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EXECUTIVE SUMMARY

Highlights from the Forum

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1. DEEPENING THE EMU & BREXIT IMPACTS

Impacts of Brexit for the EU financial sector

1. Brexit is a complex and difficult process that requires a clear framework

Brexit is the most structural and systemic event that has happened in the European Union. It will not be possible to carry on with 'business as usual', otherwise the future of the EU and the Eurozone might be threatened. This is not only an economic issue; there are also social issues and governance implications to be considered.

Although there are indications that Ms May may trigger 'Article 50' before the end of March 2017, there are still many uncertainties and Brexit is likely to be a protracted process. There are difficult trade-offs to be decided by the UK in terms of autonomy, budgetary constraints and access to the single market. Reconciling the EU and UK views on access to the single market and labour mobility in particular will be difficult, and it was suggested that one solution to facilitate negotiations could be to refine the definition of these concepts, in a fair and symmetric way. Moreover any change from the present situation will have quite different impacts from sector to sector which all need to be assessed. Negotiations over a free trade agreement will most probably take longer than 2 years if the UK chooses a 'hard Brexit'; however, it was pointed out that the negotiation period can be prolonged beyond 2 years if there is a unanimous decision between the country leaving and the other EU nations.

Although these issues are complex to solve, there is a need to move quickly and to establish at the outset of negotiations a clear framework for the end-scenario and also for the interim period that minimises disruption. The deadline for resolution that needs to be borne in mind is the next European election, one panel member suggested. At that point, it needs to be clear whether the elections are to a body with either 27 or 28 Member States, and as such, the process needs to be finished by the end of 2018, with the parties involved seeking a 'gentleman's agreement' that no future Commissioner or MEPs will be appointed from the UK.

In the view of one panel member, European governments should not have Brexit as their most significant priority, but should focus on EU integration, its link with globalisation, and the ability to encourage nations such as China and the US to take European views better into account.

2. Significant impacts can be expected for the EU, at least during the transition period

The impact of Brexit on the EU economy and financial sector is likely to be quite significant, some members of the panel considered, although it is difficult to evaluate and there is no other event to compare Brexit to. There are two extreme scenarios that can be assessed: one in which the City of London effectively remains within the EU, and one in which it is totally outside. The latter could have significant implications for the EU; for one thing, London is likely to take competitive actions in relation to regulation, taxation, and related topics in order to retain its business. In addition the positive externalities that are currently achieved for the whole of Europe with the City of London hub may be difficult to reproduce if these activities and expertise are dispersed throughout Europe. Many global and European clients of the financial industry, including EU Member State's debt management organisations, are already struggling to deal with the implications of Brexit, and it is possible that it is the US that may in the end benefit from post-Brexit relocations if an appropriate arrangement is not found between the UK and the EU, a panellist stressed. The debate will be essentially a political one, but the financial and economic aspects also need to be considered; the less the UK ecosystem is damaged, the better the outcome is likely to be in the transition and in the eventual steady state.

Financial institutions are committed to helping their clients, and are planning for the 'worst case scenario' of the City of London leaving the EU entirely, but actual execution is likely to be costly and complex in a relatively short two-year timeframe and may involve significant operational risks. Some institutions have the appropriate legal entities and licenses in >>>

>>> place throughout Europe but that is not the case for all of them. Moreover, relocation decisions are likely to be delayed until the situation is clearer, because in the case of Brexit, there is a 'last mover advantage', a panel member remarked: institutions will want to verify first that they are not going to be alone in a location before deciding to move. As long as UK has access to the single market, moving is not a sensible strategy for most players, and even in the worst case scenario, many institutions will first want to see what the UK has to offer.

One panel member however stated that the negative impacts of Brexit for the EU will be temporary and will not raise any financial stability issues. Over time the EU 27 financial sector will adapt, and any services that cannot be provided from the UK any more will move to continental Europe; but the longer the process takes and the more uncertainty there is, the higher the transition costs will be.

3. Potential impacts of Brexit on the CMU

The speakers on the panel generally believed that there is no need to change the objectives of the Capital Markets Union (CMU) project with Brexit and some considered that Brexit may actually make the need for CMU stronger. The CMU is important from an economic point of view; it can reduce the cost of capital for EU businesses and particularly SMEs, help them to raise more funds from different sources and also provide EU citizens with better investment opportunities. CMU is also essential, from a financial stability perspective and to make the monetary union work. Further convergence is needed on issues such as insolvency laws or taxation in the CMU, even if this is challenging, due to the connection with civil law and the complexity of agreement among EU Member States. Progress in these areas will also help to illustrate in more practical terms the potential benefits of CMU for 'ordinary' citizens.

However, despite the case for CMU being potentially stronger, its deliverability is weaker, an industry speaker warned, due to the fact that expertise in the capital market in Europe is mostly located in London. The political part of the CMU project has been 'derailed' by Brexit, and although a CMU is still possible, it will be necessary to start from 'a completely different base'.

One panellist emphasized that the CMU would have yielded more if the UK had stayed within the EU given the importance of the UK capital market, which should be a reason for trying to make sure that the UK stays close to the EU and considering how the UK can be brought into this project despite Brexit. Another speaker considered that it is now important to be pragmatic and press ahead on a 27 state basis, not '27 plus one', because the latter solution would involve very difficult legal convergence and joint rulemaking. In some areas of civil law, EU 27 jurisdictions will probably be more willing than before, given the circumstances, to surmount domestic 'legal traditions' and hopefully EU 27 may become more convergent and stronger as a result. ●

Should the governance and functioning of the Eurozone and the EU change following the Brexit vote?

1. Brexit and the Economic and Monetary Union (EMU)

The issue of deepening the EMU remains the same both before and after the Brexit result. A stronger economic governance framework alongside the implementation of the Capital Markets Union and the completion of the Banking Union is still needed. The UK's decision to leave the EU makes the case stronger and more urgent than ever.

Brexit is a clear indicator of mistrust in Europe and ought to trigger a change in dynamics within Europe and the Eurozone. The result complements the geopolitical, demographic and technological problems faced by the European project, and the uncertainty at various levels could be a factor in why growth and private investment are so low.

A prerequisite to strengthening the European project is to return to its key aims of fostering peace, liberty and stability. The European project needs to demonstrate more accountability and a focus on delivery of the project's aims.

2. Proposals for deepening the EMU

The Single Market and the euro are two important assets for EU policy makers. Moreover the Eurozone is benefiting from a huge advantage: an >>>

>>> excess of savings versus investment of more than 300 million yearly.

In the economic field, according to a Central Bank Governor, there is an achievable three stage approach to deepening the EMU. Stage one is a Financing and Investment Union at EU 27 level to better channel savings into the financing of innovation, which is key to foster growth. This Union should bring together all existing separate initiatives – the CMU, the Banking Union and the Juncker plan in order to achieve a stronger synergy of them. Stage two is a collective strategy with better coordination of economic policies. A Eurozone that would have more structural reforms in some countries and more public investment in others would be an area with more growth and employment. This is why we need trust institutions and a Finance Minister for the Eurozone and a common European Treasury was suggested. Stage three is a budget and/or fiscal capacity for the Eurozone. An industry leader stressed that a potential stage four could be to stop applying rules that are suitable for the US, but not Europe. If Europe remains bank centric then they need to consider how Europe will define its position in key international fora.

Complacency regarding the Eurozone is inadvisable. EU needs to deliver on their commitments, and harmonisation in terms of a tax regime would also be helpful.

If Europe wants an innovative economy it must be financed through equity in a growing proportion. Europe is lagging behind in this field. The equity share of corporate financing is half large as in the US – only 52% of GDP in the euro area, versus 120% in the US. However EU savers are mostly risk adverse; people needs to change the way they look at the financial markets and this is a challenge for policy makers to address.

Fiscal discipline and budget consolidation remain of the essence; structural reforms are essential to increase potential output and employment. But evidence also illustrates that the two pillars the EMU was built on (single monetary policy and national fiscal policies) cannot work alone, and the absence of a third pillar (shock absorption capacity) put too much pressure on national fiscal policy. Therefore, the resilience of the Eurozone depends not only of structural reforms at the national reforms but also on effective risk sharing mechanisms preventing the resurgence of financial fragmentation plagued in the euro area in the 2011-2012 period.

A public shock absorption function can only be complementary to a private one that has to be built up with the CMU and Banking Union; those two areas have to be seen in coordination. CMU is therefore not only essential for better financing SMEs but its implementation combined with the completion of the Banking Union (implementation of a European Deposit Insurance Scheme and a backstop to the Single Resolution Fund) would also make the Economic and Monetary Union more resilient to shocks that may overwhelm national budgets or overburden monetary policy.

3. EMU risk sharing mechanisms cannot be implemented before Economies of the Euro area converge further

A public decision maker explained that Europe lacks implementation of rules and ensuring that they are safeguarded. The first objective is to implement and safeguard rules in all Member States, and ensure that breaches create sanctions; otherwise the credibility of the whole system is damaged. In addition, the current EU financial environment has no cross border banks, and prudential rules do not allow their creation. So long as those problems persist, fiscal capacity may not be the right answer. EU leaders need another starting point to deliver their risk sharing needs. Moreover risk sharing requires trust and confidence among Member States and sufficient economic convergence. The Country Specific Recommendations (CSR), which are often not implemented by the relevant Country as well as the 100 violations of the rules of the Stability and Growth Pacts during the past years are not encouraging in this respect.

