rules that would need to be taken into account going forward.

Industry representative partly disagreed and said that there are certain effects of the regulatory change which were clearly demonstrable in terms of evolved behaviour within the markets, even if pinning them back to specific regulations was difficult.

The scale, the pace and interconnection of regulatory changes made the assessment difficult. In addition, many of the regulation in question were still in flight and it would be some time before their precise impact was known. Yet certain effects were clearly demonstrable, even though the task of pinning them back to specific regulations was a difficult one.

However, because so many changes had been introduced over such a compressed period of time a speaker wondered if for example the reduced potential for immediate execution in markets was a problem or if it was simply a growing pain coming from an evolved regulatory ecosystem. When it comes to the question of the cumulative impact of regulation, it was a single question that had a thousand complex and interconnected answers.

Three main concerns raised: proportionality, financing availability and market liquidity, compliance burden

Three main themes were emerging from the responses to the call for evidence explained a policy maker. They could be organized around three main themes: proportionality, financing availability and market liquidity, and finally compliance burden.

Some of the rules which not fit to the size of companies, their business models and their risk profiles, might stand in the way of the diversity of the financial system. Beyond the banking sector, investment firms were a good example. There should be a distinction between capital requirements imposed on large bank-like investment firms and those imposed on smaller firms. Proportionality was another concern. It had to do with derivatives trading. The rules are too complicated to be applied to small financial institutions and non-financial companies and, reporting requirements in EMIR (European Market Infrastructure Regulation) were too burdensome and costly. On banking, these elements were going to feed into the CRD IV/CRR (Capital Requirements Directive/ Capital Requirements Regulation) review which was taking place. EMIR was also underway.

The second main theme had to do with the amount of financing available to the wider economy. A number of respondents, unsurprisingly, claimed that capital ratios and liquidity rules made it more difficult for banks to lend to the economy. This will be assessed in the CRD review. >>>

>>> A second important sub-set was concerns expressed about the declining market liquidity, in particular in the area of corporate bonds. There had been, a very substantial contraction - between 40% and 75% depending on the asset class - in fixed income bank inventories. Many banks had also withdrawn a huge amount of repo capacity, which was crucial for the capital market union, and the consequence of which had been a reduced capacity for effective risk transmission between financial institutions. That was why the Commission was undertaking a comprehensive review of liquidity in corporate bonds markets.

The third theme had to do with often too high reporting duties due to unexpected interactions, inconsistencies and duplications between different pieces of legislation. Finally, there was also the point of the volume of information that was being asked for from market participants, which was not always proportionate to the risks that they actually posed to the system.

Three areas for progress relating to proportionality and compliance

A regulator suggested three areas for progress relating to proportionality and compliance: the remuneration guidelines, product information and two-side reporting.

A proportionate application of the remuneration guidelines there had been an intense internal debate on this issue at the EBA as well as at the ESMA (European Securities and Markets Authority). One should allow, for example, exemptions for smaller UCITS (Undertakings for Collective Investments in Transferable Securities) and also for smaller amounts.

On product information and the so-called pre-contractual information, PRIIPs (packaged retail and insurance-based investment products), which was coming into place, was a big step forward in terms of consistency across the three sectors. PRIIPs technical standards were made consistent with MiFID. However, the information demanded from UCITS do not meet the new MiFID requirements.

Under EMIR for smaller non-financials, one-side reporting where the financial counterparty would report on behalf of the couple, could be considered. Doing it for EMIR would also bring it in line with the STFR (the securities and financing transaction requirements), which was moving in that direction.

Industry representatives warned also on weak bank profitability, bank riskiness as perceived by investors and upcoming regulations from the Basel Committee

An extremely weak bank profitability came from the macro environment but also from the fact that

the overall regulation, the resulting capitalisation (indeed leverage had diminished from 25 to 18), and the regulatory uncertainty that had increased. Indeed, before the crisis, the return on equity of the European banking industry was about 13% while it was standing now around 5%. But only five points had been lost due to the decline on return in assets, low volumes, slow growth and high NPLs and a high cost of risk.

Such a situation was very dangerous and counterproductive as it would lead to financial instability, upsetting the monetary policy, and to bank consolidation, which undermined 'too big to fail' policies. It might also lead to diminished lending.

Furthermore, the risk perceived by investors in the industry had not declined despite the policies implemented together and the subsequent decline in leverage. The cost of equity before the crisis was about 8% or 9%, of which around 3% to 4% were the risk-free rate. Yet, despite a risk-free rate, which was now close to zero, the bank equity risk premium continued to be 4%. If the industry was less profitable, it should also be less risky.

Concerns were also expressed regarding upcoming Basel Committee regulations. Firstly, banks applying the Basel Committee initial draft reforming internal models, would be pushed to only offer standardised credit to SMEs (small- and medium-sized enterprises). Combined with the (negative) consequences of IFRS 9 - which was in fact a trading view on the banking portfolios though notably SMEs loans were not saleable in the market and kept up to maturity on banks' balance sheet, this would lead banks to lend less to SMEs.

Similarly, specialised lending such as aircraft, railroad, shipping financing, and project finance... would face increases by more than four times of risk weights, which did not take into account EU banks track record in managing these risks. Those constraints would come on top of the difficulties faced companies and projects to get to the bond markets since banks were bringing less liquidity.

The Basel Committee reform on the IRRBB ignored also the track record of EU banks managing fixed interest rate mortgages that correspond to borrowers' wishes in certain countries, because of the regulatory cost of fixed interest rate kept on banks' balance sheet was much too high.

Need for a pause and a clearer view of what regulators want.

An industry representative asked for some kind of pause in terms of the introduction of yet more >>>

>>> regulatory changes. The idea was not that there were no needs of further regulatory changes. But it was very difficult to accurately anticipate what that should look like without having a better quality data to understand where we were now.

An appropriate balance between financial stability and growth

The call for evidence was just one building block of the whole programme of the capital markets union, the objectives of which were ultimately to foster economic growth in the EU. However, financial stability and the resilience of the systems needed to be kept provided that sustainable growth needed it as a foundation.

Regulator stressed that the objectives of prudential and consumer protection regimes were not to have long-term investments or to foster growth in the economy. Conversely a policy maker observed that if there were no growth in the economy, there would be instability in the economy, which would be mirrored by the financial system.

Looking at the impact of regulation on financial markets with partners from other regions

An industry representative made the point that EU institutions should not be too inward looking

as the relationship between the EU and partners elsewhere was critical for looking the impact of regulation on financial markets. A European policy maker suggested that Europeans should wait at least a year after the US implementation of international banking regulations before adopting to take into account potential changes requested notably regarding Basel 4.

Better balance between Level 1 and Level 2 approaches

A public decision maker stressed that a big part of the regulatory framework was in level 1, which was more difficult to adjust while technical standards offer the possibility to adjust more easily once the impacts are observed. Regulators acknowledged that elements in the securities markets like the clearing of derivatives, the trading of financial instruments, the degree of liquidity of financial instruments, were now regulated with technical standards provided that to some extent, a supervision decision might be more appropriate. A European policy maker reacted by saying that experience showed that problems that had not been solved on Level 1 would never be solved on Level 2. ●

Juncker Plan: what lessons can be drawn from the first 6 months?

KEY ISSUES | *The EU Investment Plan was announced in December 2014. It has been launched to remove obstacles to investment notably in infrastructure and SMEs, to provide visibility and technical assistance to investment projects and make smarter use of financial resources. This Investment Plan was intended to mobilise investments of at least €315 billion in three years. In July 2015 the related legislation entered into force, in the Autumn 2015 the European Fund was created, and finally the European Investment Project Portal was launched at the end of 2015.*

In this context, the session tried to contribute to a first assessment of the steps already taken by this EU initiative, provided that by mid 2016 the EU commission was expected to start taking stock of those recent initiatives.

A three-pillar approach to unlock investment in the EU

Weak investment was a major concern for Europe. The investment level in the EU had fallen to 18% of

GDP, against a historic average of 21-22%. There had also been a number of regulatory barriers needing to be tackled, and constraints such as low rates and little margin in the EU budget. >>>

>>> Therefore, it was necessary to take some action, and this had been one of the first decisions announced by the new Commission in December 2014: to launch an investment plan for Europe, consisting of three pillars. The first was the EFSI, a €21 billion guarantee from the EU allowing the EIB to lend €63 billion, leading to a total additional investment of €315 billion on riskier projects. The second was an attempt to help promoters to put forward well-defined projects, via the Investment Project Portal, and advice and technical assistance for project structuring, via the Investment Advisory Hub. The third was improving the investment environment via removing barriers and reinforcing the internal market.

The Juncker Plan: main innovative constituents

The EFSI had been designed to maximise efficiency of public spending, with the guarantee allowing the EIB to act differently. The Commission wanted the EIB to focus on investments which truly needed EFSI presence in order to take place or be more ambitious. Thus the Commission was helping the EIB to take more risk, and ensure that the investments it made were truly additional.

The second pillar was helping investment to be unlocked. Advisory support had been beefed up, via the European Investment Hub as a single access point for technical assistance. Going further, the Commission wanted to make sure that the Hub could permanently be accessed even when EU funds were not used in the project. The idea behind the European Investment Project Portal was that a project promoter would be able to put a standard description of their project on the website, and investors from all over the world would access the portal and look for investment opportunities. It was expected to go live in June 2016.

Regulation – the third pillar – was the most important element in the medium-to-long term. The Commission had already taken a number of initiatives in this respect, aiming notably to facilitate market access for SMEs with, for instance, a revision of the Prospectus Directive. They were working on credit registers and improving securitisation, and had lowered capital charges in the insurance sector for investment. Other initiatives were also in the pipeline.

Juncker Plan in Action

The EIB used the same teams to appraise Juncker and non-Juncker projects due to the nature of the risks being taken, which require a great deal of expertise. The regulation was very clear that the EIB, who could be tempted to avoid risk, or be exposed

to too much politicisation in the choice of projects, did not have to be a party to the decision for the EU guarantee eligibility. The decision on eligibility, was made by an independent investment committee, comprised of experts who assess the specific level of risk. Consequently prior to the Juncker Plan, the EIB had €4-5 billion of risky activities, out of a total of €80 billion a year and it is going to go up to €20 billion yearly. The speakers were very much on the same page talking about a first-loss piece or a real guarantee to kick the project off. However, there were blanket loans with no subordination. Indeed, private investors were looking forward to seeing more of equity pieces, as well as structured finance situations, which large insurance companies and asset managers could see as attractive, because they were actively seeking investments with 20 to 30 years' maturity

It was suggested that the policymakers had gotten the sequencing wrong. Ideally the Portal and the Hub should have been implemented first and the structural reforms would have to begin soon. In practice, the EFSI was moving faster than the other aspects of the Plan. The Portal and Hub was not seeing results as quickly as had been expected. However, the EFSI had made a good job advancing the objectives in unfavourable circumstances.

The SME window had worked well, in part because of the area's maturity. The EIF had first-mover advantage, but as the economy improved member states would put their own schemes in place. Many were putting in structural funds, but the EIF needed to keep its leading role given its expertise.

The infrastructure window also mainly had projects in sectors with more mature policy and pipeline. Energy and transport both had stable policy environments, whereas the digital union was still taking shape. An aggressive link to capital market financing should be looked into, but the infrastructure window was challenging as it was a big area with many interlocutors.

The National Promotional Banks were supposed to be aggregators for smaller projects, with local expertise. However, there was more fragmentation in public than private banking. The desire was for the national promotional banks to learn from each other.

Assessing Success

Presently, there was an investment and infrastructure window implemented by the EIB, and an SME window by the EIF. For both institutions, 220 transactions had been approved in 25 member states, with a total investment of €82 billion. The infrastructure sectors that had been very >>>

>>> attractive were energy – particularly energy efficiency and renewable energy – and transport. The Juncker plan was at 26% implementation.

The Commission preferred the EIB to be generating additional investment rather than investment which would have taken place anyway. The second main ambition was a very high level of leverage between public guarantees and private investments. Thanks to the support of the guarantee €20 billion of risky activities would be reached each year for the next three years within the EIB. This was a clear change in the DNA of the institution. They were moving to smaller projects with much higher risks. The more additionality looked for, the riskier the projects, the more that public guarantees would be utilised.

The EIB had plenty of infrastructure on its books. On the other hand, there were many small- and medium-sized insurance companies that did not have the ability to assess infrastructure projects. Something that was being looked at was the securitisation of a number of projects that could then be bought by smaller investors. This did not deal however with the issue of existing regulatory constraints, but it could be part of the solution.

In the initial communication of the Investment Plan, the Commission had expected creation of between 1 and 1.3 million jobs, which had yet to materialise. The Investment Plan would have a positive impact, but it could not be immediate.

The EFSI was important for three reasons: first, supporting investment; secondly, showing the EU cared for investment as well as necessary structural reforms and fiscal adjustment; thirdly, to test a new medium- to long-term approach to public spending. If successful, it would generate €315 billion of investment with only €8 billion put on the table.

Investment focus issues

There were some question marks over whether the EFSI was entering areas typically financed by the private sector. Looking at geographic distribution of EFSI and EIF funds, 80% sat within Italy, France, Germany and the UK. This was understandable, but for those markets the private sector had sufficient firepower and experience itself. There was a need to channel surplus savings from northern European countries to southern European countries, rather than them going outside Europe. There was no quota per country, despite pressure from the Parliament, because it would create a permanent suspicion from private funds around the quality of the projects coming up under the EFSI label. However, the EFSI needed to take steps to make sure that projects were distributed among countries, with no country having too many.

At the same time, more effort was needed to engineer projects in the more vulnerable southern rim of Europe. Typically, it was this kind of country where, because of the level of risk, a first-loss piece was needed. The EFSI would along in the mezzanine and other investors in a senior tranche. It was one of the reasons why the Commission had provided guidance on how to associate structural funds with the EFSI. The Investment Plan not only allocated €8 billion to EFSI, but set out the target that 20% of the structural funds should be used in similar initiatives. There were big teams on the ground in countries like Greece to originate such projects, as well as a dedicated EIB taskforce, but it would take patience.

50% of funds were targeted towards the energy sector, but this was an area that was being served by the private sector notably as large insurance companies were targeting green or renewable investments; was the field getting a bit crowded? At the same time, there were a great deal of interesting projects, but almost nothing dealing with social infrastructure, in terms of education, health or social housing. There were more social projects on the way, particularly with EIF, and the Commission was working with to increase the firepower of the EaSI programme by 50%. They would support microfinance, social enterprises and incubators for social enterprises, a great deal of which would be rolled out in Q2 and Q3 2016. The social area was one where investment due to the high risk, but there was a real need to find a way to address it.

Geographic concentration was a negative element, but unfortunately monetary policy seemed to play against the mobility of capital, as it put a brake on the incentives for investors to diversify their portfolios. Governments and the Commission should examine the need for sectoral concentration. Perhaps a quota should be included around social investment in the overall plan.

Legal certainty for investors required strong efforts

There were fundamental concerns around legal certainty in Europe, a substantive issue in relation to longer term projects. There was a danger in changing the rules post-investment, and this should be avoided as it did not help private sector investors to feel comfortable with money committed for 20 to 30 year terms. Furthermore, private investors are facing a lack of a single market regarding tax law and insolvency and company law. If investment and growth in Europe was to reach the next level, then this would need to be tackled.

Moving Forward

In order to make sure this was not simply 'business as usual', the EIB needs to develop new >>>

>>> instruments and partnerships. The EIB is developing much more subordinated debt than it used to do, and was already taking more risks. It was working on an equity strategy. With the National Promotional Banks, the EIB was developing platforms, as well as strong relationships. There were a great deal of difficult issues to be discussed, such as delegation and how far the EIB could delegate the decision on the project to the platform. This had to be solved, because there was a need to avoid having too many people reviewing, and making it too heavy.