Following Brexit, implementing an integrated financial system in Europe without London will be challenging, and unless the CMU is dramatically strengthened, the European financial system will remain bank centric. The idea of a CMU with 40 national supervisors will not work. ESMA needs to be strengthened. In such a context, the Banking Union and CMU must be more ambitious in response to Brexit. EU political leaders have more to do towards integrating Europe but given the upcoming elections in multiple European countries, it may be difficult time for huge progress.

Facilitation of improvements on Monetary Union must start from well identified political steps. Common policy in various areas may support acceleration on the EMU. Trust must also be restored. Brexit is an opportunity, but afterwards the European Construction needs vision, leadership and for political counterparties to understand that monetary policy alone is insufficient to increase investment and growth. ●

Deepening the EMU: what are the conditions?

1. EMU works better than it did before the crisis, though this does not mean everything is perfect

The euro area has made positive progress since 2009. First, with the creation of new and well-functioning institutions. These include the ESM as a lender of last resort to sovereigns, the EBA, SSM, SRB and SRF as part of the Banking Union and the ESRB. While the sum of these institutions makes the EMU more robust, there has also been real adjustment in countries that had lost market access. Macro-economic imbalances have decreased within the euro area since the crisis. Finally, economic policy coordination among Member States has become stronger, with a more central role for the Commission.

2. Structural reforms are the most effective way to boost growth and reduce unemployment

Central banks can 'buy time', but cannot solve structural problems. Structural reforms – which to a large extent are a national competence - are the best way to boost potential output and productivity growth, and to reduce unemployment, which remains too high in many Member States. This will produce economic convergence. They also make economies more resilient to economic shocks by increasing their short-term flexibility and by facilitating price and wage adjustments, as well as put in place a swift allocation of resources within and across sectors. A proper single market also offers real growth potential for Europe. However, in many areas the single market is not developed well enough. More single markets, such as an innovation union, will mean more growth and a stronger EMU.

While fiscal discipline is needed, the priority should be to boost investment. It was suggested that the Stability and Growth Pact (SGP) should be renamed the 'Growth and Stability Pact' in order to reflect the need for more focus on growth. Intelligent investment plans could also be treated differently under the SGP. Policy institutions and instruments need to be designed to give stronger incentives for structural reform.

The EMU framework is still not optimal: the Eurozone remains vulnerable. EU fiscal policy has been defined by shifts between political preferences in the past years. Europe needs to develop a common narrative, and fiscal integration must be discussed before another crisis breaks out. Both a deepening of the EMU and progress on economic convergence are required.

3. National risk reduction and strengthening the EMU

Risk sharing within the Eurozone is much smaller than in the US, and smaller than it was pre crisis. Risk sharing can take place through the fiscal channel, and through capital markets. Because of the latter channel, more work needs to be done on the Capital Markets and the Banking Unions.

There are trade offs between the fiscal channel and the financial market channel. One of the most sensible ways forward is risk reduction on a national policy level, while the centre does the risk sharing. However, more risk sharing requires more trust between Member States. This can be created via more progress on fiscal and structural issues. If all countries implement structural reforms, everyone will benefit. But the challenge at this stage is designing policy institutions to incentivise individual governments to carry out structural reforms, and make convergence more effective.

EMU deepening and economic convergence should happen in parallel; as growth is returning, now is an ideal time. If Member States have risk-sharing instruments available, they have bigger incentives to reduce risk, since the shared responsibility of risks goes hand in hand with better control of these risks; this needs to be translated into practical issues. Risk sharing can be embodied in a common fiscal capacity, without interfering with the principle of subsidiarity, such as the employment insurance mechanism proposed by the Italian government.

CMU is important both to companies and the efficiency of the single market. Its implementation should not be made more difficult by Brexit, which in some ways might make it easier. The Eurozone has 19 members, and this will hopefully grow in the future. In the aftermath of the financial crisis, the Banking Union had been seen as impossible to achieve, but now it exists and the discussion is even about adding new layers, which should be done without delay. Many countries are ready to move towards more solidarity through transfers; however, this needs to be conditional and temporary, given that public opinion cannot otherwise be convinced. ●

Defining common European positions and EU representation in global fora

1. Introduction

The specificities of EU financial markets and economies are not always appropriately taken into account in global policies, as is emphasised by European industry or public sector representatives. The main reason is that EU Member States often express diverging views regarding financial regulatory issues in global regulatory fora such as FSB, IAIS, BCBS, IOSCO or IASB. The previous year, the European Parliament adopted a report to insist upon the importance of Europe presenting a united face to the world. In the Chair's view, the main reason for building Europe and safeguarding the Union and the Eurozone is the fact that, alone, even the biggest Member States like Germany and France will not be in a position to have their voices heard worldwide.

A representative of a public authority stated that the need for a more unified voice is absolutely clear, particularly in the light of the Brexit decision. The world of regulation has already changed: there has been a move from a G7 to a G20 system, and in 10 or 20 years' time, it will be even more imperative for Europe to speak with a more united voice. Another public authority representative declared that given Europe's current position, it is extremely important to have a single, united position that is much more effective in the FSB or other international fora, and Europe must move in a timely manner. The more that Europe's institutions can reflect a common European position, the better.

Moving on time is one priority and lessons must be drawn from the MREL/TLAC and Basel IV experiences. Indeed the fact that the EU achieved a specific agreement with MREL before the Financial Stability Board reached another agreement on TLAC complicates and delays the implementation of TLAC in EU legislation. Accountability and transparency is also very important, as is the role of the European Parliament. It is going to take time to complete a fully-fledged European position in many areas. As well as this, the issue of incentives needs to be taken into account. Moreover, sometimes, there are strong national positions that are very difficult to reconcile, making the EU inaudible, and which are exploited in international fora by other counterparts. However, Europe is at a much better stage than it was five or six years ago.

2. The need for a stronger European voice in global financial fora

2.1. Examples where EU nations were completely disunited

It needs to be asked what sort of progress can be made to define common EU positions in global fora. There have been negotiations on global standards where European nations were completely disunited, and rather than 'fight the battles' that they should have fought in the European Union, they did so on the international level.

2.2. More positive examples

There are also other, more positive, examples. For instance, in the current Basel process, there is a much more united EU position than in any previous negotiations, although different views still exist among EU domestic regulators regarding 'Basel IV'. It is very challenging to define a global banking standard which takes into account the critical specificities of regional banking systems and financing mechanisms, but the progress that has been made is promising.

2.3. The need to act is imperative

Before looking at large, institutional treaties with associated changes, Europe needs to address a couple of practical issues: firstly, it is necessary to recognise what has happened over the last six or seven years in the area of financial regulation, where competence and many executive powers have shifted to the Union level.

3. Moving towards a single position is very challenging

3.1. Timing is very important

Europe should try to organise processes in such a way that it can form a European opinion before it enters into the final negotiation phases on the global level; in practice, this normally happens the other way round. On important standards, there is a need to act differently. Europe is now seeing the first benefits of the Basel process since there is an ECOFIN statement on key political objectives related to "Basel IV".

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>>> 3.2. Organising the political process in terms of timing, priorities and transparency is essential

There is no EU legislation on what is currently being negotiated in 'Basel IV'. As such, Europe has to take positions on output flows and other technical issues that are being debated for which it does not yet have common legislation. The first necessity is to organise the political process in terms of timing, priorities and transparency on the political and technical related issues. Europe also needs to think about processes via which it can come to a political common position before global legislation is in place. In the case of Basel IV, Europe is facing a situation where the US have a single position, while Europe has no common view due to the specificities of the main domestic systems, differences in supervisory practices and the absence of a common political will among European regulators in the BCBS.

4. A system of global enforcement is very difficult to achieve

The issue of governance, and how to make sure that the decisions that are made are implemented, is also important, and is an issue that goes beyond Europe. It is sometimes very difficult to enforce these principles: Europe has its own difficulties, and across the Atlantic, there are linked issues relating to a level playing field. The Chair noted that one of the reasons why the EU fails to implement what it decides at the global level is that global enforcement mechanisms are 'completely under-developed'.

A public authority representative replied that this issue raises very difficult questions. If a court system is established to enforce something, there is a need to have a procedure whereby there is sufficient democratic decision making before the standard is adopted, which currently is not the case. Standard setting today is done by the standard setters, which are agencies. The strengthening of enforcement would be a useful step, but there is a need to consider which procedure and which type of standard this aims to address, as well as how to change the procedures in order to provide sufficient legitimacy. Another public authority representative agreed that it is not easy to construct a governance system at the global level that is actually credible and enforceable.

5. More transparency is required in the EU governance framework

The Chair stated that this issue goes beyond Brexit: in the current environment, citizens might no longer understand where the banking and financial rules originate from. With no transparency in the first phase, and no ultimate enforcement to make sure that the system is fair, it cannot work. The United States already perceives that Europeans are not serious about cleaning up their banks. It is not possible to have a workable system with rules, but no enforcement or institutions, and believing that this can be built step by step is a 'naïve' attitude. One public authority representative advocated a transparent approach that is accountable 'bottom up', rather than a top down approach in which there is no clear communication and no clear accountability.