There was also work, country by country, to identify market failures and how the EU guarantee could make a difference. In addition, although it took more time because it was more difficult, they would also like to see cross border projects supported by the Juncker plan.

When the Juncker Plan had been launched, there had been a lot of commitments from the National Promotional Banks to provide co-financing alongside the EIB. They could also bring projects to the table, since they were to the ground, to local projects and SMEs. Bigger projects were easy to finance, but for those under €50 million it was difficult to access the market, whilst it was too small for the EIB to deal with directly. The success of the EFSI relied on the EIB, but also on

the implementation of good projects, presented by promoters from both the public and private sectors. The National Promotional Banks could add value here, due to their networks.

The bigger the risk, the more the guarantee would face losses, but this was what the guarantee had been built for. A loss of €8 billion whilst generating €315 billion of investment would be a good deal. Risk-talking was the key element for success, otherwise they would be financing without the risk. There was a common responsibility for all parties to ensure projects were focused on risk. In addition, the Investment Plan was also important to signal reform of the use of EU money.

The steering board of the EFSI had refrained from being too prescriptive in terms of sectoral focus. Projects should be learned from and the market would adjust. It would have been abnormal to have a large quantity of social projects, when the EIB expertise lay primarily in energy and transport, so there was a need to use the good people and expertise and move on from there.

Finally, the third pillar of the investment phalanx, structural reform, was acknowledged as being the core of investment and growth policy for Europe, of which EFSI was one instrument. ●

Securitisation: is the EU proposal up to the challenges?

KEY ISSUES | *The session tried to clarify the ambitions and the expected contribution of the EU securitisation framework in the EU Capital Market Union context. The session also outlined how to make effective progress toward an efficient and consistent EU securitisation framework. In particular, the session addressed the risk specificities of securitisation techniques as a prerequisite to achieve an accurate calibration of the framework.*

Background to the Securitisation Proposal

The securitisation market was not only about how much was issued, but what was issued, what was placed, how many were buying, how many people traded, and what the secondary volume was. There was no single metric showing a positive development. Volume was in decline: 15 billion had been placed in Q1 2016, with 35 billion of retained issuance. Primary supply continued to be net negative, meaning the market was shrinking. In the last few months, four broker dealers and market

makers had been lost, a trend which was continuing. Half of the research houses from five or six years previously were left, reducing market transparency and coverage. A reduction in trading, research, inventory and in-house infrastructure was very difficult to restore. There was also concern about two effects that were very specific to Europe: the sovereign cap and the tranche maturity.

In 2005, market issuance had been around €320 billion of European securitisation. In 2015, levels had been roughly two thirds of those in 2005. >>>

>>> For auto ABS, which was the largest chunk of this, issuance was around €7 billion in 2005 and €35 billion in 2015. That segment of the market was functioning fairly normally, where debt was placed with real investors; the CMBS and SME portions of the market, though, remained quite small.

Securitisation ticked many of the boxes of Capital Markets Union. For large banks that had the choice of issuing unsecured debt, tapping into covered bond programmes or using securitisation platforms was just one of many options. However, for small- and medium-sized banks and other small financial institutions, it was a primary source of funding. Securitisation also enabled banks to manage their balance sheets and recycle capital. Getting securitisation regulation right was critical, and time was of the essence. Expertise was leaving the market, and it was important to get this right. Furthermore, at present, many SMEs were too dependent on banking finance. A strong and profitable banking industry was needed in Europe, so this was a key moment to launch the CMU.

The issues that regulatory proposal needed to address

It was important to have true recognition of the risk transfer in securitisation, as securitisations were generally quite an expensive form of funding. In actuality, experience of dealing with regulators suggested that it was very difficult to prove that no remaining risks or rewards stayed with the bank. The Basel capital calculation had been done in a very opaque way. The negative 'c' in the 'p' factor in the IRB formula was one example. Taking complexity and structural risks into account in terms of capital charges on the whole waterfall, might make sense to a certain extent, but the reduction of those risks via the conditions set by the STS regime should also be taken into account and lead to a relief of this extra capital cost. It was also important that STS securitisations had equivalent treatment to similar instruments. AA treatment, at least, should be achieved from a liquidity perspective, such as covered bonds, in all LCR determinations.

Insurers had more liability than asset managers, and for them this period had been quite difficult. Securitisation would not be bought if it was either more complex or riskier than other classes. The simpler it was, the easier it was to put money into. Compared to covered bonds, securitisation in Europe was not at all competitive. Securitisation was the only class of asset where there was a risk of criminal sanctions; therefore, covered bonds would be the preference. There should be real proportionality in terms of the sanctions to market participants linked to due diligence, whenever they

acted in good faith; this should be recognised and credited. Penalties should only be applied in cases of negligence or deliberate misconduct.

The functioning of the secondary market was also important. The Commission should ensure that the market transparency requirement and other rules impacting market-making were fully aligned with the objective of the CMU. Borders should be opened up to make sure that securitisations were open to non-EU investors and originators. Only then would there be stronger capital markets in the future.

Sensitive issues related to securitisation

The proposal was to take the prospectus and securitisation into a dialogue in Parliament soon. There was a constructive attitude in the European Parliament. However, building a political and broad majority in the Parliament would take time, given the level of detail. In addition, the lessons of the past needed to be learnt, not only for explaining it to the public, but to reach a majority in the Parliament.

Securitisation had two functions: to be a stable source of finance, and to be able to transfer risks from banks to other financial institutions. Looking at the past performance of the market, it had been less than stable. It was now approximately one tenth of pre-crisis levels, and it had nearly halved from 2008 to 2009. New issuance had decreased dramatically from pre-crisis levels. The difference between failure rates in the EU and the US was staggering. The same went for the transfer of risk. Securitisations were now seen, but they were largely retained.

The incentives needed to be examined from the investor side, but also from the supply side. However, if capital charges were higher and it was more complex, it was not clear that investors would enter this market.

Securitisation was indeed toxic in most people's minds, but it meant different things in Europe and the US. The default rates of AAA securitisation products in the EU, at the start of the crisis, had been 0.1%, compared to 16% in the US. In addition, after the crisis, European regulators had introduced significant restrictions in underwriting standards. The fact that underwriting standards had been restricted effectively meant that it would be difficult to create a bad product to go into securitisation.

Two things were being conflated within the word 'securitisation'. The results of the securitisation of the US were fundamentally different from those in the EU. One type of securitisation >>>

>>> could be separated from the other by the introduction of criteria, some of which were fundamentally different to those in the US, such as the requirement for 'skin in the game', the diversification requirement and the transparency requirement. STS capital requirements in the EU were already more ambitious than at an international level. A convergence with the US was positive, but it needed to be debated. The Commission, having produced these criteria, had enabled the international discussion to evolve.

According to the agreed schedule, they would pass both regulations in the European Parliament in November. They were at a key political moment, and could not afford delays in the dossier. What mattered was that it was being looked at carefully. If the work of the Parliament was such that it increased the appetite for STS, this would be positive. However, it was also not clear that removing the stigma alone was sufficient to make the market stable.

Potential Solutions

There were two levels: the political and the technical. There was no doubt that at the technical level there would be close co-operation and solutions would be found easily. Among the different responses of the industry, there had been quite a few workable proposals as to how to address some of these issues. The point, however, was that the stigma made the political debate very difficult.

Despite talk of toxic securitisations, this was really a portion of the market where the risk had been emanating from the US housing market. In Europe, less than half of 1% of rated securitisations had suffered any principal loss, and that had been during a period of extreme economic stress.

Finally, there was not concern around the direction of travel, but around whether the destination would be reached. ●

Equity financing: what priorities for developing equity markets in the EU?

KEY ISSUES | *This roundtable discussed the main obstacles to equity funding in the EU, whether the on-going actions (CMU, MiFID II...) are likely to foster a development of equity markets in the EU and the additional actions that may be needed. The role that the on-going expansion of fintech solutions and electronic platforms may play in the development of equity markets will also be examined.*

Obstacles to the development of equity financing and issues to be addressed

A funding gap between £2 million and £10 million revenues had been identified in the UK market for small growing companies that could not go to the banks for money and needed to access long-term finance. A specific fund had been successfully set up backed by banks (the British Growth Fund - BGF) to invest equity in this SME segment. The standardisation of the investment process and the close contacts of the banks backing the fund with the companies involved were the key factors in their success, as was the diversification of the investments that had thus been achieved.

Several panellists however felt that the European economy as a whole did not at present have a funding gap, although one might materialise in the near future if banks continued to deleverage and if

Europe's capital markets could not provide sufficient alternative funding. The current issue was more a lack of diversification, with under-developed equity channels relative to the size of the total economy.

One speaker stated that Europe lacked an equity culture, particularly compared with the US. There was a general lack of equity demand, both from retail and institutional investors and retail participation in particular should be encouraged by all possible means - directly or indirectly via investment products. Another speaker emphasised that equity investment was very difficult and best performed by professional investors (e.g. fund managers) who had the necessary time and expertise to make appropriate diversification decisions. Private equity markets also needed developing.

The European Commission (EC) had been attempting to make progress on this issue, >>>

>>> but this required time, as the issues were related to historical legacies, societal choices, and sometimes culture. Negative economic forecasts both globally and in Europe and a lack of good projects to invest in were other potential obstacles to equity financing; some panellists believed that although growth prospects were reasonably good, leadership and the collective willingness to realise these achievements were lacking. Moreover the absence of regulatory and fiscal harmonisation within Europe was an obstacle to cross-border investment, as well as the lack of easily accessible information on SMEs. Additionally, there were now fewer analysts in the market, which was increasing the reluctance of investors to invest cross-border and increasing the disconnect between retail and institutional investors.

On the issuer side, taxation currently favoured debt financing over equity financing. Moreover there was a lack of awareness among SMEs of the different available financing options. Some domestic initiatives regarding business education had been put in place but this needed extending. Bankruptcy regimes sometimes showed a punitive approach to failure and this discouraged risk taking in the EU, which the EC was aiming to address legislatively, as well as improving insolvency law in general.

Possible EU level solutions for increasing equity financing

The EC had begun the roll-out of the CMU Action Plan, which aimed at developing EU capital markets and reducing reliance on bank funding, but a great deal remained to be done and the approach was incremental.

The review of the Prospectus Directive (PD) was among the short term priorities of the CMU. Currently prospectuses were too long and complex for most investors and were mainly used by issuers as a legal tool and by professional equity analysts. Some short term improvements were suggested: a simplification of prospectuses for existing issuers (representing about 70% of UK prospectuses for example), relying on the information that had been provided previously; a streamlining of disclosures for SMEs; and thirdly, taking smaller issuances out of the pan European regime. One institutional investor believed that the PD review could have been more radical in allowing the prospectus to be brought forward within the IPO timetable, with the publication of research into the company in question delayed until investors had already received this prospectus.

MiFID 2 which would come into force at the beginning of January 2018 would introduce additional rules for the improvement of investor

protection and advice, as well as tools such as SME growth markets which could further contribute to developing equity investment. However, the unintended consequences of these rules which may in particular limit the willingness of banking networks to sell equity should be avoided. The new form of ELTIF that had come into place at the end of 2015 together with adjustments to Solvency II requirements was another positive development.

A stronger focus of trading venues on equity markets was also needed. For there to be a true equity culture and equity market across Europe, there first needed to be proper equity focused venues, connecting those who had money with those who had projects or business ideas. Properly regulated markets, capable of addressing the needs of all types of issuers and investors, needed to be in place. Trackers, indices and HFT were extremely important for the provision of liquidity to equity markets, but without market infrastructures focused on equity, the 'critical mass' necessary to ensure an alignment of interests between all market participants in the ecosystem would not be created; the focus on channelling funding towards projects and businesses would be lost also.

Some panellists also emphasized the importance of a common vision and of a single rulebook. Many of the achievements that had been realised thus far had not resulted from new regulation, but from vision and determination. The core elements that were necessary for promoting European equity financing were present; the challenge was pulling them together and approaching them with a degree of vision and sufficient scale and efficiency, as had been done in the case of the BGF fund mentioned previously.

There also needed to be a collective transition towards a single rulebook that would encourage the development of risk capital on a domestic and cross-border level. Europeans needed to be more self-confident about their collective capacity to make these developments happen. The CMU was achievable and should not be impeded by those who were sceptical about its chances of success.

The possible role of technology and electronic platforms in fostering equity financing

Some regulated platforms e.g. some e-brokers were increasingly working with robo-advisers for which they sent orders to the stock exchange. Other venues had a more passive attitude to these developments for the moment, monitoring innovations and focusing instead on their core business. Sufficient scale and standardisation were needed for innovative solutions to expand, which was not the case at present. >>>

>>> Regulators and politicians often did not feel familiar, or comfortable, regarding new technologies, but the EC nevertheless aimed to have legislation in place that did not hinder their development. Taking the example of crowdfunding, it would be beneficial to have a single European framework that was resilient, conducive to investor confidence, and enabled a free cross border flow of services; however, proposing legislation at too early a stage might hamper the development of crowdfunding and 'fossilise' the market. As such, the EC had not proposed to legislate on this issue at this stage.

Some domestic regulators were taking action. The UK had announced a 'regulatory sandbox', which meant allowing firms to test particular product offerings with live consumers, in a safe environment with no risk of 'ex-post' repercussions. Regarding crowdfunding, simple investor protection rules had

been put in place in the UK to restrict the proportion of a portfolio that an investor could put in a crowdfunding investment. France had established a national regime a year and a half ago; a light-touch approach had been chosen that aimed to find the right balance in the market and allow requirements to be adapted relatively quickly if necessary.

Many discussions were presently taking place among regulators at the European and IOSCO levels regarding fintech and blockchain; one panellist noted that, in the case of blockchain, it was important that someone should be held accountable for making the server work. Transparency and security were critical for these solutions to be operational. The speaker was confident that these innovations could be incorporated into the market. The challenge was aligning regulators, innovators and market players, and this could be achieved. ●

Retail investment: how to attract retail investors to EU capital markets?

KEY ISSUES | *This roundtable discussed the importance of retail investors for the development of capital markets in the context of the CMU, the main obstacles to overcome and the regulatory and market-driven actions needed to increase the engagement of retail investors in securities markets. The role that technological innovation may play in developing retail investment was also examined.*

Retail investment needed to be redeveloped

Both institutional and retail investment in securities had decreased over the last few years. In the current economic conditions, greater participation from retail investors was necessary. Capital markets needed retail investors in order to develop and retail investors needed capital markets to get better returns on their money than with savings products. In Europe the two did not interact sufficiently. It could have been assumed that retail investors would complement their portfolios with securities in order to have higher returns, but this was generally not the case. The current reality was that investments in funds and shares were unsatisfactorily low, investments in bonds had plummeted and cash and deposits were increasing. Moreover 85% of investors had less than €50,000 to invest in capital markets.

There were many reasons behind this situation. European culture mostly favoured saving over investment. There were also issues related to financial

education, the limited development of pension products and tax. A shift in that dynamic and asking retail investors to take more risks in their investments was necessary, but was difficult to achieve and would take time, particularly in the current economic circumstances and at a time of low confidence.

Retail investors also lacked experience of the functioning of capital markets and were generally the last ones to gain from upcoming momentum in the market and the last ones to get out from a market that was slowing down.

There were many obstacles to further developing retail investment

A first obstacle was a lack of trust in financial markets. Surveys had indicated that whilst savings gave investors feelings of confidence and control, investments generally produced confusion and anxiety. The market was riskier and less certain, and so work needed to be done to build >>>

>>> trust. This required providing investors with the appropriate information and advice, as well as strengthening financial education. Better information was preferable to more information. Investors also needed more experience of the capital markets in order to better understand how markets fluctuated, the related risks and how profits could be made.

Less than one in five investors actually got some advice with their investments either because they were not able or willing to pay for it. This was significant, as it had been established that individuals who received assistance did then go on to think longer term and make more appropriate investments.

There were four stages identified on what investors considered when deciding what to do with their money. First was the understanding of investment products; second was being sold the right product; third was maintaining a flow of information on the development of the product; and finally was the issue of redress, should the investment go wrong. Each stage carried the potential to significantly impact trust in the financial market. Regulation should help in this respect, but improvement would take time. Some speakers also considered that the regulations aimed at improving investor protection could have negative side-effects that needed to be considered, making it more difficult for intermediaries to sell investment products and making costs higher and access to the markets more difficult in some cases.

Some improvements should be expected from the Capital Markets Union (CMU) action plan

The EU Commission (EC) had worked on the regulatory framework over the recent years in an attempt to provide retail investors with better information, improve investor protection and rebuild trust, but those regulations were still in the implementation phase.

The CMU had relaunched the idea of the personal pension plan, possibly in the form of a 29th regime, some proposals for which would follow later in the year. Tax incentives were a key issue to examine in this regard with the Member States. A public consultation would also be launched, prior to the summer, on what more could be done to create a single market for investment funds in order to generate better returns for investors. Furthermore, the EC planned to conduct a study on retail investment products and how the European market functioned, to see whether retail investors could access sustainable products on cost effective terms. They also wanted to analyse how the policy framework should develop for the market to benefit from online-based services.

Finally, they had not reached a decision on the financial services green paper. A policy paper would be tabled after the summer which could propose additional actions to help retail investors get better value for money when entering capital markets.

The CMU was ultimately favouring more harmonisation and actions to attract more investment in the EU. This could be done through three routes: internationalisation by encouraging more cross-border investment notably with a stronger role of on-line platforms, disintermediation which would reduce the obstacles created in the market by intermediaries, and long term thought compensating the usual short-term bias of investors.

Additional actions were suggested regarding advice, investment products and market infrastructure

Actions to make investment advice more affordable and accessible were needed to restore trust. European regulations should help in this respect. A proposal had also been made by investor representatives to require advisors to connect with their customers regarding their portfolio on an annual basis.

Moreover the retail capital market ecosystem needed to be restored. Retail investors were currently taken aback by the fragmentation and complexity of the European market, a panellist emphasised, with multiple venues focusing on institutional investors, blue chip securities and execution-only services. This was damaging the ecosystem serving retail investors, stock exchanges were a part of; in addition, local intermediaries that were providing services for retail investors were stifled by constant changes in regulation. Regulatory developments such as MiFID would however help create greater transparency and reduce costs in markets, a panellist pointed out.

Favouring simpler investment products more directly connected with the markets and the companies concerned was also suggested. This would be a way of better aligning the long term interests of investors with those of the companies they were investing in and of developing the experience investors had with capital markets. Some speakers regretted that investors were often driven towards packaged products which were more difficult to understand and more costly than ordinary securities. Actions to foster investment in stocks and bonds were not emphasised enough in the CMU, some considered. A suggestion was made that distributors should be required to show and explain differences between complex investment products and simpler, cheaper alternatives. This was however considered to be difficult to enforce through regulation. Another suggestion was to favour simple fund structures that would allow retail investors to invest in SMEs that could for example provide them with specific rights in return. >>>

>>> Technology could also help to facilitate retail investment

Technology had the potential to link individuals with the capital markets more efficiently, and to simplify the paper chase currently used in taking out investment products. Two thirds to four fifths of people dropped out of the investment process because of the on-boarding process required when making investments.

Robo-advice had the potential to be used to provide guidance with investment decisions, asset allocation and consistent client servicing in a cost effective way, reducing significantly the data collation process in particular. Additionally, giving an individual a view of their entire balance sheet was thought to be important for encouraging a long term perspective. However, it was strongly suggested that robo advice could never replace face to face consultations; it could only supplement them. The two could work in tandem to create a superior service that would be led by human experts. The on-line version of robo-advice would indeed be more appealing to millennials, people who had smaller amounts to invest or those who liked 24/7 accessibility, some suggested. Work in

the directions of cybersecurity, confidentiality, and investor protection also had to be considered.

Technology often came with fear and excitement. The task of the regulators was not to fear such instances of new technology, but to understand them. In the future, they needed to collaborate more with those investing in and producing technology, in order to elaborate appropriate rules. Crowdfunding and peer to peer lending was one technological development that had already arrived. Such solutions offered many advantages (direct contact, developing a sense of community) but also came with less investor protection and required more risk analysis.

Developing a digital investment passport comprising all the data required to provide an individual with appropriate investment advice would make the relevant data more accessible and allow a better use of technological solutions related to investment, such as robo-advice. Individuals however needed to be in charge of their own data and to own it, some emphasised, in order to be able to share it whenever, with whomever and to whatever extent they wished, which was not the case in all jurisdictions. ●

Repo and market making: what trends and possible actions in the current regulatory context?

KEY ISSUES | *This roundtable discussed the current and future trends of capital market activities, notably repo markets and market making activities, their underlying drivers and what impacts these evolutions may have on markets and on the broader economy. The regulatory approach that was needed for such markets was also addressed, as well as the means needed to monitor these activities at a European and global level.*

Current and future trends and underlying drivers

Repo and Securities Financing Transactions (SFT) were essential for developing capital markets and achieving the objectives of the Capital Markets Union (CMU). They allowed market participants to access secured financing and were a crucial tool for the functioning and the liquidity of secondary markets.

The European and US repo markets were similar in size, but there were some differences between the two markets. The tri-party market, where the post-trade processing of the transaction is outsourced to a third-party agent, was much larger in the US (50% compared to about 10%). In Europe, roughly

25% of transactions were related to equity collateral, compared to around 10% in the US. The US repo market was dollar-denominated, whereas there was a range of currencies in Europe. The US also tended to be an overnight market, whereas in Europe there was a laddered tenor structure.

There was liquidity in the European repo market, but costs had increased and the longer term prospects were unclear. In the Bund market for example, there was no decline in activity, but tickets were bigger and volatility and failures had increased; the Bund market was however not a market of primary dealers. There was anxiety lest reduced liquidity in the SFT market should increase the impact of a possible market >>>

>>> dislocation. Vulnerability to fire-sales and run risks had been exhibited in the US repo market during the crisis. The Tri-party Repo Infrastructure Reform had since established rules that mitigated these risks to a large extent, but post-default fire-sale risk remained to be tackled.

The repo market was evolving towards higher-quality underlying collateral and relatively standardised terms of price and maturity that could be easily understood and modelled for risk management purposes.

Regulation and monetary policy were the two main drivers of the on-going trends

Regulation had had positive and negative impacts on the repo market. Basel requirements such as the Liquidity Coverage Ratio (LCR), the Net Stable Funding Ratio (NSFR) and the Supplementary Leverage Ratio (SLR) had increased costs but also made the market safer; moreover demand for secured financing was expected to increase. The impacts of these requirements however had to be examined at the business line level a speaker pointed out. Since greater capital had to be applied to some business lines, bank managers would naturally move capital to those with a greater yield and within these business lines to the most profitable clients who were also the most transaction-oriented ones. The other clients, such as pension funds, insurance companies and long-only money managers may end up having less access to the market and higher prices as a result.

Prudential requirements would also impact traditional market-making activities. Alternative providers such as HFT firms were entering the market. MiFID II would impose obligations on those providers if they acted as market-makers, with the objective of levelling the playing field. MiFID II would moreover fundamentally change the way non-equity markets operated.

The monetary policy of the ECB also had a deep impact on the repo market, affecting pricing and the length of maturities. Pricing at present was distorted. It was no longer determined by demand and supply, but mainly by the deposit rate and the view taken towards the future actions of the ECB. At present about 10% of outstanding debt was being bought by the Eurosystem but this had a major influence on market prices; it also helped to maintain the liquidity of the market. More clarity was also needed on the securities-lending programmes of central banks. The ECB and the Eurosystem were at the same time part of the solution, a panellist noted, developing market infrastructure, encouraging tri-party repos and lending to the market, all of which contributed to increasing the velocity of collateral, which was essential for repo.

Way forward and possible actions

A possible regulatory pause

Some panellists suggested that given the current uncertainty in the market, caution was needed. It was suggested that the best that could be done was to take a regulatory pause and to develop a clearer view of how the market was functioning and how pricing was determined, in order to decide the best course for action. A pause would also help to see how much price transparency and depth there was in the market, particularly in relatively standardised trades and instruments.

Other participants considered that there was no need for a regulatory pause. Some issues needed to be addressed and it was preferable for analysts to go over the data urgently. Another suggestion was that regulation – i.e. the SFT Regulation (SFTR), the CSD Regulation (CSDR) and secondary legislation regarding CCPs - could be a way around the obstacles to increasing collateral velocity.

Adopting a notion of ‘do no harm’ was proposed by a panellist. As long as the impact was not known, care should be taken regarding the speed of implementation of new changes. A continuous monitoring of market trends was also necessary. More importantly, if significant issues were identified during the implementation of a regulation, a ‘reverse gear’ mechanism should be available in order to stop or amend the process. This was the type of approach that was intended with the Call for Evidence, which should be used more systematically across legislations. The SFTR would also help to better measure trends.

Central clearing

Developing the central clearing of repo was also proposed. This could alleviate some of the balance sheet constraints of dealers. There would be netting benefits which could release more assets in the market. There might also be benefits for financial stability, potentially reducing the risk of fire-sale under stress. Central clearing was however not a panacea because it increased risk concentration. In addition with repo the underlying assets would have to be disposed of in case of default. Further standardisation of products and of underlying assets would be needed in this perspective. Issues related to leverage ratio rules would also have to be further assessed.

Haircut floors

The FSB had tabled a proposed framework for haircut floors, which Europe would decide >>>

>>> in 2017 whether to implement. Haircut floors aimed at making markets more resilient by addressing contagion and procyclicality risks and excessive leverage. This was a measure that would be desirable, but required further modelling and analysis in order to understand how it would be implemented. There was indeed much variety in the market (types of collateral, tenors) and it seemed difficult to reconcile interests in this perspective. It was moreover suggested that, although the FSB proposal was useful, it was perhaps not the right timing. Developing benchmarks and metrics would in any case be helpful.

Monitoring repo and SFT activities

There were many data gaps in securities financing markets at the EU and global levels.

SFT data that should be available in the EU following the implementation of the SFTR was critically important to monitor the on-going trends in the market, assess the impacts of different factors, evaluate whether there was a failure in the market and determine which tools could help. A challenge was that SFT data was spread out over multiple databases in Europe. A project had therefore been launched at the Eurosystem level to consolidate those databases into one that could be used by the ECB for supervision.

Another issue was that the ECB monetary actions were currently masking the underlying trends in

the SFT market, which required further assessment. The cumulative impact of the different regulatory measures that were going to affect the SFT market in Europe also needed modelling.

Some modelling had been done in the US, but data was still missing; there was some aggregate information regarding securities lending, but more granular and detailed information was needed, particularly regarding bilateral repo transactions. The OFR was collaborating with the Fed and the SEC to conduct pilot data collections in the bilateral repo and securities lending markets, which were due to become permanent. Establishing a partnership between regulators and the industry was extremely important and valuable in order to define from the start what data represented and how to collect it. Moreover it was essential to standardise the data using standard legal entity, product and transaction identifiers. Supervisors were collaborating at the international level in order to understand the differences across markets, the interconnections and the transmission mechanisms of shocks.

There should also be a specific focus on collecting liquidity data regarding market depth or the time it took for a portfolio to be liquidated. Liquidity measures indeed lacked the history of data supporting them that those related to market or credit risks possessed. ●

Investment funds: how to reduce fragmentation in the EU investment funds market?

KEY ISSUES | *The objective of this roundtable was to discuss the key remaining areas of fragmentation of the EU investment fund market, their impacts for investors and the industry as well as the solutions that could be proposed at the EU level to reduce this fragmentation*

The EU investment fund market has remained fragmented

The EU investment fund market has remained fragmented despite the implementation of European product, distribution and investor protection regulations. Investment funds were key to making the CMU a reality, helping to reduce banking finance and increasing capital market finance in Europe. Funds had grown in the EU, but

there was a question of whether investors got the best value for their investments and whether the cross-border penetration of funds was sufficient.

At first glance the European fund industry appeared successful. UCITS and AIFMD were appropriate frameworks allowing the passporting of investment funds across Europe. Many actions had also been undertaken with MiFID II, PRIIPs and the KID to harmonise client information and >>>

>>> investor protection across Member States and across different types of investment products. The objective of these measures was to facilitate investors' access to information and to simplify the process of comparing investment products on a domestic and cross-border basis. Service providers were also facilitating the access of their clients to a broad range of markets and supporting them with reporting requirements.

The EU investment fund sector however remained quite fragmented and some Member States had very few foreign funds. As a result, the EU had three times as many funds as the US; around 30,000. The average size of EU funds was one fifth of the size of those in the US, and the costs of managing EU funds were consequently 50% higher. The large number of small funds increased the regulatory burden for management companies and thus the cost of managing funds, which impacted investor returns. That was an important problem to address to make the CMU a reality.

The levels of fragmentation were however not the same across Europe a panellist emphasized, because some European funds, such as those domiciled in Luxembourg are well passported across Europe and outside Europe.

The EU fund sector was fragmented for various reasons

Only a small amount of the higher fragmentation of the EU market compared to the US could be attributed to different currencies.

Differing implementation across Member States of European legislations related to funds and specific domestic rules were a major source of fragmentation. Several examples were mentioned during the roundtable: additional disclosures required by domestic regulators on the marketing side; high registration fees; the requirement of local paying or facilities agents forcing UCITS to have a physical presence in a host Member State; and inconsistent definitions in AIFMD of who were the return investors and the professional investors which limited the extent to which AIFs could be distributed. Many of these barriers were due to the mistrust between regulators and to differences in the way directives had been implemented. Differences in taxation and concern over double taxation were another reason why retail investors were put off cross border investments within the EU, a speaker believed.

Another source of fragmentation were the inconsistencies across regulations affecting investment funds, for example regarding reporting,

which made cross border distribution and compliance with each set of regulation increasingly more difficult; new regulatory developments such as MiFID II and PRIIPs would add to the complexity. The risk was that the demands of regulation could eventually become insurmountable for smaller players and new entrants, potentially reducing competition.

A further source of fragmentation was the structure of distribution channels in most of Europe and the vertical integration or banks selling their own funds, some panellists considered, which was at odds with creating a single market. Private and retail banks were still the largest distribution channels of funds in Europe, owning a total share of 75%. This part of the market was largely excluded from competition between funds. Moreover, certain well intended regulatory measures, such as the requirements related to the oversight of distributors in MiFID II could favour the move towards more vertical integration. This could affect the level playing field in the market and hinder competition that was needed for service to clients to improve and for prices to fall.

Possible solutions for reducing fragmentation in the EU fund market

Different solutions were discussed during the roundtable to reduce fragmentation in the EU fund market including a better cooperation among regulators and supervisors, a central registration of funds, a streamlining of regulations and developing the use of technology.

A more coordinated and proactive approach to regulation and supervision at the EU level was first needed. When MiFID II, KID and PRIIPs were in place, regulators should be able to agree that there was little or no scope left for national gold plating. In passporting, the rules that applied should be those of the EU frameworks (i.e. MiFID II, AIFMD, UCITS...) and nothing else. There should be no possibility to add fees, to impose local agents or to have extra marketing rules. That was what the maximum harmonisation of regulation was about. A central registration of funds at EU level was moreover proposed. The passporting regime in place indeed mainly focused on the sale of investment funds and did not deal with marketing requirements. Once an investment fund was registered and had met the requirements in one Member State, it should be possible to use that authorisation for more than selling the fund. This would give more power to ESMA and was considered by some speakers to be a positive step towards reaching a CMU. A concern one panellist expressed was that ESMA did not carry out sufficient peer reviews on the >>>

>>> implementation of legislation with domestic regulators. However, that was disputed. ESMA had a strategic plan for 2016-2020 on the single rulebook and supervisory convergence, amongst other initiatives and this was a priority for the authority.