Another public authority representative added that the first question that needs to be answered is what politically people are willing to subject to global enforcement. People probably do not understand 95% of financial services legislation, but European legislators freely chose to adopt it. If, once the legitimacy issue has been addressed, there are areas in which global enforcement is crucial and Europe is willing to subject itself to the decisions of a non ECJ court of justice, it will need binding treaties and sufficient parliamentary involvement before the standard is enforceable. ●

ESAs: key challenges ahead

1. Supervisory convergence, proper financing mechanisms and cross sectoral cooperation are shared priorities of the ESAs

EIOPA has three main strategic priorities in the coming years: 1) supervisory convergence, which is obviously necessary because of the implementation of Solvency II; 2) consumer protection with an emphasis on preventative risk based supervision for business conduct; and 3) preserving financial stability in the present low yield environment. Regarding supervisory convergence the driver is the need for a coherent application of EU legislation in all member states, a level playing field which prevents regulatory arbitrage and a similar level of protection to all policyholders and >>>

>>> beneficiaries in the EU. With the shift from regulation to supervision, EIOPA has been developing an oversight role with the cooperation of the national authorities for the last two years.

Supervisory convergence will also be among ESMA's core work in the coming years; ESMA is moving away from 'rulebook making' and dealing with different topics than it has dealt with in past years, such as with the work it is now doing on home/host issues relating to Contracts for Difference (CFDs) and binary options. In addition, the ESMA and EBA representatives stressed that guidelines and Q&As are very important for their convergence work. The EBA is also working hard on supervisory convergence; its main focus has been on Pillar 2. The EBA's presence in colleges will allow it to assess how much consistency of outcomes has been achieved across the Union in this area. There is now a perception that the EBA sometimes acts outside its remit as own initiative guidelines are seen as quasi-legislative actions, but in the absence of transparent work done by the EBA, initiatives would be taken by competent authorities leading to more opaque and less consistent outcomes.

The Chair of EIOPA stated that there are two main institutional issues that need to be overcome. The first is having proper financing mechanisms, and the second is having proper resourcing at the national and EU levels. Moreover, EIOPA's mandate for supervisory convergence also needs to be strengthened; it needs a clear mandate on the initiation, collection and decision of supervisory convergence. Hence, it should allow conveying critical but constructive recommendations regarding national practices.

The representative of ESMA noted that cooperation with the other ESAs was very important: two key dossiers in the past year, in terms of rulemaking, were PRIIPs and bilateral clearing, and in both cases, agreement had to be reached in parallel in the boards of the three ESAs. Moreover monitoring risks moving from the banking sector to financial markets will be a challenge that requires cooperation between EBA, ESMA and EIOPA. It was also stated that some issues of consistency of EU rules across sectors need to be solved at a primary level.

2. Specific EIOPA challenges

The delivery of the draft Regulatory Technical Standards (RTS) on Key Information Documents (KID) for Packaged Retail and Insurance-based Products (PRIIPs) has been achieved, despite relatively tight deadlines. It has been based on extensive public consultation, including consumer testing by the European Commission and it resulted in a very good technical solution. EIOPA has been working intensively on the occupational pension side, although the fragmentation of this market in Europe makes a proper evaluation very difficult: EIOPA has been working with the stock that exists, which, in many cases showed that defined benefit (DB) promises that have been made in the past, and has advocated a more realistic check on these promises and their stability. EIOPA also stressed that a simple, standardized and fully transparent Pan-European Personal Pension product (PEPP) can contribute through the benefits of economies of scale but also to the implementation of the European Capital Markets Union by supporting the supply of long-term capital. EIOPA stands ready to engage with the different stakeholder in order to develop "PEPP pilot products" and to explore a possible specific prudential regulatory framework, which should be accompanied with a clear supervisory convergence mandate to ensure the trust and confidence by European Citizens. On the occupational pension side, EIOPA has conducted its first pension stress test and is already preparing for the next one in 2017. This one will look at the effects of a low interest rate environment on the sponsors behind the pension funds' promises.

3. Specific ESMA challenges

To successfully achieve the single rulebook, it is important that all actors keep pace with the finalisation of technical standards taking into account the deadlines set out in the founding Regulations. The implementation of MiFID gives rise to many consistency and transparency issues, which need EU-wide coordination. ESMA has taken on board a very large IT project, with the help of the national competent authorities essentially for MiFIR purposes and notably to enhance the quality of reported data. Being consistent in the area of CCPs and related topics is also vital, because small differences will result in regulatory competition. Concerning the direct supervision of trade repositories and credit rating agencies, ESMA has established effective supervisory processes and also implemented a robust enforcement process. ESMA underlined that the current level of fines are not sufficiently deterrent to change behaviour of market participants. ESMA will remain committed to supporting the objectives of CMU paying particular attention to consumer protection, financial stability and orderly markets.

4. Specific EBA challenges

There are three components to the process of repairing bank' balance sheets: the first is capital strengthening, and the second is to assess the quality of assets, which have both been done. >>>

>>> The third component, which is still work in progress, is cleaning up balance sheets and dealing with the issue of non performing loans: there remain one trillion non performing loans in the European banking sector, and the pace of reduction is still too slow.

Regarding the low profitability and low valuations of banks, the EBA representative did not believe that supervisors' objective should be boosting the profits of supervised entities; rather, it should be checking the viability of business models, and whether these are sustainable in the medium term. The EBA is trying to develop ideas about how to use the business model analysis under Pillar 2 to ensure that the necessary steps are taken to return the sector to profitability and viability in the shorter term. The EBA is doing a lot of work on the issue of internal models, with a 'roadmap' in place to repair the recognised problems in the function of internal models, and is also trying to coordinate a common European stance on Basel. Once this work is done, the repair and reform agenda on prudential matters will effectively be completed, but the EBA is also becoming work in new areas of rule-making, including payments services under PSD2.

The yardstick that should be used to assess the harshness of a stress test is how much loss or depletion of capital the stress test has generated. It is clear that the adverse scenario of the EBA is somewhat less harsh than the US's, because the baseline in the US is much better, but both are in 'exactly the same ballpark' in terms of capital impact. Some critics also say that the adverse scenario should have focused on low and negative interest rates, so as to address low bank profitability; but the exercise of the EBA is more challenging as it generates very low profitability while a rebound in interest rates is driving loan losses to higher levels. ●


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2. KEY VULNERABILITIES IN THE EU FINANCIAL SYSTEM

Key vulnerabilities in the EU financial system

1. Debt levels, Non Performing Loans and profitability challenges

Generally speaking, the financial sector is weakened by a lesser growth prone economy. Most of our problems derive from an excessive stock of debt. The world around Europe has also never been confronted with such severe geopolitical risks.

The recent stress test carried out by the ECB (July 2016) has indicated that the financial industry is more stable, but in the context of a much less stable world. The ECB's 'Referendum in the UK' stress-test identified that a 'Leave' vote was prepared for in advance; a number of the industry's misgivings arose from the wish to link these issues to their desire for policy change.

Regarding the vulnerabilities of the EU banking sector, there are great differences across countries and across types of banks. High levels of debt and non-performing loans in some Member States have been slowing down the recovery of the euro, impeded lending and investment, and hampered the transmission of monetary policy. NPL levels remain around €900 billion in Europe; both bank earnings and equity valuations are structurally lower than in the United States, which makes it more challenging for banks to raise capital in particular for the purpose of credit expansion.

Liquidity has not decreased, but its resilience appears to have done so. In the long term, however, incidents such as the 'taper tantrum' will recur, and the central banks will need to articulate the circumstances in which they will act as market makers of the last resort and the conditions that they will propose for doing so.

It is not clear if the low level of interest rates will assist or restrain policy-makers in implementing structural reforms and reducing public indebtedness.

Deepening the foundations of the euro area would not only increase the resilience of the economies of the Eurozone but would also facilitate the consolidation of the EU banking sector.

2. The size of the European banking sector and the lack of cross border consolidation

Lasting low rates put pressure on bank profitability, particularly on retail banks that rely on net interest income. The banking sector is currently not profitable, but mainly for structural reasons. It is notably overlarge in some Member States. In such a context, Italian banks, for instance, are not being acquired by sound banks and financial intermediaries, due to an unattractive probability of distribution of returns, and this is not just the case in Italy; there is profound structural weakness elsewhere in Europe which requires consolidation, a change of business models and the downsizing of the sector as a whole. In addition there is a chronic problem of competitiveness in certain Member States, which reduces the appetite of investors to invest in EU banks. There is also significant doubt in the market regarding the stress tests that agencies carry out.

3. The lack of a European equity market

Although in the past the Capital Market Union has been presented as extremely technical, it is fundamentally about introducing mechanisms for risk transfer across Europe through the equity market. Risk sharing through equity is indeed a key mechanism to achieve risk sharing, or, at least, it can be more effective than EU public transfers. Not having a European equity market that can distribute risk is a 'tragic' situation. The IMF will need to play a greater role in this area, and possibly be less technical in how it presents the issue. In any case, there is a need for urgency and politicians must demand agreement on this key issue. ●

Improving systemic risk policy in the insurance industry

1. The main changes introduced into the international systemic risk framework for insurance companies

Many governments have made it clear that it is now even more difficult to provide liquidity or capital to ailing financial entities, and many countries have huge debt problems. A non public funding solution has to be reached. This was the reason for working with the FSB and creating the SIFI programme, and for improving related assessment methodology. There have been constant technical improvements regarding the international systemic risk framework for insurance companies. IAIS will report its conclusions to the FSB, which will in turn report to the G20 in November 2016.