It was also felt that national authorities needed a mechanism whereby they could work together towards a European goal; some however considered that that was already possible, but prevented by a lack of willingness among the participants. Some speakers suggested that the EU Commission could play a more proactive role by undertaking infringement procedures. If barriers to cross border fund distribution were not tackled, retail investors would suffer the most. They needed greater convergence amongst supervisors, which was currently easier than it historically had been thanks to technological developments.

A single rule book for investment funds and a streamlining of regulations were also proposed. Several panellists stressed that further harmonisation and a streamlining of existing rules affecting EU investment funds were needed, rather than additional layers of legislation. A single rule book already existed to a large extent with the measures related to passports, the notification procedure, the KID, the provisions regarding master feeder structures and fund mergers, but the implementation of these rules differed across Member States. It was difficult to anticipate how initiatives like MiFID II would impact the industry; they needed to see how they applied and how distribution models would evolve before considering whether or not additional rules were necessary. It was further recommended that superfluous parts of regulation should be removed. There would be an EU Commission consultation in Q2 of 2016 on these issues.

Better cooperation between regulators and the industry was also necessary, some suggested. Regulators needed to talk to the industry more and to understand market practices better. This would allow them to appreciate what level of regulation they needed to apply whilst also bearing in mind the need for consumer protection. The process should start with understanding the market before moving to legislation. Moreover the industry was encouraged to collaborate on creating industry wide templates for information exchange and communication with distributors when MiFID II was totally implemented.

New technology could also be used for the streamlining of processes and the improvement of distribution. However, it was noted that accessing optimal technology could then be a problem for

small and medium asset managers. The prospect of new digital entrants reducing costs and challenging traditional methods of handling investment funds was also welcomed by some panellists, as an improvement for both consumers and the industry as a whole.

The industry also needed to look into products that would encourage retail investors, who only had 7% of their investments in funds, to move savings from low interest rate bank accounts into funds. ●

4. BANKING REGULATION

Forthcoming banking regulations: what potential impacts and issues for the EU banking sector?

KEY ISSUES | *The session tried to assess the magnitude of the forthcoming global regulatory evolutions in the context of an already unprecedented regulatory overhaul initiated in the wake of the financial crisis. The rationale and the main consequences and issues related to these additional significant initiatives were also outlined.*

Basel IV: reducing risk weight variability

Many consultations were underway on issues such as changes to leverage ratio and operational risk. A 3% Basel global minimum for leverage ratio had been confirmed, although some countries had adopted a higher standard. Current challenges included specifying the capital baseline and ensuring that all regions reached it. Conversely, there were instances where regions had adopted more robust standards than the Basel minimum.

One critical intention was to reduce risk weighted asset variability. Some risk weights had been revealed to be unfathomably low, which proposals had been introduced to fix. The governors and heads of supervision had announced a yearend deadline for completion of reforms.

Indeed, Several CEOs in 2011 had said at the time that the recapitalisation exercise had been launched by the EBA, that they would comply by risk weighting optimisation, which everybody had read as tweaking the models to circumvent the requirement. The investors had been concerned seeing banks with similar portfolios coming out with very different calculations of risk weighted assets.

The EBA had since produced five reports to understand the issue, and Basel had also completed useful work. The industry understood that the issue needed to be addressed and they had to accept that a lot of those differences had been driven by supervisors applying different rules. They needed to repair those issues and provide clarity and consistency to the market.

A prominent issue arose from what was considered 'significant'. In the finalisation of Basel IV the main

restriction had been on not 'significantly' increasing capital requirements. However 'not significantly increasing capital' was a vague term. One way of viewing significantly increasing capital was its impact on outliers. Outliers were likely to have to increase their capital. A concern was that there were a number of outliers banks in the EU, which actually needed to have 20% more capital.

Housing Finance and Real Estate

A public authority representative noted that the issue that received the most attention regarding risk weighting was housing finance and real estate. It had been suggested that all housing and real estate markets were special. It was also highlighted that differences between markets were never as significant as people thought. Finally, the panellist from the industry concluded by saying that a number of distortions had been introduced by creating something floor based on the basis that those markets were the same.

Low-default portfolios had been given high risk weight in the latest proposals. Though they could not ignore that low risk weights did not indicated that Probability of Defaults (PD) were low, but also reduced Loss Given Default (LGD). Indeed, they often had low default portfolios either because not many defaults happened or because the transactions that they did with those clients were self liquidating. The desire to be conservative was understood, but it was stated that the combination of the PD and LGD could not lead to the risk weights that they were seeing, which was a concern.

To move forward they had to look at the structure of those markets in greater depth. Indeed, >>>

>>> European systems under Insolvency legislation featured personal liability and there were therefore fewer losses in those systems than in the US. In addition, although one would have thought that large banks adding up to the majority of the population in a given country would have to have the same risk profile, however, their risk weights were very different.

The differences in the investor perceptions between the EU and US banking sectors might had to do with the different respective supervisory practices, which were also illustrated by the respective stress testing approaches that had happened.

Regulatory Uncertainty

Another important concern of bankers, investors and analysts was the regulatory uncertainty arising from decisions yet to be made, and reforms yet to be closed. It was becoming increasingly urgent to complete processes and move to a different stage.

The specific issues of regulatory uncertainty needed clarification. The calibration of already agreed requirements was an area with no uncertainty. However, there was uncertainty in the repair of internal models, and providing clarity and consistency in the application of completed reforms. Both areas required rapid regulatory responses.

If organisations needed more capital, they would endeavour to find it; however, the uncertainty was over the amount of capital that was required, which then needed to be communicated outwards.

Pillar II was an additional challenge due to fragmented application; however, there was commitment to eliminating differences. Resolving the issues in definitions would also reduce the difference in risk weighted asset calculations.

A Risk Weighted Approach to Banking Regulation

Further reduction in the differences of risk weighted asset calculations required improving the standard and internal models, and implementing the leverage ratio as a complement to capital requirements. Stress testing was also important.

Getting the capital level right had become less accurate in the current proposals. However, there were reasons to think that some portfolios could not be individually modelled. Input and output floors needed to be considered, and they also had to define how they implemented leverage ratio.

Models tended to be more effective in practice if used for both regulatory and business purposes. Consequently, the more regulators desensitised

models for risk, the bigger the problem would become as whenever risk weights were defined according to a floor higher than the actual risk, the incentive to provide more careless lending would be there.

On the risk weighted approach towards banking regulation; first, they were not afraid of well capitalised banks releasing capital requirements. Second, it was concerning that the industry increasingly sought shortcuts to push for better capitalised banks rather than working on plain capital requirements based on risk weights.

There were also points that undermined the risk based approach. First was on incentives; if they insisted that risk weights were defined according to a floor higher than the actual risk, the incentive to provide more careless lending would have been there. Second was on complexity; they had many ways of accounting for capital requirements, which made some people uncomfortable. Third was that risk weights were not perfect.

There were some firm believers in stress testing and the virtues of the leverage ratio. However, Insolvency legislation was identified as a problem which made life different across jurisdictions.

One element of the 24 March proposals that had gained attention was the prospect of an output floor. Some thought that capital floors were a problem. If they wanted to calibrate their capital levels, it had to be done through a portfolio of floors.

Supervision

The framework for the prudential regulation of the banking sector was essentially a three legged stool with risk based metrics, leverage ratio and stress tests. There was a danger in the extent to which they were turning the risk based leg into a non-risk based measure.

It would also be important to discuss the role of supervision. The Basel Committee had completed a lot of work which had seemed to be setting the stage for more intrusive work as supervisors. It was worth inserting that as a much more significant part of the Basel agenda. It was noted by some that they were moving back towards supervision, and that they also had to consider the importance of risk management governance culture in banks.

The work over the course of the year had largely been taking the risk based leg of the stool and turning it into a second non risk based leg. Further work in that area was recommended.

There was a critical role for supervision. The regulatory phase was concluding and >>>

>>> they were seeing a clear move towards implementation and supervision.

Remaining Issues

On the lack of analyses of the cumulative effects of all measures completed by separate bodies, there was a discrepancy highlighted between the ambition levels of the organisations driving it, and the realities at the level of a real bank considering the consequences.

There was also uncertainty on who would reduce risk if the banking sector shifted them into the markets. There was also lingering uncertainty as to whether that would benefit taxpayers or if Europe was prepared to intervene and absorb some of the risks through the Central Bank balance sheet.

Package reforms had consistently strengthened the treatment of the trading book, reinforcing capital requirements, introducing a non risk weighted

metric, and repairing the problems identified in the internal model.

Conclusion

Since the beginning of the crisis, the intention had been to make something coherent, but the results had not always been so. Directives were thought to no longer be the correct instruments for a 28-member union. They perhaps needed to make fewer regulations, but also had to reduce creativity in implementation at a national level.

Second, the importance of supervision was emphasised. They needed strong supervisors with tough powers.

Finally, the industry was advised to relax. They concluded that they had to believe that progress was possible and, although they wanted to keep the UK on board, they would carry on. ●

Banking Union: what are the priorities of the SSM to achieve trust in the banking system?

KEY ISSUES | *This session discussed whether the expectations related to the SSM had been met so far. The objective of this session was also to review the priorities of the SSM and the significant challenges of how to achieve trust in the banking system of the Eurozone and make banks' business models sustainable in the current monetary, economic and regulatory environment.*

Benefits of a Single Supervisor

Since 2014, the Single supervisory mechanism (SSM) has been responsible for supervising the most significant banks in the Eurozone, with the aim of ensuring consistent supervisory practices and increasing the soundness and stability of the banking system. In order to treat equally all supervised banks showing the same characteristics, the ECB needs homogeneous rules and homogeneous ways of applying them. Some benefits had arisen from the moves towards an integrated framework that had taken place over the course of the past year and a half. The SSM has achieved a lot in the areas of common approaches, common supervision, and levelling differences. There had been in particular an integration of practices, and willingness to borrow from best practices that were already present across Europe.

As the SSM operational units, joint supervisory teams (JSTs) are composed of ECB and national competent authorities (NCAs) staff. The SSM draws therefore on the expertise and resources of 19 NCAs in performing its supervisory tasks, while also benefiting from centralised processes and procedures. This set-up allows for a cross-border perspective while retaining a national perspective. The SSM is a major step towards a level playing field in banking supervision in Europe. In the future it will continue its endeavours towards full comparability and harmonisation.

The EBA's deliberations had included the important issue of how to ensure the existence of a common rulebook and practices across the European Union, beyond the boundaries of the monetary union and the SSM. The concept of dealing with a single supervisor was a very attractive one to >>>

>>> international banks, and now that regulators in the Eurozone were gathered together, it was easier to identify the differences between regulatory approaches across Europe: for example, the differing approaches to the supervisory review and the evaluation process (SREP). Indeed there had been 19 different approaches to Supervisory Review and evaluation Process (SREP), but these were now being organised in a much more consistent and integrated way. It took some time to fully realise all those benefits in an operational sense, but there had still been some 'major game changers' and steps forward.

In addition, having a single representative body able to conduct meetings with the Federal Reserve or the Prudential Regulation Authority (PRA), as an equal partner in a trilateral context, had also been helpful.

Predictability, consistency and Coordination Issues

SSM was a major investment, and the result of a major crisis; it had been in place for 16 months, and had achieved some of its goals, but a lot more work needed to be done. There needed to be both operational and regulatory improvements to improve the performance of the SSM. Firstly, it would be necessary to plan the SSM's actions better, with involved parties receiving the agendas of meetings sufficiently early to prepare for them; more transparency and feedback in relation to things like the SREP methodology and internal model validation; and clarification on how the ECB intended to integrate the stress-test results in the SREP analysis in 2016. The calendar of the SREP needed to be reformed, to reduce the amount of activity that was front loaded into the first half of the year.

Increased visibility would also be necessary in relation to the Basel Committee, SSM and EU Commission regulatory agendas. There should be clarification regarding reporting requirements, to reduce duplicated requests. Although the concept of having a single approach was being widely debated, there had been multiple perspectives prevalent during the discussion at the end of 2015 on Pillar II and MDA; there needed to be a more coherent and consistent view on these crucial issues, as this had led to instability in the market and higher volatility. More precisely, the EU legislation created notably an inconsistent treatment of AT1 instruments across Europe. Firstly, these instruments were paid, not based on group results, but on solo accounts of the company. In his institution's case, their holding company is based in Germany, and subject to German GAAP. In order to avoid confusion of investors, the payment on AT1 instruments should be based on IFRS. Secondly, many investors do not understand that in Germany AT1 payments were not based on the Group level but on the GAAP solo account of the company. This should be based on

the consolidated accounts of the group, as is the case in the US. Thirdly, uncertainty is created due to the different interpretations of the interaction between the Pillar II requirement and MDA (e.g. CRD IV vs. EBA/ECB and European Commission).

There was no more volume in the market: banks were keeping liquidity for themselves, which made banks safer but weakened the market. As such, adjustments were based on price, which created huge volatility, and made the market susceptible to shocks such as the one that had happened over Chinese New Year 2016. Inconsistency in legislation, uncertainty about supervision, and huge volatility added up to cause accidents.

The question of MREL and TLAC, and the respective role of SRM and SSM, needed to be considered, along with the problem of Basel IV and the consequences for the IRB. There also ought to be more guidance and transparency in the area of internal models. Although the direction of Basel on this issue was not necessarily welcomed by the industry, banks would still want to know what was impending.

Banks needed to become accustomed to the fact that the macro environment, technology and regulation were the three key factors that were structuring and lowering prospective profitability, and the enhanced perspective of organic capital generation. The SSM should also become familiar with these issues, in the sense that capital needed to increase generally, and would also need to develop a fruitful relationship with other supervisors. It would be helpful, as well, for the SSM to unify its practices and to be seen as banks' main interlocutor, rather than just another partner; to become better known outside of the Eurozone; and to build up its relationship with US regulators.

International groups were calling for the banking union to be treated as in a single jurisdiction and not face local requirements (capital, liquidity); some progress had been made towards this goal, such as having waivers for solo rules in individual countries, but these moves had been too cautious. Best practices from individual countries were currently being brought to bear in the supervisory approach of the SSM; Dutch bankers had introduced a bankers' oath, and the SSM had also taken an interest in countries that paid more attention to details, file reviews, and data analysis. These two approaches were complementary and enriching.

A lot more could be done in relation to the SRB and the SRM. Regarding the former, the focus was always on when a bank was failing or likely to fail, and when control moved over to the resolution authorities: it had become clear that it was usually not difficult to determine that a bank was failing, but it was >>>

>>> more difficult to determine what form the bank should take after the resolution weekend, and what supervisory requirements would need to be imposed on it. This topic needed to further looked at.

Progress on conduct had been slower. Conduct regulation and supervision had been kept within the scope of national authorities; this was a very important issue, and now that prudential aspects had been dealt with, it was the next thing to look at.

SSM Evolution in Countries with Large Foreign Banking Sectors

Representatives of national banks in countries where large percentages of the banks were foreign banks differed regarding the impact that SSM had had. One stated that the SSM environment meant that co-ordination had to take place at the higher SSM banking union level, or Eurozone level, which had significant impacts on their regulatory and supervision cultures. The other stated that national organisations had worked well with their counterparts in different countries in the past; they had had joint memoranda of understanding, and he did not perceive a significant difference between the pre SSM and post SSM situation. Improvements could be made: the supervisory review process timelines could be better aligned, and there should be a clearer policy stance on stress testing approaches for subsidiaries, although the panel member acknowledged that more time was needed.

Achieving Trust, Reforming Banks' Business Models and improving profitability

One banking representative stated that profitability would inevitably be lower in the future taking into account the monetary, economic, technological and regulatory environment; to manage this, it was vital to have notably clarity and guidance on the forthcoming regulations. The instability of legislation has not helped to restore confidence in the EU banking sector and had had major consequences for the profitability of banks. For instance, specialised lending could lead to a threefold or fourfold increase in capital requirements. Investors wanted opportunities to discuss Basel with European banks, and when they did so, it was important for banks to be able to speak about them in detail. Due to the uncertainty on the forthcoming global (Basel IV) regulations, banks had not been in a position to do so and this could create volatility in European financial stocks, which was something that definitely needed to be avoided in the current, already volatile context.

Non-performing loans in the banking system in Europe, and levels of certainty business models,

also needed to be considered. Non performing loans having recurred as a source of concern was surprising, because a very comprehensive assessment had taken place at the end of 2014, with provisions increasing to the necessary level. However, investors did not accept this when banks had non performing loan percentages of 20% or higher; this would need to be addressed via the SSM.

Regarding NPL, this was an important indicator, but from a supervisory capital and equities calculation perspective, prudent and concrete asset value was more important. Ultimately, capital adequacy was the most important ratio, and if the value of assets was correct, differences in NPL ratios did not distort the analysis and comparability of the banks.

According to a central banker, with the present low interest rates they had not yet significantly damaged the interest income of banks but, eventually, they would do so, and there was also concern about how banks would develop their business models. To address these kinds of concerns, it would be necessary to enhance synergies, and to produce more realistic assessments at both the local and group levels and at the SSM level. Risk assessment methodology was vital: uniform terminology, uniform assessment of scoring indicators, and uniform reporting needed to be in place; otherwise, different requirements would be in place for the same risk level in different banks and groups, which would cause competitive disadvantages. A panel member from a smaller European country noted that there was a need to consider the pressure that all of these demands placed on administrative capacities and on staff.

In such a context, for stable profits to be achievable in the future, regulatory stability was essential. The finalisation of Basel III needed to be completed within a reasonable timeframe and calibration for stability's sake, although there were good reasons why time had been taken over this. Other challenges to banks' business models included competition, technological innovation and market developments; instability was not only arising from regulatory concerns.

A Central Banker summarised the job of supervisors as containing three aspects: promoting a stable regulatory environment while completing the banking union project in the appropriate way; promoting consistency and a level playing field, both within the SSM and globally with peers; and to militate against the huge amount of pressure that was placed on institutions to be profitable, which created a risk of them acting in ill advised ways. Supervisors should identify weak practices reaching for yield, inappropriate risk return, and short term type behaviour. ●

EDIS: what prospects for an EU Deposit Insurance Scheme?

KEY ISSUES | *The “Five Presidents’ report” highlighted common deposit insurance as a desirable and realistic objective for the financial sector. The aim of this session was to discuss the key success factors needed for the adoption of the legislative proposal of the EU Commission for a common deposit insurance scheme.*

Speakers were also be invited to assess the improvements brought about by the EDIS proposal to the Banking Union and the added value of tackling at the same time the risk reduction measures in the banking system (notably bank exposure to sovereign risk).

The Commission’s Proposal on EDIS

The key objective of the EDIS is to enhance the effective deposit guarantee framework with a view to protecting depositors, in the banking union, against the consequences of deposits becoming unavailable.

According to the European Commission’s legislative proposal the European Deposit Insurance Scheme would be established in three successive stages. During the reinsurance period of three years, the national DGSs would have to be exhausted first before EDIS could be used, providing with national schemes an additional source of funding. This reinsurance phase would be followed by a progressive mutualisation of deposit insurance over a period of four years. To reduce moral hazard, the EDIS proposal contains some safeguards. For instance, in the first two phases, the national scheme has to comply with the obligations of the DGS Directive (adopted in June 2014), in particular with regard to the required annual target levels, before receiving any extra support by EDIS. The full insurance of depositors would fall under EDIS from 2024 onwards

Everybody had an opinion on EDIS, many of which differed. However, a majority of those opinions were in favour of EDIS, and there was agreement that it would be a good thing for a lot of European citizens.

7.2 trillion of the 15 trillion of deposits in the EU were protected by deposit schemes. The current average of DGSs in Europe was 0.62% of covered deposits. From that they could conclude that EDIS would initially need to provide liquidity support; it needed to be designed to avoid unfair disadvantages to less funded schemes; it had to be cost neutral compared to current schemes for participating banks; and it had to take into account risk based contributions. The first stage of EDIS that the Commission had proposed helped because it accounted for those legacy issues.

For full coverage, they also needed to consider bank structures because those under joint liability schemes or IPS would never trigger EDIS. Furthermore, they needed to discuss the alternative use of DGSs in other countries, and the safeguards in the Commission’s proposal.

The legal basis could be discussed, but they were confident that it was correct.

Some felt that the discussion was actually about the singleness of money, and not EDIS, and that questioning EDIS was questioning the single currency.

The Commission had said that they needed to work in parallel on risk reduction measures. It was agreed that they needed to do so, and they had worked on many over the past few years. In terms of risk sharing, the SRF would not be mutualised until 2024. They therefore had to work on risk education and risk sharing in parallel. If they did so, they could create stability and protection for savers anywhere in Europe.

Some had already established teams to deal with EDIS, anticipating that it would be both important and difficult. The real question on EDIS was not whether it should be implemented, but on the timing of the sequencing, and various tasks needed to reach completion before EDIS could progress.

Scepticism

Some contended that, on EDIS, it was inadequate to consider phase II and III of the EU Commission’s legislative proposal and that they should consider renaming the regulation to EDRIS (European Deposit Reinsurance Scheme), because reinsurance was an effective long term solution. A second reason for caution was that the EU needed to translate TLAC in the EU legislation and precise the interaction between TLAC and MREL. Third, priority needed to be >>>

>>> given to transposing and implementing DGSD II in all Member States. Fourth, it was common sense to check risks before sharing them.

An argument against EDIS was that there were already common standards for a DGS, including mandatory pre financing. If the DGSD were fully implemented by all Member States, there would be equal protection across Europe. The EDIS proposal was therefore unnecessary.

It was suggested that there could be interesting relationships between the DGSD and EDIS. The DGSD proposal had a voluntary mutual assistance mechanism and they could consider how to implement the EDIS proposal into the DGSD. However, that was disputed, as an attempt to put mandatory lending between DGSs had faced unanimous rejection in the past.

It was thought that EDRIS would establish a good operational sharing of responsibilities between national funds and the reinsurance entity. Second, it would ensure better cost neutrality and a more centralised system. Third, it would increase operational certainty when it came to the breakdown of contributions between banks. Fourth, it would reduce moral hazard. It would also send the right message and create two interlinked capsules: the national DGS and the European mechanism. Finally, citizens would know that they were protected at two levels.

A reinsurance system appeared pragmatic, efficient, and a good compromise between eurozone members, which would respect the principle of subsidiarity. Others were advised to consider it.

However a public decision maker reminded the audience that EDRIS was the first half of the journey. The second half was building on reinsurance and moving towards co insurance. They had to complete both parts.

The ECB 's support to EDIS

The ECB saw EDIS as a logical and necessary third pillar. They had said that a well performing banking union required further steps beyond the establishment of the EDIS, and that progress on other risk reducing measures had to be achieved in parallel with the establishment of the EDIS. They had also said that delays could be caused by a solution that made transition from one phase of EDIS to another dependent on progress, and that if conditional phase in of EDIS was supported, any milestones on risk reduction had to be precisely defined ex ante.

The ECB had considered that an impact assessment could have been warranted on the most important

elements of the proposal; it was recommended that they did so.

The treatment of sovereign exposures was something to be discussed at Basel level. It would have been problematic to have a single European solution to it. Europe should have had a decisive role in Basel, but there was also the key question of what Europe's strategy in Basel was.

Sovereign risk was typically at the forefront of discussions on risk reduction. Not all sovereigns were alike, so they had to find ways to limit the exposures of local banks to local sovereigns. Europe could use the opportunity to foster diversification at the level of local banks. There were ways of entering hybrid approaches with long phase in periods that could produce a diversified market for sovereigns in Europe. They therefore warned against rushing ahead of the international process.

Building a compromise

EDIS was a topic of growing political pressure. There were two consequences to avoid: first, was that they should not forget the progress they had made with the Banking Union; second, was that they could not pour all resources into the debate, as they also had to make progress elsewhere (e.g. fostering investment through the Juncker plan, progress on economic coordination).

One way forward was to build a compromise, comprised of three elements. The first step was the Commission's proposal on reinsurance; second was a fiscal common backstop on resolution; and a third was added on governance of EDIS because of the proposed different bodies and voting mechanisms which made it too complex. Instead a weighted voting system like in other European institutions should be contemplated.

Conclusion

There were three phases of EDIS, and it was suggested that support would decrease as they progressed along the scale. On the first phase, EDRIS would solve the problems of citizens to a large extent, but they had to consider how markets would react to them sticking to the first half. The only way to reach the final stage of EDIS, with support decreasing as they progressed, was to have risk reduction increasing.

Singularity of money as the necessary third pillar and the need for a legal debate about text were key takeaways from the debate. They all saw EDIS as a necessary component of a Banking Union. However their job was to determine which pillars, beyond sovereign risk, were required to support EDIS. ●

Cross-border bank resolution: how to make it workable?

KEY ISSUES | *Banks need to issue significant amounts of TLAC/MREL instruments and investors require a clear understanding of these products and under what conditions they will assume losses.*

In such a context, the objective of this session was to discuss the remaining challenges regarding the EU resolution framework taking into account the global context. Speakers were also invited to assess the obstacles to the smooth resolution of a global bank.

EU Resolution Framework

The rationale for the discussion was to ensure that the right instruments were available to let taxpayers ‘off the hook’ following the financial crisis, and de-risking the banking system. For the single currency’s purposes, it might be necessary to have a single decision making body. For cross-border groups and those under the single supervisor, there was now a single resolution authority in the form of the banking union, although some areas needed to be clarified further.

Differences between MREL and TLAC

A number of representatives of resolution authorities agreed that TLAC and MREL were ‘two sides of the same coin.’ One explained that TLAC, as the international standard, was required to be 18% of risk-weighted assets and 6.75% of leverage ratio as from 1 January 2022 (16% of RWA and 6% of leverage ratio as from 1 January 2019). It was relatively easy to implement the main features of TLAC within the MREL framework; however, for this to take place, a change in legislation would be necessary, for which a proposal was currently being mooted. To reconcile MREL and TLAC in relation to G-SIBs, the best approach would be to begin with a standard MREL requirement for G-SIBs that was entirely consistent with the TLAC term sheet, before building the Pillar II aspect on top. Another panel member noted that Europe was trying to guarantee stability in the market by addressing systemic institutions, but was disregarding the systemic impact of bailing in certain asset classes, such as senior debt or deposits. Attention would need to be paid to this issue, especially as the stability elements of the package had not been addressed.

The UK’s proposal regarding MREL had had a constructive intent behind it: MREL and TLAC needed to be aligned in order to implement them beyond the borders of the EU, and this proposal

demonstrated that this synthesis could be achieved. Banks and regulators had previously been looking at different aspects of this question, but Europe needed to start considering what the unintended consequences might be in five years’ time, and identify whether anything that had been introduced might have a destabilising impact. One bank had considered how it could meet its TLAC requirements in five years’ time, and had concluded that it could not: these needed to be met on an on-going basis. One risk was the risk of liquidity not being forthcoming to refinance TLAC or the MREL liabilities, which added an element of instability during the interim period.

Who would invest in these bail-in instruments?

Investors also needed clarity regarding the creditor hierarchy, which meant having consistency across countries. They also needed clarity in relation to the precise definition of the MREL targets; as of the third quarter, investors still did not know the liabilities accepted, or anything about calibration and compatibility with business models, which was key to institutions’ financial planning and capital planning of institutions.

It was important to preserve neutrality of design in relation to business models when designing resolution approaches. In order to fulfil the requirements of MREL and TLAC, an institution should not need to change anything particularly substantial about its business model; this was especially true regarding the SPE/MPE organisation of a bank. If an MPE group were treated as a consolidated group in relation to resolution, it was not clear what would be done about bail-in-able instruments in small jurisdictions where it was very difficult to issue subordinated debt.

For a common framework for subordination

Having a common European approach to the different types of debt that could be eligible >>>

>>> for MREL requirements would be desirable, but would take a long time to put in place; in the meantime, effective tools for resolution would need to be implemented. The Italians and the French had put in place reforms, with the French approach similar to that of Germany eventually.

However, it was not only subordination that needed to be considered, but also the counter-factual analysis and how to implement the framework in the context of different legal frameworks. More harmonisation on the insolvency law front and a more harmonised approach to creditor hierarchy would be desirable, although this would not be easy to achieve. A representative of a resolution authority reminded the audience that in any resolution, we have the counterfactual analysis and we have to prove that the creditor is not worse off than in insolvency. Therefore clarity and transparency were vital: investors should know that somebody who had invested in a deeply subordinated tool would hopefully never be called upon, but would be called upon before someone who had invested in a senior investment, and that only investors in guaranteed deposits would never be called.

The 8% issue was a controversial topic

BRRD and the SRM regulation had come into full effect on 1 January 2016, and there was now a mandatory bail in scheme, with bail-in decided by creditor hierarchy and not by credit name or wealth. European legislation made clear that MREL was a Pillar II requirement; it needed to be set entity by entity and was entirely risk specific. Resolution authorities would want to have all possible tools available, part of which was respecting that the SRB would need to bail-in de minimis 8% of total liability before it had access to the Single Resolution Fund. For these 120 systemically important institutions, and only these institutions, MREL of potentially 8% of total liability would be the norm.

There was a controversial discussion of this 8% rule: one banking representative stated that there needed to be increased clarity regarding what this 8% referred to, as BRRD made it very clear that this was an entry hurdle to the resolution fund, expressed as the amount of bail-in that had to occur: there was no direct link to MREL. It was also not clear how small institutions with a lot of NPLs could be asked to raise 8% of bail-in-able assets in the context of a non-performing economy and a low rate of interest, or how this was compatible with the European projects on capital markets union.

It was a common-sense conclusion that a minimum MREL would need to be established for all of the banks, but this might give rise to very serious consequences if the minimum MREL were to be

set at 8%, notably as a substantive part of bail-in-able debt was not included in the current MREL definition. Additionally, this should not mean that every resolution case should require use of the resolution fund.

Global Crisis Management Framework

Living Wills

US authorities had recently issued results, including deficiencies and/or shortcomings, for eight of the firms subject to US living will requirements, providing this feedback in a transparent manner with two joint public documents having been issued. The firms involved had been asked to deal with a number of issues in their next submissions, including sorting out the capital and liquidity necessary in resolution; establishing a methodology for determining what that might be, and ensuring that these resources could get to where they were needed; a governance process to promote confidence that resolution would be entered into at the appropriate time; and dealing with some of the operational continuity issues that would arise during resolution, while dealing with derivatives in a way that did not engender disruption. Legal entity rationalisation would also need to be tackled.

Cooperation between Home/Host Supervisors and Resolution Authorities

There had recently been a US proposal for TLAC, which would require the US subsidiary a European G-SIB to issue internal TLAC to its parent bank, even if even if an MPE resolution strategy is contemplated for the foreign firm. MPE firms have raised concerns regarding the proposed requirement that foreign banking operations operating in the US issue internal TLAC to the parent; these MPE firms had been used to issuing debt externally in the local jurisdiction, and this proposed requirement would cause an adjustment to that. These firms would also like to be viewed in the same way as some of the US regional banks that were of their size and more closely resembled them, and to be allowed to compete on that basis. This raised some difficult issues, and discussions were underway.