The main change introduced by the work on Non-traditional Non-insurance (NTNI) activities is the proposal to abandon NT activities. A conceptual framework has been introduced, which is key to creating something important in the future. It is focused on two main vulnerabilities – macro economic risk and liquidity risk – which need to be measured and mitigated in some way. The framework has been translated into the current methodology, which is still based on an entity specific and a product approach.

The new methodology addresses many concerns of the industry as a whole, but it is not yet clear what impacts this will have on the designation process itself. Additionally, the threshold values introduced to limit the list of potential G SIIs will only be fixed afterward; it is therefore not possible for insurance groups to organise themselves in accordance with these thresholds. Having indicators as measures against absolute reference values only makes sense if there is one single list for all global SIFIs, including the banking sector. Furthermore, a sound legal process does not exist for designation. A public authority representative pointed out that liquidity has different meanings in different sectors, and there is a need to be cognisant of this.

There have already been two iterations of systemic risk policy, the most recent of which was published in 2016. The next stage will involve further refinements, which will link in with the debate about macro prudential policies in insurance, and this framework could lead to additional work. Such a framework would allow for a number of future developments, such as being able to aggregate the risk of single entities at sector level. The IAIS needs to look at the activities based issues; however, an activity based approach has to be part of a hybrid model, rather than a replacement. The entity based approach is the right one, although not perfect, and some kind of activity-based approach needs to supplement the entity based one.

2. Remaining challenges

An industry representative regarded what has been done as a 'step in the right direction', but the sources of systemic risk are not yet adequately discovered. More work needs to be done soon; 'size' in the sense of the amount of risky activities that must be taken into consideration when discussing policy measures, must be taken into account, and 'discrimination' can be solved via an activity based approach.

IAIS's approach is at present based on company specific confidential data, which companies do not want disclosed. Many improvements on transparency have been made over the course of 2016, and each company participating in this exercise will receive a very clear explanation of the data. In addition, though Phase III of the identification process has improved, and transparency is now much better, governance and discretionary elements remain matter of concern.

3. An approach focusing on the main transmission channels

An industry representative stated that the third generation framework should be built upon four elements: identifying the source and amplifiers of systemic risks; measuring the amount of systemic risk that these activities cause or transmit; setting a limit on the amount of systemic risk that the industry is willing to accept; and subjecting systemic risk activities to targeted and proportionate mitigation policy measures. Another industry representative added that, having analysed geographical and institutional concentration risks, there is no concentration risk in either perspective in the insurance sector and it would require a one in a 20,000-year event to create a loss that would use up policy holders' liabilities after equity holders and debt holders. A public authority representative noted that cross-asset correlations have risen despite low volatility, which has implications not only for insurers, but for all kinds of market participants.

An industry representative commented that the activity-based approach is a much better >>>

>>> method for both identifying and managing any systemic risk. The starting point needs to be better identification; many systemic risk issues can be dealt with at the micro level. Derivatives, securities lending and asset liquidation issues are the topics that are of potential systemic relevance, but the entire insurance industry represents only 1% of the derivatives market. The third benefit of an activity-based approach is that it would allow for a much more tailored solution to the problem, whether this is derivatives, securities lending, or other activities. Whatever approach is taken has to incorporate best risk management practices and take account of residual risk. A public authority representative stated that vulnerabilities need to be better measured, and it is important to integrate the entity specific approach into a hybrid approach as well as to apply a more global monitoring of the sector.

Ultimately, liquidity risk needs to be measured, which is more difficult than macro economic exposure. In order to gauge liquidity risks, it is very helpful to look at the economic penalty faced by policyholders: the new IAIS framework states that, if there is less than 20% contractual penalty, the product can be called 'liquid'. From a French perspective, clients also take into account tax advantages and advantages in the inheritance treatment of life insurance contracts, and it is possible to augment this contractual approach with an economic one, which would be much more pertinent to the goal of modelling policy behaviour. There is also a need to consider whether the 20% threshold is right. There are tools other than capital that may be used to address liquidity: for instance, in France, there is a new law called Sapin II which deals with cancellation possibilities.

4. Making the systemic risk framework consistent with solvency and recovery and resolution regimes

One panel member stated that the methodology cannot be a standalone methodology that designates a particular entity; it has to be embedded in the 'general regulation', and it is essential to follow an activity-based route.

A public authority representative added that his institution supports the entity-based approach, but believes that this should be looked at from systemic and macro prudential points of view. Another public authority representative remarked that they believe in the effectiveness of the Solvency II framework, but also in the benefits of international supervisory convergence. The purpose of the additional regulation and consistency with domestic regulation must be clarified.

Another public authority representative pointed out that more time needed to be invested in the work on recovery and resolution: there needs to be a bespoke approach, rather than a 'copy paste' from the banking side.

5. Achieving a sufficient buy in of international frameworks by EU legislators

Although a number of accurate criticisms have been made of IAIS, the challenge is also one for the industry. IAIS needs to make improvements, and is committed to doing so. It is important for the process of designating G-SIIs to be better understood, and for ownership of the process to be more widely shared, as well as for insurance groups to be able to participate in the designation process. The criticisms that have been made of the designation process for G SIIs has been heard in the European Parliament.

A public authority representative concluded by stating that three key issues need to be addressed in the ongoing discussion: the level of commitment of all IAIS members should be evaluated and possibly reinforced, the credibility of the process needs to be further strengthened, and although IAIS and supervisors have the necessary expertise to develop an international supervisory framework, it is difficult to give political support to something that has been agreed 'behind closed doors'. ●

Improving the resilience of market based finance

1. Can there be a systemic crisis outside the banking sector?

Policymakers usually believe that banking is a matter of economic substance, not a matter of legal form, and that by re-regulating de jure banks to make them safer, some essential banking-type activities may move out of the banking system together with related fragilities. As a result, authorities first proposed to designate individual asset managers who could potentially have systemic importance, but following heated debates in the market, regulators then decided to focus on activities and functions. The underlying substance, however, has not >>>

>>> changed; it is likely that the risky features of banking may develop outside banking and this could result in a crisis at some stage, a speaker declared.

The members of the panel generally considered that a crisis cannot be totally avoided in the non-banking sector, but stressed that no major crisis has happened so far in Europe in this sector. With the tightening of bank regulation, money is beginning to move out of the banking sector and into the non banking sector, but what the 'non banking world' actually includes needs to be clarified. From a global perspective, about half of the world's financial assets are in non-banks; around half of these non-bank assets are managed professionally, and only half of that (i.e. one quarter of the non-banking sector) is in the form of regulated funds. Therefore market-based finance is much wider than asset management. Moreover, only one portion of the non banking sector is real 'shadow banking' performing maturity transformation.

Lessons have been learned from the non-bank crises that have happened in the past, mainly in the US, such as LTCM, AIG, and the savings and loan crisis. Both in Europe and at the global level, regulators are now focusing on leverage, derivatives and securities financing as well as liquidity. One panel member emphasised that Europe cannot afford a crisis happening in the non banking sector: this sector is key to the delivery of the Capital Markets Union (CMU), and people need to have trust in investment products if the CMU is to be a success. This is a primary concern of the EU Parliament in particular.

2. How should financial stability in the market based finance sector be approached?

First it is difficult to identify ex ante which sectors in market finance are the most important or concerning from a financial stability perspective, because crises can arise from areas that are not predicted in advance.

Several panel members emphasized that risks in the non-banking sector therefore have to be addressed in a transversal manner, rather than by type of product, investor or player. Regulators, notably in the US, have cross sectorial efforts underway to identify where the risks are and work out how best to address them and where to allocate resources, based on market data and information gathering. Interconnectedness with the banking sector is also a significant issue and a great deal has been done over the past few years to reduce it and to mitigate counterparty risk. But dealing with run risk remains challenging; building 'fire breaks' is normally the best solution but how this may be done in an optimal way still requires some thought.

One panellist noted that risk is not necessarily a bad thing; however, it needs to be properly priced and understood by investors relative to potential reward; professional management and product frameworks are appropriate ways of mitigating risk at a product level.

Secondly, it was generally agreed that risks associated with market based finance activities should be addressed differently from those stemming from banks, given their specificities. With the former, the end investor is exposed to market movements, and even large asset managers are subject to the whims of their clients and investors, while banks can decide to a large extent what to do with assets.

Using bank type regulation to deal with shadow banking or bank like activities leads to using the wrong approaches to tackle risks; this is why the FSB has changed the focus to activities. One panel member added that asset management entities cannot be considered 'too big to fail' even if the sector is growing and could have a greater impact in the future. Although regulatory debates tended to be dominated in the past by prudential regulators, this is no longer the case and securities regulators have developed more specific approaches. Not moving forward with the designation of systemic entities does not mean treating asset management risks less seriously.

Loan funds for example do not need banking type regulation, some stressed, because they have no retail investors and investors may lose their capital, but they do need rules that are more appropriate for funds, such as leverage or stress testing rules. One speaker commented that financial players outside the banking sector usually say they will never need assistance from public authorities but that is not always the case; one way of clarifying whether assistance might be needed would be to severely punish those who request such assistance after having previously denied that they would; however, this might not be possible in practice.