Meanwhile there was not yet sufficient confidence from the firm perspective in the home/host discussion to accept pre-positioning of internal TLAC that might be outside of cash instruments, or that the legal context would allow for such contractual arrangements to take precedence over a statutory approach. This ties to the viability of large institutions' cross-border resolvability. With one bank's assets located in a different country, subject to different law, supervisors tended to ring fence and take precautions, which was reflected in the rules and in other ways. >>>

>>> It was also important to note that, in small markets, it was inconceivable that the complex instruments that were issued in developed markets would be replicated, and SPE models had not yet been put to the test. Collaboration between home or host via MOUs could be helpful.

According to a leader of the industry, It was not yet clear whether enough had been done to reduce the amount of ring fencing that had been seen in the past; this could still be dealt with, because the rules were not in place yet and it was not yet clear how internal MREL or internal TLAC would need to be distributed within Europe. Europe needed to be careful to preserve the many different 'level playing fields' that it was host to: the trans Atlantic field, where G SIBs from one continent adhered to the same rules as those from another, and the domestic 'playing fields' within individual European jurisdictions.

Many G-SIB groups had quite varied balance sheets, containing tranches of debt that would qualify for TLAC and be ideal for bail in, but many of their subsidiaries were straightforward retail deposit-funded banks in a particular jurisdiction. From the industry perspective, whatever was done in relation to internal TLAC should not interfere with those business models, and to ensure that this was the case, it would be necessary to find forms of non-cash and non-rigidifying MREL and TLAC, i.e. 'soft' MREL and TLAC in the form of guarantees. Such guarantees did not need to be collateralised: loss absorbency or recapitalisation should flow within a group, with due

attention being paid to the need not to ring fence liquidity and capital, and thereby create problems with 'brittleness'.

Legal Backing for Effective Cross Border Resolution

Effective resolution of a cross-border bank requires a high degree of trust between supervisors before, during and after resolution. But some countries do not yet have a full resolution regime in place and of those that do, there are questions over whether they contain avenues for giving effect to the resolution actions of a foreign authority. This is the reason why the question is whether mutual confidence between supervisors needs to be supplemented by additional arrangements and what could be envisaged to favour such arrangements. The FSB has work in progress in this regard.

A representative of a bank stated that his institution's approach to meeting the TLAC requirements had been to do so via holding company issuance. This meant having a surplus of long dated funds at the centre; therefore, you were 'damned if you did, and damned if you did not'. Having these centrally while not needing them created a drag on the business, but these were not needed out in the group, either. The question was what kinds of arrangements his bank needed to implement – not only to meet the expectations of CMG countries, but also, and importantly, those of non-CMG countries as well – to find a good balance. His institution would not want to be over-deploying TLAC within the group, where there was a direct cost of holding it centrally. ●

Retail banking: what priorities for building a single retail financial market?

KEY ISSUES | *The session was dedicated to identifying how the EU Digital Single Market Strategy (DSMS) was unfolding in the financial services area. It notably tried to clarify the challenges specific to existing and incoming players, assess actual achievements in the EU and the difficulties posed to the DSMS by cybercriminality. The session finally outlined the possibly relevant regulatory initiatives and financial infrastructures required.*

The demand for, and the current state of the EU single market for Retail Financial Services

There was no single retail market in Europe: many consumers did not know what a cross-border opportunity was, and those who did were not sure that they would profit from this kind of opportunity. Only 3% of consumers had purchased credit cards,

current accounts or a mortgage from another EU state, and only 5% had bought a consumer loan abroad. Most consumers did not want these services, or did not have a need for them, but it was also possible that those who would have bought them had not been able to overcome the obstacles that existed, which included fixed cost regulatory obstacles, reporting requirements, and tax >>>

>>> impediments. Consumers also exhibited different behaviours in different countries, and people's ages also affected their behaviours: some citizens still wanted to speak to people in person at a physical bank branch, but there was also an increasing number of 'digital natives'. As such, the needs of these different types of consumers would have to be taken into account.

The European Commission's Green Paper on retail financial services, adopted by the European Commission in December 2015, had received 428 replies and between 180 and 200 had been from individual citizens. Citizens expected that they should be able to buy financial services cross border, but, they faced a number of issues such as lack of information about products available in other Member States, or data protection concerns. that made cross border buying and selling harder. Favouring competition was also vital, and passporting was critical to the development of a retail single market. The barriers to a single European market tended to be the result of domestic-specific consumer protection regulations. Customers' concerns were primarily convenience, trust and cost; any system to unify the market would need to address each of those issues.

These expectations came in a context where customers were becoming more and more demanding, wanting 24-hour service and immediate answers to any of their demands, as well as the opportunity to have a face-to-face relationship. European banks needed to move towards digitalisation for the sake of their own citizens and customers, but should not lose sight of the need not to impair confidence, which has been based on face-to-face relationships. Finally, customers wanted more digital interaction, but were not explicitly demanding cross border banking.

Main Impediments and risk of a Single Market for Retail Financial Services

Predominant domestic bias

Digital exclusion was a potential impediment to a single retail financial market. Inefficiency in the home/host environment was also an important impediment as it required to devise multiple IT systems to address for example the Anti Money Laundering (AML) requirements of each individual country impeded innovation and increased costs to the consumer.

Some elements of supervision needed to become a little broader and more holistic. There it might be helpful to look at the status of apps as a way of determining whether a bank needed additional liquidity: if banking

was done more digitally, and if users did not have efficient and appropriate apps on their smartphones, then banks would have liquidity problems when their customers took their business elsewhere.

One representative of a bank felt that the biggest major obstacle on the demand side was the lack of a single deposit guarantee fund; the lack of a European Deposit Insurance Scheme created fragmentation as witnessed by the crisis during which deposits moved in search of stronger banks in strong Member States. The harmonisation achieved via the Directive had been a step in the right direction, but had not been sufficient. On the supply side, although passporting and common frameworks were in place, local AML and KYC demands varied, and more coordination would be welcome. Data protection was another key issue.

Limited demand and difficult access to domestic customers from abroad

There were also demand side issues relating to consumer protection, where clear rules were required, and in the area of contracts: consumers still had doubts around the applicable jurisdiction, for instance. Furthermore, customers did not engage much with financial services, and were not very vocal about the need for a single European market. People from younger generations were difficult to contact; they would not read generic letters, and to contact these people, you needed a primary account. Accessing to account information, a bank could then send meaningful and relevant information to a client.

Initiatives to Encourage Further Integration

Key possible Policy Initiatives

The single market was premised on the idea that more open economies generated more competition, which in turn created more productivity and better outcomes for consumers. The area of payments was one where the benefits of competition could be demonstrated: consumers wanted to be able to make payments when they went on holiday, when they lived abroad, and when they worked abroad.

The work that had already taken place across Europe regarding financial stability had been very valuable, and what had been done on the Single Rulebook, CRR, CRD4 and Bank Recovery and Resolution Directive was done also to rebuild trust of EU citizens. The question of redress would also need to be considered; this could be addressed through encouraging the national ombudsmen that existed in different countries to work closer together. A EU regulation relating to data protection had now been adopted, and would come into force in 2018. >>>

>>> Investment in IT needed to be encouraged within banks, as the accounting framework did not help them to meet the goal of creating a single retail financial market, indeed software has been identified as an intangible asset, and this is very costly for us in terms of capital. All players in the market needed to contribute to digitalisation, and banks – given the additional regulation that they worked under – would need particular help to digitalise effectively.

The European Commission had already created a palette of tools containing a number of ideas and initiatives, in order to address the issue of retail. Indeed, the issue of retail was a multifaceted one: payments, for instance, lent themselves to harmonisation well, but others did not.

In some areas, such as motor vehicle insurance, the problem of compensation at different levels had already been seen, and further harmonisation work would need to take place in this space. Increasing the portability of pension schemes was necessary, and this would not work without a common legislative framework. Harmonisation was more difficult in other sectors, such as mortgages.

European Commission regulations could also contribute more in a number of spaces, including digital onboarding. A European Deposit Guarantee Scheme would help make customers feel more comfortable about putting deposits in banks.

There needed to be more interconnection between DGs to make sure that the agenda of building a single retail financial market could be pursued, and also to preserve the added value of each banking model, which might have something to offer in relation to these new retail financial services.

The challenge was how to strike the right balance between legitimate differences between national markets and producing value for consumers by doing things at a more consistent level across the whole EU. Very different answers to these questions arose depending on which aspect of retail financial services was being considered. One should be open to other ways by which best practices could be shared and innovation at the national level towards a common goal could be encouraged. Europe should be able to employ not only regulation, but also best practices, guidelines, various groups' initiatives, and so on. However, creating exceptions increased costs, reduced advantages and decreased competition, and consumers suffered as a result.

The Role of Digitalisation

Payments was the first field in which cross-border selling and digitalisation could go together.

One European institution was about to launch a payments system based on voice-biometric technology, but there were trust issues surrounding this that would need to be addressed at the EU level.

Representative of various banks agreed that eID would be very useful for their institutions' purposes, with one noting that common rules needed to be created that everyone agreed to, and that applied to everybody. eID and trust services was one of the areas in which the European Commission could provide 'building blocks'.

It was now possible to look at where transactions were crossing borders and sectors 'more or less automatically', and as criminals did not respect borders, cyber criminality was another reason for having a European Directive.

Expected Contribution of EU Digital Market Strategy and PSD2

The European Commission's package on trust services would come into force on 1 July, so people could identify themselves via eID; the Network and Information Security Directive would also be adopted soon. A contractual public-private partnership would soon be in place to help prevent criminals from gaining access, and the Commission was also beginning an evidence-gathering procedure in relation to bad algorithms. It had created a palette of measures containing a number of ideas and initiatives in order to address this issue.

PSD2 had been a good development in the sense that it made it easier for new players to enter the market, but it also created burdens on the traditional players. The problems that existed could be managed, but consideration needed to be given to the question of what might go wrong if all payments were opened up and clients gave their identification to a new payment provider. Banks might be required to automatically compensate the client, and to start chasing all of the parties who provided new payment services. More balance was needed in this space to promote fair competition. Ways would need to be found for innovative banks to operate, with some regulatory exemptions that would make them less subject to constraints and more capable of contributing well and quickly to innovation and digitalisation. ●



5. RESILIENCE OF THE EU NON-BANKING SECTOR IN THE GLOBAL CONTEXT

Market liquidity and volatility: what trends and impacts?

KEY ISSUES | *The objective of this session was to discuss the current status and future trends of liquidity and volatility in EU capital markets, the main drivers and possible solutions for ensuring sufficiently resilient market liquidity.*

Current status of market liquidity and volatility

In recent years many regulatory initiatives had impacted the way institutions and financial markets worked. One issue of concern and under research was the change in market liquidity. The typical indicators of market liquidity had revealed no significant problem; liquidity conditions had returned to pre crisis levels.

However quantity-based indicators were showing some changes; the depth of the market was decreasing. Issuance numbers were high but turnover had declined in a number of segments including some that were very liquid. There was also liquidity bifurcation, as well as more frequent short-term liquidity jumps, and it was becoming increasingly difficult to trade large quantities quickly in the market. Prices had not adjusted accordingly yet.

There was also increased volatility that was affecting the most liquid markets, particularly US Treasuries. That had been illustrated by the “flash rally” in the US market and the “Bund tantrum” in the German market.

Main drivers of market liquidity trends

Regulation was thought to be merely one of many drivers of change in the liquidity of fixed income markets.

The first major driver was the widening gap between supply and demand for liquidity services. That was due to a reduction of market-making capacity, and this was where regulation was possibly having an impact. At the same time regulation was making

market-makers more resilient and the appetite for risk-taking in that activity had changed in many institutions. Second was the development of electronic trading, which had positive aspects for liquidity but also possible negative effects with the development of algo-trading in particular. The third was the development of non conventional monetary measures and asset purchase programmes, which could have both positive short-term and negative medium term implications for liquidity.

The main source of the liquidity issue was a macro problem, a speaker considered: there was a global issue of excess saving and under investment, which policy-makers needed to respond to. Low interest rates were a response of central banks to under investment. In Germany for example there was too much investment in bonds, which were affected by low interest rates, and not enough in longer term riskier assets such as equities and infrastructure projects. Prudential banking regulation may amplify effects (for example the NSFR), but was not the main source of the problem.

The market needed to adapt to this new environment. Market participants were in the process of adjusting to these changes; and authorities were advised not to stand in the way of that adjustment. Adjustments could take place through pricing, changes in business models or behaviours (e.g. risk management practices). Market participants were in an uncomfortable position because they were mid transformation and many changes were happening. It had to be hoped that those conditions would not last forever; and it was thought that once those conditions began to change, many of the concerns currently expressed regarding regulation would dissipate. >>>

>>> The effects of regulatory changes needed to continue to be monitored, and market participants needed assistance in their adjustments to the changing marketplace.

Possible solutions and way forward to be considered

Encouraging more investment in a longer term perspective and mobilising excess savings back into investments would make a great deal of difference. Short term interest rates would then start to normalise and this would progressively allow moving out from unconventional monetary policies, but this was still a remote objective. Investors who have a long-term business model such as insurance companies or pension funds should be encouraged to invest for the long term and in riskier assets. Making changes in Solvency II for example to allow more equity investment could be beneficial. Tax incentives or regulatory changes that would encourage investors to move to longer term and riskier assets would also help to address the current liquidity issues at the source.

However, more confidence was needed in the future development of the economy in order to address the imbalance between saving and investment. At present corporates preferred to buy-back their own shares and pay dividends to shareholders rather than reinvesting profits. Politicians and regulators had to come together to change the incentives for long term business and investment.

Technology and electronic trading platforms could help to stabilise the provision of liquidity services together with the development of new liquidity

providers, although it was not yet clear if these new players would remain present in the market in periods of stress. Market-makers were also adjusting their business models. Further product standardisation would help to improve liquidity and facilitate electronic trading. The side-effects associated with the rise of electronic trading however needed to be taken care of. The development of high frequency trading which was felt to be a persistent trend which would eventually encompass broader markets over time was a particular issue as it was changing the way fixed income markets were functioning. It was however acknowledged that regulating high frequency trading was difficult. Market participants would have to accept a world with episodes of heightened volatility.

Work was moreover being conducted by the FSB and IOSCO looking at strengthening liquidity management practices in the asset management industry. A consultative document would be released in June/July. Asset managers were also in the process of reviewing the way they approached the liquidity risk management of individual funds. One solution was to raise cash buffers but that would reduce returns for investors. Another possible action was making sure that there was no mismatch between the perception that clients had of the liquidity terms of investment funds and the liquidity profile of the underlying assets in the fund portfolios. Other measures were to consider backup credit lines for the event of large redemptions after significant bouts of volatility, stress testing and redemption tools (e.g. redemptions in kind). Each of the measures considered had arguable benefits and drawbacks; the key was finding the right balance and adapting risk management to the current altered market conditions. ●

CCP resilience, recovery and resolution: key elements of a possible EU framework

KEY ISSUES | *The objective of this roundtable was to discuss the key elements of an EU regulatory framework for the recovery and resolution of CCPs, the level of flexibility or predictability that should be built into the framework, how the availability of appropriate financial resources could be ensured and the possible issues raised by the global dimension of many CCPs.*

Key elements of a CCP Recovery and Resolution (R&R) framework

CCPs had been identified by the G20 as the appropriate financial market infrastructure

for concentrating counterparty risk with the implementation of the clearing obligation. There was now a need to provide a framework on how recovery and resolution of CCPs was expected to work. The systemic risks associated with >>>

>>> these infrastructures were indeed very high and the impact of a potential failure on the economy could be immense. Moreover, this needed to be a global approach given the international dimension of many CCPs and legal certainty had to be ensured for all stakeholders in the system.

Regulators had withheld action, pending further work in the FSB and guidance from the September 2016 G20 meeting. The European Commission was planning a subsequent legislative approach near the end of the year.

Definitions had to be agreed first because there were different interpretations across jurisdictions.

Resolution meant finding a way to preserve critical business functions with a financial reconstruction in order to allow the systemic functions of a CCP to continue. Public support was not an option.