Continuous innovation is a third characteristic of market based finance and specifically of the asset management industry. The high level of innovation of the sector may create risk, because it is outstripping the pace of regulation. Legislators tend to react to problems that already exist; they need to be less 'behind the curve' while simultaneously making sure not to introduce regulations too early, in a way that may interfere with enterprise. This does not necessarily imply a need to create more regulation, but it does mean that direction needs to be given to the industry in advance, e.g. with regard to leverage risk or stress testing; such guidance should be embedded in specific EU >>>

>>> legislation, when appropriate, in order to avoid the excessive diversity of rules that can still be observed in some areas e.g. loan funds. More data needs to be gathered also.

3. Has enough been done in the EU to mitigate systemic risks in the asset management sector?

Much has been done in the EU to regulate investment funds with the UCITS and AIFMD directives, and Europe has been ahead of the curve to a certain extent compared to other regions regarding liquidity risk management regulation in particular. Both UCITS and AIFMD have provisions to manage liquidity risk mismatch in funds, and in many European jurisdictions, tools such as swing pricing, anti dilution levies, and redemption gates already exist; these domestic approaches are broadly convergent thanks to the supervisory convergence efforts of ESMA.

Over the last couple of years, a 'very concerted effort' has also been made at the global level and in the main jurisdictions to deal with risk in the asset management space. Work and consultations are under way in several areas, including liquidity and leverage risks, transition planning, improving data and stress testing. Improving liquidity rules concerning open-ended funds is a particular area of focus in the US. Rules are being improved by a broader definition of liquidity and more specific requirements to ensure that the assets held by open-ended funds are consistent with the aim for same-day redemption, completing the long-standing SEC rule regarding the proportion of illiquid assets that mutual funds can hold (15%).

Money Market Funds (MMFs) are an area where Europe is still finalising a pan-EU framework; this delay compared to the US in particular is the result of the actions undertaken by the sector, and the national sensitivities of some Member States. However the solution proposed by the Parliament is now being considered by the Council and was commended by an industry representative on the panel; the proposal is now at the trialogue stage.

More could also be done in Europe to make markets more efficient by improving fund cross border distribution and breaking down domestic barriers, which is part of the CMU action plan. Investors in Europe also need to be more comfortable with risk taking; risk transfer could indeed be improved in Europe if the continent had a deeper transcontinental equity market. Securities Financing Transactions (SFT) also deserve attention; margin requirements for transactions between non-bank counterparties still need working on, and following this, a review of the different regulations impacting SFT would be appropriate, a panellist suggested. ●

Resilience of capital markets

1. Cyber-resilience in capital markets

Cyber-resilience is a complex and fast-developing issue that has become a very important element of market stability, particularly concerning Financial Market Infrastructures (FMIs). The ability to clear and settle transactions is essential in order to keep financial markets stable and requires the integrity of data and a functioning marketplace to be preserved. Managing cyber security should be a key focus of both financial institutions and FMIs and should be an enterprise wide effort within each institution. However, it must be placed in the broader context of the other risks that FMIs and other institutions have to manage.

1.1. The need for a principle based approach focusing on the core elements of the system

A principle based approach to cyber security is essential in such a fast changing environment; over-prescription will never keep up with the pace of change and the private sector needs to continue innovating. This is the US approach to cyber resilience, which focuses particularly on testing and having an appropriate enterprise technology risk assessment in place. However, US FMIs need to continue following best practices at a granular level; and there are prescriptive requirements regarding independent testing in some areas. The CPMI-IOSCO cyber security framework and the European NIS Directive on the security of network and information systems establish guiding principles and minimum standards at the international level that FMIs and other organisations should follow. They recommend identifying core assets and the weakest components in a network and protecting them from cyber-risk in an end-to-end and adaptable way. Current threat dynamics indeed drive the emphasis away from prevention and the ring-fencing of activities >>>

>>> towards protection, detection, response and recovery measures.

The feasibility of the two hour recovery time objective of the Principles for Financial Market Infrastructures (PFMIs) is debatable in the context of cyber crime. Cyber attacks will come from a variety of constituents with the intent to harm and their characteristics or entry strategy will be unknown in most cases. Furthermore, many cyber attacks are two pronged, involving a first diversionary approach, whilst the real objective is situated in some other part of the institution. Two hours may be insufficient in most cases and an open ended and open minded approach seems preferable.

1.2. Information sharing and cooperation

Cyber security requires creating a unified defence against attacks; a public/private partnership is needed with regards to sharing information about threats, best practices, and testing e.g. continuity plans. However, it is ultimately the responsibility of private institutions and FMIs to execute the tasks that result in the highest level of cyber security protection and to ensure that they have the appropriate frameworks in place, even if this may be done in conjunction with the Authorities.

Cross border cooperation is another important aspect of cyber security. Work in cyber tends to be jurisdictionally national, but cyber attacks have no borders. Developing cyber security strategies across multiple countries is challenging because the marketing and implementation of policies can take time. However, positive developments are seen: the CPMI-IOSCO guidelines and the NIS Directive provide a good way forward. There is substantially more cooperation in information and thought around a framework for the management of information; and cooperation between law enforcement organisations in Europe has started to improve. Some issues however remain to be dealt with, such as the removal of barriers to information sharing.

1.3. Possible need for further standardisation and coordination of cyber-security approaches

Developing cooperation requires creating a common language and standards amongst organisations for dealing with cyber risk. However, standardisation and adaptability are in conflict, because excessive standardisation makes it harder to adapt to changing circumstances and to innovate. Standardisation ought not to be thought of as a compliance exercise, but as a way to define the appropriate measures and good hygiene that are needed. For example, penetration testing is an area where standardisation is important. Several testing standards have been implemented across the globe. However, there is an opportunity for a further standardisation of penetration testing scenarios and co ordination among regulators when considering multinational institutions that may be confronted with multiple simultaneous penetration tests, which may ultimately create major operational risk. There is also an urgent need for appropriate protocols on how information is to be shared in such a context.

1.4. Impact of new technologies on cyber-resilience

New technologies such as blockchain and cloud applications are attractive because of their potential to reduce costs and bring about transformational change in the securities industry. However, digitisation and automation contribute to extending the exposure of the sector to cyber attacks because more activity is running through systems; there is increased interconnectedness among actors and processes; and new players are introduced into securities processing chains. Moreover, Fintechs and handheld devices are creating new options for customers to engage in financial services activity, but they also add a whole new potential for cyber risk. Those risks must be addressed in order to ensure that increased risk to the financial system does not outweigh the benefits of innovation. The development of these technological capabilities is not always comprehensively approached in current security measures, particularly when they happen outside the financial services industry, so caution and collective work are needed on these developments.

Fintech developments are closely monitored by regulators in connection with industry participants, but no threatening developments have thus far been observed with regard to financial stability, a panellist commented. Moreover, the business and governance models used e.g. in blockchains are moving closer to those used in the traditional clearing space, so sufficient accountability and responsibility may be achievable with such concepts. However, some concepts such as 'smart contracts' remain matters for concern, as they cannot be easily terminated if necessary. Furthermore, regulation could be more prescriptive regarding the transfer of innovation from an experimental to an industry environment, which could help further secure the financial services sector.

The issues raised by new technologies may be addressed by simply applying the guidelines put forward in the CPMI-IOSCO and NIS frameworks. There is however a need to raise awareness of the issues at stake among top management and to be proactive in determining and implementing >>>

>>> protection, mitigation, recovery plans and measures. The development of cyber risk increases the importance of operational risk. Management of the vendor supply chain and third party providers is also important, in terms of cyber risk. The requirement for institutions to consider security end to end is clearly mentioned in the CPMI-IOSCO guidance, as well as the fact that risk can never be outsourced. However, one of the missed opportunities of the regulation was not setting out a proposal to address cloud and other third-party providers, outlining the expected hygiene levels of individual institutions operating in the financial services space, a panellist considered. Regulators could also perhaps be more prescriptive with key supply chain technology providers.

2. CCP Resilience, Recovery and Resolution

Proposals about the recovery and resolution (R&R) of CCPs are in gestation and are essential given the central position of CCPs in the financial system and the possibility for them to transmit shocks. The discussion is not about an orderly wind down but about how a CCP can stay open for business, potentially under new constructs and with a new management team. CCPs are designed to manage and reduce systemic risk and resilience, recovery and resolution (R&R) are a continuum where daily resilience management is the first line of defence. When evaluating the additional level of protection that may be needed for CCPs in order to mitigate possible stresses emerging in the system, policy makers need to take into account existing protections and evaluate whether additional tools are necessary given their cost and potential impact.

Outstanding issues

Discussions on international consistency regarding CCP requirements must continue. Collective progress has been made, but some jurisdictions are moving faster than others. Consistency of outcome must be maintained, given the interconnectedness of FMIs and the global nature of the markets that they serve. Regulations should set minimum standards at the international level in terms of recovery planning by FMIs and of what may be achieved by the resolution authority if a resolution is necessary. Standards are probably not granular enough in some areas, such as testing, but work is underway to improve them.