The protection of the financial system and its constituents in the event of a CCP stress required a toolbox, something which needed to be clearly stated in the rules. It was suggested that recovery tools should be favoured at first instance given the objective of continuity. They also needed sufficient transparency regarding the recovery plan and there should be clarity and alignment of the incentives of shareholders and clearing members in order to ensure an appropriate resolution of the failure. Prudential and market supervisors moreover should be required to work together in order to avoid conflicts regarding clearing members in particular. The suggestion was also made that a solution needed to be worked out for non-default losses i.e. those that were unrelated to a clearing member's default, as there was still uncertainty as to who should bear the losses in such a case; it should be shareholders, a panellist suggested, but equity might also have been wiped out.

Ensuring that appropriate risk governance was in place was another important issue. Members wanted a forum to enable them to put forward their views, from a membership liability perspective, on clearinghouse rules and risk management frameworks, as they provided a large part of the capital. There were rules under EMIR, but some felt that they were not always appropriately applied in the CCPs' risk committee. Representatives from clearing members and clients sat on CCP risk committees but they just supplied market expertise, and were not supposed to speak in their organizations' interests. Many clearinghouses did not take their member feedback seriously enough but some CCPs are engaged regularly with their members and are very much user-orientated, some speakers considered.

Another issue was defining who the decision-makers were and how they interacted with the other stakeholders in a recovery and resolution process.

The nature and the role of the resolution authority in particular needed clarification. One speaker suggested that the resolution authority should be the local authority supervising the CCP on a day-to-day basis because it was the only one able to understand how the CCP worked and to anticipate how markets would react. Another speaker however suggested that there should in any event be a clear division of roles and responsibilities in that case, and in the cases where a CCP was supervised by a college, such as European cross-border CCPs, resolution should be conducted by a resolution college that would be narrower in order to facilitate coordination.

The resolution authority came in at the resolution stage and the EU Parliament had recommended that there should be oversight by public authorities when end-investor money was involved. It was suggested by several speakers that the resolution authority also needed to be involved in the recovery stage, given that recovery would be a fast process and the authority needed to be well-informed of the situation. Moreover there was merit in an early intervention while resources were still remaining, in cases where a recovery was destined for failure, although this was difficult to predict and it could be unhelpful to intervene prematurely in some cases.

Flexibility vs predictability of the CCP R&R framework

Some panellists were in favour of limiting flexibility in the R&R process and ensuring a presumptive path as the most predictable way possible.

Predictability in resolution was very important because at that point all stakeholders would need clarity on where the process was heading, what resources would be used and how the continuity of the CCP could be managed. Clearing members were favourable to predictability, a panellist stressed, because they needed to know upfront what were their financial exposure and liabilities and to be able to plan operations, given that there would be multiple issues to face in the event of a CCP failure i.e. closing bilateral exposures, bidding on auctions in several markets, etc... Shareholders and asset holders also wanted to know what would happen and what they would be liable for. Moreover predictability was important for incentive reasons, because the market would internalise the risks of failure thereby diminishing the risk of failure. Finally, resolution involved interfering with property rights and if resolution authorities did not follow a contractual order in loss >>>

>>> allocation for flexibility reasons, they might face legal proceedings and the threat of successful compensation claims under the ‘no creditor worse off’ safeguard.

Other panellists were in favour of more flexibility. It was indeed very difficult to know what to expect in advance because all defaults were different and in severe crises a rulebook could only be used to a certain extent, before specific thinking was needed. Transparency regarding the waterfall and the obligations of the different stakeholders was however essential.

A balance had to be struck between flexibility and legal certainty, a speaker emphasised. There were various reasons why flexibility was important. The toolbox of measures needed to reflect the differences among CCPs and had to be broad enough to adapt to different liquidity situations in the market and different crisis scenarios. At the same time there had to be legal certainty for supervisors; in addition investors and asset holders needed to know what would happen. Also, there should be no conflict between the actions of prudential and market supervisors, that otherwise might prevent clearing members from participating in the resolution process.

One speaker understood the benefits of a fixed order of loss allocation in resolution in particular but stressed the importance of having appropriate incentives in order to prevent manageable situations from becoming crises. A key to success was in incentivising the clearing members who were crucial for the resolution of the CCP to behave in an appropriate way and to participate in the auction process, if one was needed. This required the incentives to be carefully thought through. For example, if a resolution strategy led to clearing members regaining control of a CCP that had been demutualised, through the provision of equity to members that absorbed losses in resolution, this could influence their behaviour earlier on in the process. Another issue was having the appropriate capital and leverage ratios that would allow members to bid on the defaulting member’s portfolio. Predictability and transparency about the order of loss allocation could be beneficial in this case provided the incentives were well-aligned.

Ensuring the availability of appropriate financial resources

Where the question of predictability really arose was regarding financial resources. If the two largest net debtors defaulted, there had to be sufficient aggregate financial safeguards to cover the losses. The resolution discussion had reached an awkward position because CCPs were required to implement

comprehensive loss allocation rules, meaning that the losses would have to be absorbed by the market right down to the end of the waterfall, with less attractive tools as they moved further down.

The question was where the resources would come from and to what extent they needed to be pre-funded. Implementing a resolution fund and TLAC was challenging because they were difficult to scale and involved additional costs. A speaker felt that asking CCPs to pre-fund resources on top of defaulter margins and Cover 2 requirements (the EMIR requirement that total financial resources should cover the default of the two largest members) would challenge their business models and go against incentivising central clearing. An option for ensuring that adequate resources would be available for resolution without requiring additional pre-funding might be to reserve parts of the waterfall for potential use by the resolution authority. They could incorporate a final cash call in the recovery plan or in tools such as variation margin gains haircutting or partial tear-ups of trades, subject to discussion with the resolution authority. It was also suggested that the clearing members should receive equity in return for contributions to the resolution cash call. However, another speaker considered that this approach would lead to re-mutualising the CCP and needed further thought; if equity was wiped out, it should be in favour of new money. Another issue was that these tools impacted end-users and this would be a situation left to management discretion; it would therefore be preferable to put that under resolution, a panellist suggested.

Whether an exposure to a CCP was capped or uncapped was also a critical issue for clearing members, who were asked by their regulators to measure risk ex ante if they were joining a clearing house that had the potential for uncapped liability. This was the case for some CCPs, where members had to cover remaining losses that exceeded the guarantee fund for the CCP to continue its operations. In many other CCPs however there was a cap on a single default, for which the guarantee fund could be used. What happened in this case if the breakdown was more systemic and if more than one clearing member defaulted was however unclear, because clearinghouse approval was necessary for a member to withdraw and members were subject to a continued replenishment obligation of the guarantee fund over a period of time. Having the market provide large cash calls at a bad time was procyclical. Therefore the best way to arrange financial resources, in terms of market stability, was to have a capped structure as the standard, a speaker stated.

International Coordination

The delay of European legislation until the end of the year to allow international standards to >>>

>>> develop was applauded. The prospects for success were far greater when everybody reached a degree of consensus around international standards at the start, and were held to them, rather than engaging in lengthy equivalence processes.

They however faced the challenge that laws were made nationally and decisions were made by local authorities, while the financial system was global, markets were interconnected and many CCPs had a global dimension and shared the same clearing members. Outcomes had to be delivered that worked for all jurisdictions when they faced a stress event, but they did not yet have an appropriate answer for that, a speaker believed. Barriers had been created between financial systems because it had not been possible to reach reliance and trust. Although the framework should work for both the home and host countries of a cross-border CCP, the issue was not to protect a specific country but the whole financial system,

another speaker emphasised, this was a global issue. Another challenge was that business could move from one CCP to another and potentially concentrate in the weakest point in terms of regulation, and this would threaten stability.

Establishing a minimum set of common standards at the international level, such as those defined by the FSB and CPMI-IOSCO, was a necessary starting point for addressing these different issues. There remained however the issue that laws were local and would be applied by local authorities, a speaker stressed.

Moreover prudential and market supervisors needed to be brought together in the event of a CCP resolution in order to avoid contradictions between them. This required knowing where the possible barriers were, e.g. regarding clearing members that may be located in different jurisdictions, and pre-planning in order to have enough legal certainty. ●

Insurance: what systemic risks in the insurance sector?

KEY ISSUES | *This session was intended to clarify where we stand regarding the definition of NTNI and HLA and more generally the global framework dedicated to the systemic threats possibly posed by certain insurance groups. The panel also outlined possible adjustments required by the Global framework.*

Designing globally a better methodology for systemically important insurers

The IAIS was a technocratic body of supervisors, not a legislative body, and had no legal authority. Its role was to develop standards, which democratically elected bodies can then decide whether or not to adopt.

However, a 'glass ceiling' existed between the IAIS and the FSB: the FSB was pursuing its objectives without access notably to systemic risk management plans that were submitted to the IAIS, and a more detailed consideration would need to take place of what should be in these reports, to avoid systemic risk in the sector.

The Parliament had recently adopted an initiative report on the governance issue linked to global standard setting. Elected representatives of the population should be capable of explaining to voters where rules arose from; sometimes, this was not

possible. This was very important provided that insurance regulation had significant potential impacts on growth and job creation. During the financial crisis, the G20 had played a major and positive role in finding a global solution; however, the G20 was also entirely undemocratic, and non-universal. Now there needed to be more consideration of how to increase cooperation and accountability.

In 2013, the IAIS published its First Methodology to assess globally systemically important insurers which contained provision for review every three years. The first review took place and an updated methodology was published in November 2015 for public comment. The IAIS has been considering comments received and revisions to be made to the 2015 Updated Methodology. Comments have been supportive of the direction of travel, although some had wanted to go further.

The IAIS was focusing on the development of 'absolute reference values'; clarification of >>>

>>> what was going to happen within ‘phase 3’, the qualitative phase, and the reinsurance supplemental assessment; and the best way to make processes transparent for the benefit of firms. This new methodology would be published in the first half of this year, and would be applied to data that the IAIS had already started collecting, with a recommendation made to the financial stability body regarding designations in October.

Although there had been a lot of concern about nine groups being designated as internationally systemic, this should not detract from what the IAIS had done to work towards a common framework for the supervision of internationally active groups that recommends good practices, a common culture of supervision, and early warning systems, among other improvements. Given that the IAIS had no legal authority over any firm, no standard was legally enforceable; crisis management groups were already active, assessing liquidity and producing resolution plans. Initiating the development of the first ever capital standard in insurance was a significant achievement.

Systemic Risk and Reinsurance Groups

Reinsurance has been singled out for supplemental assessment in the latest IAIS G-SII designation methodology proposal, despite consensus that traditional reinsurance business is unlikely to be systemically risky. The rationale provided by the IAIS is the concern that reinsurance might lead to institutional and/or geographical concentration risk. Many studies by IAIS, regulators, and rating agencies classify reinsurance as “unlikely to be systemically risky”. Accordingly, reinsurance is neither a source nor an amplifier, but rather a mitigant of systemic risk. Concentration risk assessment is first and foremost quantitative in its nature and cannot be captured with a discretionary qualitative assessment. If there were concerns about large exposures – i.e. concentration risk, a solid quantitative assessment should primarily take place and not a totally discretionary qualitative assessment. At least one reinsurance institution prepared such a quantitative assessment and is making it available to the IAIS. The outcome of this assessment has proven to be quite impressive, having identified that reinsurance is far from systemic.

Concerns Raised by Insurers

The European Parliament had recently adopted an initiative report on the governance issue; it had appreciated the direction that it had been given, but had some concerns, as did the insurance sector.

One institution stated that it was generally accepted that, in banking, size was the basis of designation as

systematically important, but this was not the case in insurance: diversification meant that large groups were not necessarily riskier. The notion of residual risk also needed to be borne in mind as an insurance company’s role was to accept and manage risks i.e. the products might be hedged or not hedged, or diversified or non diversified. They were of the view that the designation framework focusing on a few institutions and activities overlooked the biggest risk: namely, low interest rates, which endangered long-term savings, social security and social stability and had a significant impact on the financial sector. This was not just a risk for insurance, but for society more broadly; it was a risk for long-term savings, social security and social stability, because people did not get a return on their savings, and it was very difficult to get guarantees. This had a very broad-based impact on the financial sector.

There was a difference between FSB and the United States in relation to designation: the Metlife case demonstrated the possibility of judicial reviews in the United States, but if an institution was designated as a GSII by the FSB, it had no right of appeal. FSOC derived its authority to designate U.S. non-bank financial institutions as U.S. non-bank SIFIs, from the Dodd-Frank Act, which also provided designated firms with a legal means to contest their designation. In this context, Metlife requested a judicial review of FSOC’s decision and the judge rescinded its designation. FSOC has filed an appeal. Metlife welcomed this decision as a recognition of certain of its claims.

There was a need for increased transparency; one insurance representative noted that her institution delivered data, but did not know how its scores were calculated, or at what level an activity was deemed to be systemically risky. Firms should be told what their situation was, in order to allow them to manage their systemically risky activities. The IAIS could consider developing a more proportionate approach to policy measures, whereby as institutions became less important, the policy measures applied to them decreased proportionately. This needed to be articulated to avoid large cliff effects.

Non Traditional/Non Insurance

The IAIS had published a paper regarding the definition of NTNI activity in November, separate from its proposed updated Methodology; this affected a number of work-streams. Its purpose was to articulate why the IAIS considered certain activities NTNI, and to connect this to transmission channels. Numerous comments had been received, with the industry generally welcoming the fact that the IAIS was trying to better articulate why certain products were NTNI, but being concerned >>>

>>> that the IAIS was conflating macro prudential risk with micro risk, particularly in the case of variable annuities and the management of variable annuity risks with purchase of derivatives.

Most people agreed on the definition of non insurance activity, but the non traditional space was more difficult to define. One insurer had conducted work on this issue identified, which demonstrated that the notion of NT was not conceptually sound. Another agreed, noting that the ‘NT’ aspects of NTNI were most concerning in terms of systemic risk. They had identified that it was very difficult to achieve a binary, strict classification of which products were NT: in an overall assessment of how systemic a company was, it was necessary to look at what the drivers of the systemic risk were, and what features of an insurance product were most likely to contribute to systemic impacts. Qualitative assessment needed to be taken into account.

Single large institutions’ failures are not the only source of market impact. Several medium institutions’ reactions to market stress must also be considered, as identified in the 2016 IMF global financial stability report. One example of this form of stress is low interest rates, which is something that is not captured within the definition of NTNI or via the designation of companies; it is an issue that impacts small and medium sized companies also. To tackle this, it would be necessary to take into account different measures, including macro surveillance programmes, micro supervision, and cooperation between supervisors.

Alternative Approaches

If activities gave rise to systemic risk, they should be appropriately noted and regulated across the industry as a whole. This approach was much less likely to disturb competitive balance within markets and give certain firms advantages over others; at least one representative of the insurance industry was pleased that the assessment methodology was being reviewed and reconsidered, as the current methodology confused the concept of vulnerability with the concept of systemic impact. Within the industry, there were extensive risk management programmes, but the many of the assessment Methodology presently in use ignored these product and balance sheet risk management tools.

One insurer felt that if the IAIS and others persisted in assessing firms, they would need to not only look at the relevance of the firm compared to other insurance firms, but also as compared to financial markets as a whole. The comparison should be with some kind of objective benchmark of the sort of damage that a firm or an activity could do to

the financial system. Separating vulnerability from impact of failure, considering risk management tools, and using objective benchmarks instead of relative analysis would produce a much more reasonable approach.

A representative of a different insurer replied that products could not be labelled as non traditional without understanding the individual product features, and the proposal should not introduce an entirely discretionary assessment. A representative of a supervisory authority commented that the ideal approach was one that combined quantitative proxies with more accurate qualitative information, while maintaining full transparency in relation to designation.