Several other potential issues were mentioned. First, regarding the balance between predictability versus flexibility in the R&R process; one concern is about what the incentives are for different stakeholders of a CCP and how to ensure that those incentives are correctly aligned so that there is sufficient focus on recovery. The debate is progressing on this at the international level and the forthcoming EU R&R framework is expected to bring additional clarity. Second, regarding non clearing member default losses, which may be related for example to cyber-risks or CCP management decisions regarding margins or collateral, discussions have still not really begun, although progress has been noted in governance. The final issue concerns the tools that should be used in the context of recovery and resolution, who is responsible for using them and how to ensure that resources are sufficient for using them. Maximum assessment authority could also be better defined in order to avoid unpredictable risks occurring. ●

Impacts of volatility and liquidity trends on the financial system

1. Market liquidity trends

1.1. While liquidity is back to pre crisis level, there are huge disconnects across asset classes

There is a gap between perception and reality regarding liquidity conditions: there is a widespread perception that liquidity conditions are evolving, particularly, in the fixed income market, but on looking to the data the diagnostic is more nuanced: we observe that price-based indicators have moved back to around the level they were before the crisis. However, it is different when looking at quantity-based indicators. A diagnosis is indeed developing that the market depth is changing. 'Bifurcated market activity' is indeed tending to concentrate in the most liquid market segments, reduce liquidity, and cause fragility.

Regulation, innovation and unconventional monetary measures are the main drivers of market liquidity trends. Regulation has a bearing on important actors in terms of liquidity provision which are market makers; but also brings benefits in making those critical players more resilient to shocks. It is not yet clear what the impacts of innovation, automation, monetary policy and unconventional operations are. >>>

>>> There is an enormous difference across different asset classes, although liquidity levels are back at pre crisis levels. For instance, the outstanding stock of corporate bonds has risen by 50% since the financial crisis, but turnover of the secondary market has halved. While liquidity is back to those pre crisis levels, this is 'the wrong sort of liquidity', driven by central bank market activity in the primary market. The concentration of holdings and the lack of liquidity in the secondary market is creating disconnects, pricing tension, and challenges for the future. The current environment is the best it has ever been for issuers, but it is not nearly as good for investors. The main question is what will happen when QE and bond purchasing from central banks end. Volatility has become very event-driven: over the last year, three of the big events have created unprecedented degrees of volatility in FX markets.

In summary, the market environment is very unusual, and there will be some huge challenges in the future. The outcomes of what happens when bond purchasing ends, or indeed what the macro environment is going to look like, remain uncertain. Additionally, regarding non standard monetary policy, there has been a positive impact in terms of the primary market and no real disturbances in the secondary markets, although it may impact liquidity by reducing the amount of available assets in the market. This makes securities lending facilities managed by the Eurosystem much more important to support bond and repo market liquidity without unduly curtailing normal repo market activity.

1.2. Repo market is changing significantly

The repo market is also changing significantly. The transformation of liquidity conditions on the repo market leads to an excessive level of volatility in this market. Surge volatility is a useful way for the market to adjust to changes in general conditions; over the last 12 months, there have been episodes of volatility moving up and down, related to monetary policy developments, growth prospects, revisions and political uncertainties. One concern is that, if these volatility shifts are amplified by a structural reduction of liquidity in the market, they could affect financial stability. However, this is not yet the case, and there are a number of safeguards that are already in place to prevent this happening.

Regulation has had an obvious impact on this market: the volume of activity is decreasing, but it is not clear whether this is dangerous, in the sense that it could alter the fundamental function performed by this important market. Before the crisis, there were trading activities and volumes which were not essential; the fact that they disappeared might not be a serious problem for the functioning of the overall financial system. Appetite has changed in a number of institutions; some institutions are now more willing to put a risk budget on those kinds of activities, and research on this is ongoing.

2. Way forward

2.1. Capital Markets Union: a unique opportunity to address some of these challenges

The industry representative stated that the broader ramifications and environment need to be addressed; the CMU presents an extraordinary opportunity to be able to address some of these challenges. Fundamental liquidity is clearly much less in the markets than it was previously, which makes it even more important and necessary to create broader, wider and different sources of funding and different products for investors. The possibility of developing securitisation markets presents one of the biggest and most important challenges for the industry; a harmonised environment should be created for products, and the fragmented approach to regulatory challenges removed.

There is a need to move faster towards CMU, and there is no point launching a CMU, or a process of securitisation, if the rules that are imposed on it make it impossible to work. It is good to begin by taking small steps, but there is a need for confidence in the system, a track record, and the ability of investors to understand the process. The public authority representative commented that institutional diversity is important: the market is now transitioning, with new players – high frequency traders, or proprietary trading firms in critical market segments – playing an increasingly important part in the secondary market. It is very important that diversity is maintained, and that the critical role of market-makers is also maintained, even if this has to evolve; this makes it all the more important that the CMU is brought forward. Channelling savings into productive investment should be essentially developed through the equity markets.

2.2. Digitalisation and electronification are going to present some answers to liquidity challenges

The industry representative stated that there are other aspects of the issue outside CMU: new technology is indeed very important. There are unprecedented levels of e-trading. FX spot is now 95% traded electronically. Equities are moving towards 90% electronic trading; and even fixed income, which is some way behind, is now reaching around 60% electronic trading. In the coming era, digitalisation and electronification will present some of the answers to the liquidity challenges. >>>

>>> Hence, there are other things besides CMU and regulation, which are only components and are not primary drivers.

Algo trading could create more volatility on the markets, although this is not necessarily something to be worried about; it has to be ensured that the types of clients that are being onboarded, and the type of processes and systems that they are using, are fit for purpose. Both the industry and the regulator have a significant responsibility in this area. The representative of the public authorities added that algo trading is a new phenomenon in fixed income markets in Europe, brought about by automation and the development of electronic trading. Although, there have been regulatory adjustments to take this reality into account, it is however unclear whether these are sufficient to ensure a positive contribution to the functioning of the system. ●

Capital market data harmonisation and sharing at the EU and global levels

1. Progress made in data collection and harmonisation

Data is essential for providing the transparency needed for effective supervision and for fighting market abuse. Data also relates to market efficiency, as it allows best execution.

Much progress has been made towards collecting and harmonising data. The first priority was OTC derivatives data in order to fulfil the G20 mandate. Data requirements have been incorporated into derivatives legislation, notably in the EU. There are no more major data gaps in the OTC derivatives market, but data quality and consistency issues remain at the global level. CPMI IOSCO has established a working group aiming at assessing remaining data gaps, harmonising key data elements globally, and identifying inconsistencies in global methods of collecting information on OTC derivatives. The objective is to allow regulators to aggregate data in a meaningful way and to analyse it, in order to identify emerging risks. One industry representative pointed out that interaction with CPMI IOSCO on producing common data standards for various asset classes has been very effective.

Significant progress has also been made with identifiers. The implementation of Legal Entity Identifiers (LEIs) has been very successful so far, and there are now about 450,000 LEIs across 140 countries. However, the marketplace is estimated to be significantly larger than this: close to three million, including all smaller corporates and parent entities using OTC derivatives. A speaker suggested that, to achieve the roll-out of LEIs, all jurisdictions would need to mandate their use in legislation. It was also remarked that LEIs are useful for many other purposes, including anti-money laundering and countering the financing of terrorism, but their application in the payment world is less advanced than in capital markets. Two other identifiers - the unique transaction identifier (UTI) and the unique product identifier (UPI) – are being developed by CPMI-IOSCO to facilitate data aggregation at the global level. The work on UTIs is being finalised, and they should be launched in 2017; a panellist emphasised, however, that the nature of transactions still needs to be better reflected in UTIs. A consultation is also underway regarding UPIs, which are essential for identifying OTC derivatives in a structured way.

Data related work is on-going in other parts of the financial industry, aiming at facilitating broader monitoring and mitigation of systemic vulnerabilities. The availability of data varies across sectors and activities evolve over time making it a ‘moving target’. Data needs to be completed in all areas that have systemic significance because otherwise, it is likely that partial data will be used, potentially leading to drawing wrong conclusions. Market based finance is one of these areas and more specifically asset management products such as open ended funds, separately managed accounts, and alternative funds; leverage risk also needs to be measured more precisely. Other areas where assessments are under way at the global level are CCP interdependencies and bond market liquidity.

2. Remaining issues regarding data collection, aggregation and sharing

A first issue relates to the data collected by Trade Repositories (TRs). Currently, trade reporting requirements are in force in 19 out of 24 FSB member jurisdictions, covering more than 90% of OTC derivative transactions. The level of information is unprecedented, but regulators are mainly using this trade data domestically for market >>>

>>> abuse purposes, because there are still many issues with TR data in terms of quality, usability and aggregation. Many of these issues relate to differences between jurisdictions in reporting requirements and the way that data is recorded by the TRs.

Secondly, appropriate formats and structures for reporting data are required, as well as governance mechanisms for managing them over time. Some panellists suggested that ISO 20022, the messaging protocol used notably for securities transactions straight through processing, should also be used for reporting; this idea is supported by ESMA and CPMI-IOSCO. ISO 20022 is indeed a means for defining data elements in a standard manner, and creating the structures that can be used for interacting with the Authorities. It also provides a framework for conducting the ongoing maintenance of these elements and processes. One panel member emphasized that ISO 20022 needs to be consistent with FpML, the messaging standard used for OTC derivatives; work is underway involving ISDA and SWIFT to define a coherent solution for this problem.

A third issue concerns the legal barriers to accessing market data across jurisdictions. No authority has all the information that is required to assess risks fully, therefore, they need to be able to use information held by other jurisdictions and authorities. The problem is that domestic data protection and privacy laws prevent this in many cases. This question is now being considered by the FSB, which should give it some political impetus, and the aim is to remove all barriers to sharing data by mid 2018. Regulation at the EU level will probably be needed to address this issue, a panellist suggested. Another speaker emphasized that transactional data, which is the type of data required for monitoring risks, should be treated differently from genuine personal data in privacy terms, because it is a public good that may help to anticipate future crises. In the US, the removal of indemnification provisions that occurred at the end of 2016 shows a positive development in this regard.

A final issue concerns the governance of data standards and processes. There is a need for regulators to monitor continuously the definition of data elements and the way they are aggregated and shared at the global level in order to ensure that they can be used appropriately. Although the speed of product innovation has slowed down following the crisis, standards also need to keep up with the ongoing changes in the financial sector. A working group has been set up by the FSB to assess these difficulties. Although there was previously a debate about the extent to which regulators needed to be agnostic with regard to data, this is no longer the case, because clear specifications are needed to be able to aggregate and share data at the global level.

3. New developments and concepts for improving data management

In 2015, ESMA proposed a concept of centralising data management at the EU level, in order to improve data processes: i.e. the collection, maintenance and sharing of data with the international and national competent authorities, and the publication of this data. A panel member explained that after many debates, it appears that most Member States are now favourable to this project, for cost efficiency and data quality reasons. The production and handling of data elements could be improved if data-related activities could be conducted at an EU level through ESMA, rather than each authority constructing its own hub and IT system. This could be applied both to EMIR-related data collected through TRs and to MiFID reference data. The goal is for this project to be operational by the beginning of 2018.

New technologies such as Distributed Ledger Technology (DLT) and blockchain also need to be taken into account and monitored, as they have the potential to significantly improve and automate trade reporting; a specific working group on DLT and blockchain has been set up by CPMI IOSCO to this end. The challenges previously mentioned in terms of data quality, aggregation, and sharing will still affect new technology, however, and there will still be a need for clear, consistent and well governed data definitions and processes.

Several other issues need to be considered. One is the multiplication of new technologies and their current lack of standardisation. Second is the present lack of scalability of DLT, which so far does not allow the handling of very large amounts of data. A third issue is the regulation of the Fintech sector. Some have advocated a 'do no harm' approach in order to foster innovation, while others support a technology agnostic regulatory approach and the regulation of financial activities and players regardless of the technology used. In any case, a panel member concluded, 'misguided innovation' should be avoided. ●


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3. FUNDING THE EU ECONOMY

Challenges posed by ultra-low interest rates

1. Introduction

Major central banks around the world have adopted dramatic programmes of quantitative easing. Low interest rates are a worldwide phenomenon; this is not just something that is done by the ECB. It is important to distinguish between low interest rates and a convergence of interest rates, and it has no intention of getting rid of risk premia: As long as there are differences in risk, there will never be full convergence, which is appropriate.

The general level of interest rates is due to major macroeconomic forces: a reflection of the low-growth and low inflation environment. If this environment changes, interest rates policy may also change. In other words, interest rates have to stay low until the economic recovery in the euro area has gained sufficient momentum to lift the inflation rate to a level in line with the ECB's definition of price stability.

2. Impacts of ultra low interest rates on inflation were debated

It is important not to overlook the positive effects of the monetary policy of the ECB on the inflation rate; the ECB has been successful in avoiding slipping into deflation. Monetary policy has costs and benefits: it is very efficient to defeat inflation; on the other hand, it is much more difficult for monetary policy to overcome deflationary effects. This is also the reason why the ECB and many other central banks define price stability as an inflation rate of below, but close to, 2%.

The industry representative stressed that inflation cannot be pushed higher and higher in an attempt to get more growth; at some stage, expectations adjust and real growth falls. Moreover he reminded the audience that, there are main questions about the efficacy of policy in raising inflation: Japan for instance has been doing QE 'on steroids' for several years now, but any positive effects have not lasted.

In the US, as a consequence of QE, we saw savings switch to equities and rebound of equity markets triggering a "wealth-effect", which contributed to more consumption. No wealth effect has happened so far in Europe. European savers are not the same as those in the US. They are mostly risk adverse and tax system often does not sufficiently encourage equity investment.

3. Ultra low interest rates are not sufficient to improve growth

Unconventional interest rates policies improve underlying economic and financing conditions. There is a continued pick-up in lending in the euro area. The lowering of rates is transmitted to the real economy However the industry leader stressed that between 2012 and 2015, there was over €1,7 trillion of issuance from European non-financial corporates. However less than half of 1% was earmarked for proper economic investment: namely gross fixed capital formation or research and development. Instead it was about balance-sheet restructuring, and disintermediation and deleveraging effects. So it did not really get through the final demand. Additionally, the old-fashioned redistribution channel, whereby cuts in interest rates shift income from savers to borrowers, does not really work in Europe with QE. Indeed probably due economic uncertainty, a significant number of savers are trying to offset lower returns by further savings.

It is always possible for central bankers to create more money, but in practice, there are political-economy constraints to monetary policy. It was notably pointed out that the monetary policy should remain moderate and not excessive. There is a limit to how low interest rates can go. Cutting interest rates even more would increase risks as reactions to such cuts might not always be linear.

Moreover monetary policy cannot solve structural problems. There was a consensus among the speakers that achieving sustainable growth requires contributions from all policy areas: monetary policy, fiscal policy and structural policies, and relying on one policy tool is not advisable. Every single Member State should engage in structural reforms to make their economies more competitive and flexible. The sooner they are implemented the stronger and more sustainable the recovery will be. >>>

>>> **4. Impacts of ultra low interest rates on banks**

The central bank representatives stated that the ECB's Quantitative Easing policy is working. Thanks to very low interest rates, banks have considerably eased access to financing for the private sector and the lowering of rates is transmitted to the real economy. Indeed there is a continued pickup in lending to non-financial companies and households within the euro area. So the transmission mechanism seems to work. Negative interest rates will also contribute to lowering non performing loans in banks' balance sheets.

It is clear that central banks do have a direct influence in the yield by buying up long-term bonds. The Central Bank Governors recognised that lasting low rates put pressure on banks' profitability, particularly on retail banks which are very reliant on net interest income. Lasting low interest rates clearly added to the list of challenges banks are facing today. Nonetheless the present low profitability of the banks of the euro area result essentially from legacy non-performing loans, regulatory uncertainty, excess banking capacity, growing competition of non-banks and slow adjustment to new business models.

Non-standard policy measures come with side effects and the longer interest rates remain low, the more pronounced the negative side effects will become. However, according to the central bank representatives, the overall impact on bank profitability of recent monetary policy actions is net positive, compared with a scenario with no monetary policy action. The question to be asked is whether a bank that cannot weather headwinds over a few years still has a sufficiently robust business model to stay in the market.

The industry representative explained that is difficult to see much impact so far in terms of net interest margins. One of the reasons for this is if bank lending rates do not fall with policy rates, because banks need to maintain interest margins between deposit and lending rates, and therefore the benefit of very low interest rates is not getting to the real economy.

5. This monetary environment poses major challenges for the insurance sector

This issue becomes more difficult in the field of life insurance; very low interest rates weighs heavily on the profitability and solvency of financial companies which promise minimum nominal returns over the longer term, e.g. life insurers and pension funds. If this phase lasts for too long, it could challenge the viability of 'return guarantee' business models. Such risks need to be monitored. There is evidence that the insurance and pension sectors have already been moving from guaranteed-return to unit-linked business models. This shows that the industry is adjusting.

In such a monetary context, life insurers need to reach into riskier areas, which are more difficult due to the EU regulatory framework. Pension funds have always had the inherent problem that it is difficult to combine high returns and low risk. According to the leader of the industry there is widespread worry regarding the life-insurance sector, and it is conceivable that a number of smaller players, although nobody present, might go out of business in the not too distant future. This would raise the issue of the impact that low rates have on different parts of the financial and economic sectors in a way that the public has not quite connected with yet. ●

CMU 1 year on: is it up to speed and what is the potential impact from Brexit?

1. Progress made and challenges remaining

The EU Commission (EC) issued a status report in April 2016 that is due to be updated; the short term actions that have been launched include the securitisation proposal, a renewed prospectus proposal, a proposal on venture capital funds, and a recalibration of Solvency II to encourage long term investment in infrastructure. An extension of Solvency II recalibrations to corporate investments and a review of Capital Requirement Regulation (CRR) calibrations regarding infrastructure investment are also being considered. An acceleration of the Capital Markets Union (CMU) is however needed regarding notably the adoption of the securitisation proposal and other important initiatives launched concerning personal pensions, investment fund cross-border distribution and liquidity in corporate bond markets.

The European Parliament's position on the prospectus proposal has been approved >>>

>>> including the concept of a less burdensome 'growth prospectus' that was introduced by the Parliament for SME growth markets. During the coming six months, the EU Presidency aims to close the debate on the prospectus and securitisation proposals in particular.