Expected Evolutions

The designation of individual large companies misses an additional equally important source of systemic relevance, which might come from small to medium sized firms’ reaction to continued low interest rates coupled with asset price shocks, or through very large duration mismatches. These could affect a wide variety of firms. This activity based or sectoral source of systemic risk was different in nature, and therefore required different policy measures. To deal with the possibility of activities based or sectoral systemic risk, as opposed to that arising from individual companies, the IAIS was providing the appropriate ‘building blocks’; one of these was ComFrame, which contained within it the ICS that the IAIS was developing.

Today, much of the focus in relation to systemic risk in the insurance space was on variable annuities, because managing these required dynamic derivative hedging; if markets were to stop, the owner of these would be ‘stuck’ with a lot of derivatives and liabilities that did not have any more cover. Companies should not be incentivised to not hedge to cover their risk, and as such, incentives to reduce interconnection needed to be put in place, with the systemic designation taking derivatives’ interconnectedness into account in a thorough way.

The ICS represented an opportunity to improve the product based approach: it would be a better base for calculating the HLA, compared with the BCR, but would also allow for all supervisors to use the same metrics for measurement, and would avoid regulatory arbitrage between different jurisdictions. It would also allow product based classification to be abandoned to a certain extent, and would promote the development of better measurement of certain dimensions that were relevant to systemic risk analysis. ●

Market-based finance: what systemic risks associated with asset management and other market-based finance activities?

KEY ISSUES | *This roundtable discussed the possible systemic risks and vulnerabilities associated with asset management and other market-based finance activities such as money market funds and securities financing transactions, whether current or proposed policy measures were sufficient to appropriately mitigate these risks and additional measures that may be needed.*

Financial stability risks associated with asset management activities

Market-based finance, which provided banks with diverse sources of finance and helped to reduce reliance on bank funding, had grown in importance.

Within market-based finance, asset management was playing an increasing role in the functioning of the financial system and for investors; there had been strong growth in particular in the bond fund market. Generally, investment managers reduced systemic risks because they were making informed choices, unlike many retail investors, but the risks entailed by the development of investment funds needed to be understood. The FSB had identified four areas of potential vulnerability in asset management activities: misalignment between fund assets, asset liquidity and redemption features; the use of leverage within funds; the operational risks and challenges associated with transferring investment mandates in distressed circumstances; and securities-lending activities. Recommendations had been made by the FSB and IOSCO for mitigating liquidity mismatch and leverage risks which would be published in June for public consultation, after which IOSCO would develop a follow-up framework.

It was quite clear now that systemic risk in the field of asset management was not related to size, per se, a panellist stated. Moreover activities, as well as liquidity and leverage issues were now the main focus of systemic risk assessments, rather than the designation of possibly systemic entities. This was because asset managers did not use their own balance sheets, but acted as agents. There was no issue with substitutability in the asset management sector, as clients who invested in funds had a choice of alternative funds and mandates in the marketplace.

Liquidity mismatch

Liquidity mismatch was a key concern and appropriate disclosures were important for asset managers and the authorities as well as for investors. Robust stress testing was also needed. Fund liquidity depended on a number of factors. One was the liquidity of underlying assets, which had become more fragile, notably in the corporate bonds market. Other factors included the subscription-redemption flow of funds, the cash that was available in the fund to face redemptions, the price at which fund assets were valued and the time taken by the settlement of asset sales. There were also herding issues that went with the delegation of portfolio management and the incentives that this created.

The UCITS and AIFMD directives in Europe provided liquidity measures. There was however still scope for improvement in the tools available for managing liquidity risk in funds with e.g. appropriate redemption terms better aligned with the liquidity of underlying assets and liquidity buffers, a regulator considered. There might also be scope for improvement of the tools that could be used to manage significant redemption pressures, such as gates, side-pockets and suspensions of redemptions. These latter tools were being debated as some believed that their use could create panic in the market and contagion risks; moreover, there was discussion as to whether the system as a whole was well served by such tools being at the discretion of boards of funds, rather than decided by regulators. Temporary credit solutions could also be proposed as an alternative to redemption in some cases, a panellist suggested. Tools such as swing pricing and redemption fees were moreover needed to reduce first-mover advantages and dampen run risks.

Leverage

With respect to leverage, the FSB was in favour of the provision of consistent and accessible >>>

>>> data on the use of leverage in funds which required an appropriate set of measurements to be developed. Leverage was an important issue in the fund sector, as it could amplify liquidity and herding risks in particular. Rules in the EU and US imposed limits on cash borrowing by mutual funds, but quite significant leverage could still be built in some cases through derivatives, an official stated; such hidden leverage existed in some bond funds for example.

In Europe there was already an extensive reporting mechanism provided by the AIFMD that included leverage, as well as the possibility for ESMA and the ESRB to intervene if critical leverage risks developed at market-level. Reporting on leverage was however not available for UCITS. Some speakers regretted this because although such funds could not borrow money, leverage could still be built for example through the use of synthetic products. Other speakers argued that the leverage cap for UCITS concerned the overall leverage exposure of funds and not only borrowings. Improved data would help to determine this more precisely.

Conduct

A regulator considered that the main risk in the fund industry nowadays was from conduct, rather than liquidity or leverage. Inappropriate conduct could damage investor confidence and have systemic consequences. The issue at present was that with the present market conditions funds were moving into riskier assets in order to obtain better investor returns and could be tempted to look for ways to generate more fees. The rules on custody had been greatly strengthened, which was important in this perspective since custodians played an important role in checking the way funds were managed, but other measures may still be needed.

Update on the EU Money Market Funds (MMFs) regulation proposal

Significant moves were being made towards developing a regulatory framework for MMFs in Europe, following the report adopted by the EU Parliament in April 2015. Satisfactory progress was also being made in other jurisdictions according to the FSB.

The concerns that were raised regarding MMFs were related to liquidity, run risk and contagion. An industry speaker stressed that even in October 2008 outflows from prime MMFs, which invested both in corporate and government debt, had only reached 13%; moreover most of the outflows had gone into other government MMFs. Ensuring that the potential issues raised by MMFs were addressed was supported by the industry. Three main types

of measures were included in the current EU proposal: required weekly liquidity levels of 30%, the possibility for fund boards to impose fees and gates and the limitation or ban of sponsor support.

A regulator was supportive of an EU MMF framework but regretted that the approach proposed was quite rigid; this may be an issue if market conditions changed, as co-decision would be needed to change the rules. General principles relating to liquidity, building on the *acquis* of the UCITS and AIFMD directives would have been preferable to the detailed rules proposed. Supervision of MMFs was another issue, as MMFs did not exist in all EU countries; a reinforced supervision would be needed including the countries from which investment originated, as these could be hit by issues affecting these funds.

Vulnerabilities associated with other market-based finance activities

The FSB had a broad monitoring framework for shadow banking, with a specific focus on activities involving credit intermediation, leverage, maturity mismatch and imperfect credit-risk transfer, which raised stability risks. Asset management activities were the largest component of this latter segment in which there had not been significant growth over the past few years.

The starting point for defining how shadow banking risks should be regulated and supervised was to better understand the underlying drivers of their development which included search for yield, regulatory circumvention, complementarities with the rest of the financial system and the growth of large institutional investors that demanded assets. In order to identify and address these risks, an efficient interplay between micro- and macro-prudential authorities and business conduct authorities was needed. Moreover transparency regarding the products that clients were investing in and the tools that investment managers were utilising was essential. Transparency on a fund level was not sufficient though, because regulators needed to be able to understand the risks across the entire sector.

A number of policies had been set out for the areas where there had been clear regulatory shortcomings before the crisis, which included MMFs and securitisation. The interdependencies between the shadow banking sector and the banking system had reduced and would be further addressed by Basel III rules. Securities financing and repo activities were another area of focus of the FSB, as they fostered pro-cyclicality and leverage; minimum haircut floors had been proposed in order to limit the development of leverage. >>>

>>> Substitute products that were manufactured outside the UCITS/AIFM world, such as notes were another issue to be addressed in Europe, a regulator suggested. Some of these products which resembled UCITS did not offer the same level of protection, but would be circulating quite freely with the implementation of PRIIPS in 2017.

In the insurance sector the situation was different, an official noted. The sector as a whole had not

shifted towards riskier assets, but had become more exposed to risk, due in part to the low interest rate environment and to changes in market dynamics. Higher cross-asset correlations had also been observed with the rest of the financial system, diminishing the potential role of insurers as shock absorbers. ●

Global coordination: how to improve the coordination of capital market regulation and capital market data?

KEY ISSUES | *This roundtable discussed the need for further regulatory coordination at the global level in the capital markets area and the possible solutions for improving the global coordination and cross-border implementation of capital markets regulations. The progress made at the international level in the standardisation and sharing of data needed for financial stability monitoring was also examined as well as the remaining issues.*

Regulatory coordination needed improving at the global level despite significant progress

Significant progress had been made regarding global cooperation since the crisis, but many issues remained to be addressed.

A regulator stressed that the communiqué from the 2009 Pittsburgh G20 meeting had been a remarkable statement. The spirit of cooperation read through virtually every paragraph, with encouragement to avoid balkanisation and protectionism. However, in the six and a half years since, the spirit of cooperation had been subsiding; regulators, notably in the US, had been operating somewhat unilaterally. A significant step forward had been achieved regarding equivalence determination in February 2016 in the area of CCPs, which was a positive sign. There was also a general agreement among regulators that more international cooperation was necessary. But countries had different histories and legal systems, which made harmonisation difficult. The backdrop of this situation was substandard growth in which the lack of coordination on global rules played a part. Maintaining a strong global financial services market was essential for economic growth.

Two main issues had to be addressed in order to achieve greater cross-border cooperation between Europe, the US and Asia. Political risk was a first

issue: regulators were concerned that deference to other jurisdictions would expose them to a greater risk of being challenged by politicians if investors lost money. Loss of sovereignty was a second concern, with global standards often giving rise to defensive postures on the part of domestic regulators.

The issue, however, was that these problems would not go away in a world driven by a greater degree of populism. A cultural shift was needed, and regulators had a role to play in this, to remind the marketplace that investment in securities markets was essential to prosperity but that this would not go without risks. Market risks should not systematically lead to a political crisis or to investigations. Systemic risks and manipulation were a different issue and regulators were there to police these risks. Making sure that regulators could continue to work together and finding global ways of addressing market issues was also essential in a context where issues were increasingly being looked at in a similar way around the globe, some panellists emphasised. Further developing a culture of compromise among regulators was also necessary.

When considering which areas of regulation could benefit from more global cooperation, OTC derivatives were an obvious candidate, because of the global nature of the market. Repo markets >>>

>>> and the related reporting were another area worth considering.

IOSCO had produced a very detailed paper at the end of 2015, laying out three main approaches to regulatory co-operation (national treatment, recognition and passporting) that would be completed later in the year with a next-steps paper on cross-border regulation. IOSCO was also increasingly using a toolbox approach in its different initiatives, but this raised potential implementation issues. Toolboxes were a set of options but did not establish a standard. Moreover it was not yet clear how equivalence assessments could work with existing vested domestic interests.

Progress had been made with TRs to improve market data

Improving market data was essential since a lack of transparency on the counterparty credit exposures of large swap dealers had been at the heart of the financial crisis. Significant progress had been made towards making the derivatives market more transparent with the implementation of Trade Repositories (TRs).

TRs had emerged as a key tool for identifying and monitoring systemic risk through the collection and maintenance of derivatives data. They were supported by significant investments and were now receiving and reporting massive volumes of data on derivatives markets. Key questions however remained about whether TRs were achieving the G20 mandate for measuring systemic risks; the usefulness of the data was indeed limited by the fragmentation of TRs at the global level, the difficulty of sharing data across jurisdictions, as well as data standardisation and quality issues including formatting, completeness and accuracy. The implementation of TRs had been so far mostly domestic, with a focus on the surveillance and identification of risks in individual domestic markets - TR data was being successfully used in Europe by the ECB and the ESRB and also in Singapore and Hong-Kong for example - rather than on the monitoring of systemic risk on a global basis, as had originally been planned by the G20.

Capital market data required further harmonisation at the international level

Achieving full consistency of data was a daunting task; therefore an incremental approach had been chosen in order to progressively expand the group of players using standards and a harmonised dataset. Establishing a target for a global data architecture was however necessary, not to lose track of the longer term ambition to achieve more complete

harmonisation; swaps data was the number one priority in this regard, some speakers emphasised.

Data standardisation was a win-win improvement for regulators and the financial industry. The importance of data was recognised both by regulators and the industry, notably for systemic risk measurement purposes. There were however huge costs associated with the collection and processing of data, most of which was performed by the industry, in a context of lower margins and higher regulatory costs. Further harmonisation was essential for improving the efficiency of these data-related processes.

It had been hoped initially that standards would first have been defined globally and then implemented domestically, but the implementation had been faster than expected and domestic jurisdictions had established rules before international standards were available. There was a real need to look at data harmonisation issues globally, in connection with organisations such as CPMI-IOSCO, before implementing some of the detailed level requirements at a national level, because data was difficult to improve ex-post. Ideally, a single standard-setting authority could be in charge of establishing standards at the global level, monitoring their adoption and the related rulemaking at the domestic level and ensuring compliance with them, a panellist suggested.

Progress was being made towards further standardisation, in particular through international efforts to establish standard identifiers such as the Legal Entity Identifier (LEI). The adoption of LEIs was very encouraging; more than 430,000 LEIs were registered in Europe and some institutions had about 30% of their counterparties already using one. However, the type of data hierarchy to be used with LEIs had to be defined, since an accounting hierarchy did not work for all parts of the industry, a panellist believed. Moreover, 20% of LEIs had already lapsed, and it was a challenge to keep pressure up to renew them each year; this required cooperation between regulators and the industry. A broader adoption of identifiers, such as securities identifiers, should also be planned in a second stage.

The importance of good quality data was emphasised

Sufficiently clean and good quality data was essential for analysing, sharing and using data collectively across jurisdictions.

Improving the quality of data was a main focus of ESMA in particular, both at the domestic and EU levels. Cleaning data so that it could be used effectively was however a difficult and time-consuming >>>

>>> task. It was important to draw common experiences from the implementation of EMIR, MiFID and SFTR reporting in this perspective, a speaker suggested. EMIR data was not easy to use, and there was the need to gather more information than had initially been defined, because the understanding of risks had evolved. Expectations had to be well managed in such a context, taking into account the tools that were available. Involving the users and providers of the data in the definition of objectives was also important in order to check the feasibility of data collection and analysis.

Another focus was the measurement of systemic risks. This required ensuring that sufficient data sources were available for assessing the interconnectedness between the banking sector and other parts of the financial sector and for monitoring financial stability in the capital markets, which was increasingly important with the CMU objective to diversify the financing of the EU economy. This was quite challenging because the capital markets had a hugely broad horizon. Trying to get reliable data from across the range of different market participants and activities was quite difficult; the attempts made so far had not been very successful. Supervisors needed to work collectively to assess risks in the overall financial system and how they were moving between its different components. In any case, spotting the next crisis was probably too ambitious, so supervisors had to make sure at least that the last crisis would not repeat itself, a panellist stated.

Data governance and access to data at the international level also had to be improved

The FSB target to remove all barriers to sharing data by the middle of 2017 was an important step towards the further harmonisation of derivatives data reporting. It was suggested that a data governance and access framework was urgently needed. This would ensure that data standards were maintained and updated, as markets and regulatory requirements evolved, whilst providing a formal structure for the appropriate sharing of and access to data across jurisdictions.

Data privacy and transference was an emerging issue to be considered in this regard, with ongoing data protection initiatives in Europe and Japan for example. There was concern about whether data would be handled in an appropriate manner if such rules developed further. Moreover, while some regulatory obstacles to the sharing of data had been removed (for example the indemnification provision in the US), others remained, such as Article 75 of EMIR relative to the recognition of TRs authorised in third-countries. ●