The panel members generally supported the main objectives of the CMU – strengthening capital markets and diversifying the financing of the EU economy – and agreed that the appropriate priorities have been defined. Important steps have been taken, although some issues remain to be addressed, notably regarding securitisation. Developing diversified sources of financing is important, given the restrictions on bank balance sheets and the specific needs of growing companies, as well as developing well organised, cross border capital flows for better mitigating asymmetric shocks.

One panel member stressed that the capital requirements related to STS (simple, transparent and standardised) securitisation remain too high for the market to develop; it would cost a bank more capital to provide funding with collateral such as an asset backed commercial paper (ABCP) than to provide the corporate on an unsecured basis. Reducing capital market requirements could be a method of stimulating the market, as well as introducing flexibility in the way STS criteria are implemented.

The broader impacts of banking regulation on CMU objectives are another concern. One panel member felt that Basel IV proposals would strongly penalize specialised financing (e.g. airplanes, shipping, railways…). The need to look holistically at the basis of bank regulation after the financial crisis, particularly the calibration of prudential rules and the impact of Net Stable Funding Ratio (NSFR) on repo was also emphasized, given the role played by banks in capital market activities. An observation period for CRRII / CRDIV rules was also proposed. A policymaker emphasized however that any review of bank requirements in order to stimulate capital market development would need to be assessed also from a financial stability perspective taking into account the macro-prudential benefits of a more diversified financial system versus the risks of exerting less control over banks.

There is also a need to be proportionate in how CMU legislation is created and implemented one speaker stressed: the size or stage of development of particular markets should be considered, as there may be a risk of over regulation and reduction of market diversity in some less developed capital markets. Local markets should be able to compete, a policy maker agreed, but should develop in a way that allows them to be integrated in the future into the broader single market.

2. Priorities ahead for the CMU

The second phase of the CMU is to move forward with 'big ticket' reforms for which acceleration is also required. These include a further harmonisation of insolvency frameworks in the EU and removing tax obstacles to investment related to withholding tax and to taxation systems which advantage debt over equity (debt/equity bias); all of these will be a focus of the EC mid-term review in 2017. Although these are difficult areas, the EC is committed to addressing them, and requests the support of Member States in doing so, otherwise sufficient speed and ambition will not be achievable for the CMU. Other areas that need to be addressed include accounting treatments, post trade, and the institutional setup of the EU 27.

The EU also requires a well-functioning equity market channel to facilitate private risk transfer in a sustainable way, as the banking sector will have less ability to provide this in the future and the fiscal channel is too politically sensitive. Moreover equity investment is essential in a negative rate environment, with no yield for savers, with a bubble looming in the fixed income markets of emerging countries and cash levels at their highest since 2001 in fund managers' portfolios.

3. Potential impact of Brexit on the CMU

The CMU project remains valid, despite Brexit. Some panel members were of the view that Brexit makes CMU even more significant, because the EU 27 is more dependent on bank financing than EU 28. The CMU is also important as a way of demonstrating to its citizens and outside partners that Europe is moving on, without the need for any change in treaties.

The consequences of Brexit are difficult to predict and depend on the future state of relations between the EU and the UK, but the nature of the CMU project may change with a stronger focus on EU 27 or the Eurozone.

A market survey recently conducted across Europe highlighted worries that the CMU could be significantly disrupted by Brexit and generally showed no benefit from Brexit in relation to the CMU. Disentangling the interdependence of UK and EU could be a complex, lengthy and costly process. Another risk was also identified: that CMU and European projects in general, might become more inward looking without the input of the UK.

An industry representative agreed that the question of whether CMU objectives could remain >>>

>>> unchanged without the UK as a member state was valid. The main objective of the CMU is to break down barriers and to reduce or alleviate costs within European markets and Brexit could have an opposite effect. The role of the City of London within the CMU will need to be clarified in this respect, as well as the future of passporting out of the UK.

Another industry representative considered that the Eurozone is becoming much more relevant to the goal of accelerating the CMU project after Brexit. Succeeding with the CMU will require Europe taking ownership of its future in a more integrated manner and addressing the current concentration of liquidity and talents in the City. The Brexit vote has indeed led to a useful clarification; it has drawn attention to the fact that the current situation where most clients and savings are based on the continent but most bankers, asset managers and a significant part of euro asset trading and clearing are in London is anomalous. Strong financial centres exist on the continent and the current position of London is unlikely to continue over time if the City loses access to the single market, the speaker believed.

A third industry participant emphasized that whatever the outcome of the Brexit discussions, any positioning that increases market fragmentation will impair liquidity, perhaps even inflicting damage on longer term success prospects for developing a deep and well functioning capital market in Europe. As a general principle, EU legislators and the stakeholders concerned should be mindful of encouraging constructive relations between the EU and the rest of the world, which will also include the UK in the future. This will serve the goal of enhancing inward investment and liquidity provision in capital markets that are useful to Europe as a whole. ●

Next steps after the call for evidence regarding capital market activities

1. Update on the call for evidence process and next steps

A call for evidence was initiated in 2015 by the EU Commission (EC) regarding the evaluation of regulation broadly across the financial system and across financial sectors. This exercise is not about undoing what has been achieved so far, but about refining it. There is moreover an objective to develop evidence-based regulation as part of the Better Regulation agenda.

In the summer, the EC published a summary feedback that presented a factual overview of the main issues that have emerged, among which legislation concerning the securities-markets area ranked quite high. More evidence would be required in some areas, notably on the impact of EU regulations on the economy, or on market liquidity. Follow-up actions will be published in the autumn and will feed into the individual reviews that are being planned: examples include the upcoming CRR/CRD package and EMIR reviews, the review of the macroprudential framework planned for next year, and a number of Level II measures. The EC would also be willing to reopen some Level I measures if the evidence that is submitted is robust and convincing enough.

Some issues can be immediately tackled, but others will need more time. Legislative processes including consultations and impact assessments will remain as they are, but there should be progress in the way they are applied.

2. Main issues raised in the output from the call for evidence

Five main themes emerged in the call for evidence regarding improvements that could be made to capital-markets legislation: impact of regulation on the financing of the economy, ensuring proportionality, reducing unnecessary regulatory burden, improving investor protection and keeping the regulatory framework up to speed with technological innovation. One member of the panel stressed that the existing EU regulatory framework has allowed the creation of a robust market structure and of efficient communication channels between the industry and regulators that ensure sufficient stability and integrity in the market; this was recently demonstrated following the Brexit vote.

Regarding the impact of regulation on the financing of the economy, stakeholders argued in their contributions to the call for evidence that there are some prudential rules that may reduce the amount of funding available for investment in the economy, such as those relating to the calibration of Solvency II capital charges for long-term investment. There is also significant concern about the possible >>>

>>> decline of market liquidity in corporate bond markets, and it is felt that some banking prudential rules such as the leverage ratio, might have an impact on the objective of further developing capital markets. A number of other issues that impact the financing of EU businesses and that are part of the scope of the CMU were mentioned by a panel member: finding the right balance between equity and debt financing, further harmonising insolvency laws and taxation and providing a more diversified range of financing tools for SMEs.

In terms of proportionality, it has been argued that greater account should be taken of the different institution sizes and of different business and risk profiles. EMIR requirements which will be reviewed next year will be examined in this regard. One panellist suggested that 'proportionality' should not only be defined in relation to the size of the entities that have to apply the rules, but also in terms of the feasibility for the industry to apply obligations and for regulators to use the data provided. In many cases simpler rules would be needed, the speaker suggested; moreover there needs to be more time for the industry to develop a proper solution, and a need to set priorities better.

Much input has been received also regarding the need to reduce unnecessary regulatory burden, the overlaps and inconsistencies across EU legislations and the inconsistencies of rules across regions. EMIR and other reporting and disclosure requirements applying to capital market participants (e.g. asset managers) were seen to pose particular problems in this regard. Another issue is the interaction between the prudential framework and the clearing obligation in EMIR.

A further area highlighted in the call for evidence is the need to pay greater attention to consumer and investor protection. An industry representative emphasised investor information issues relevant to UCITS and PRIIPs, which have inconsistent requirements notably regarding the KIID, a pre-contractual information document aimed at providing information for retail investors. The UCITS KIID which already existed should have been the starting point for defining the PRIIPs KIID, the speaker felt.

3. Proposals for improving rulemaking and regulatory standards

Several suggestions were made by members of the panel to improve the rulemaking process in the EU. A first proposal is to better anticipate possible consistency issues with other legislations and market impacts, without waiting for the effective implementation of the new requirements; at present, these problems emerge too late. Better interaction with the market and with consumer representatives could also help in this regard. Consistency issues are however not always easy to anticipate due to the different timings of legislations in some cases.

Secondly, the law making process in the EU could be made more flexible. Level I remains very extensive and rigid, and the Level II process of consultation is also complex and lengthy, which means that when changes are needed in a legislation they cannot be quickly handled. Going back to the original Lamfalussy recommendations with a more general Level I should help in this regard, as well as leaving regulators and the ESAs more freedom of action to review requirements at Levels II and III .

A third set of proposals concerned reporting requirements in terms of simplification, the development of synergies across regulations and the elimination of duplications. One option could be to have a common set of reporting requirements for legislations covering similar activities and instruments. However, one panel member considered that, when objectives are different – as in the case of securities and derivatives transaction legislations – it is not possible to have only one dataset and to use it for all objectives. An alternative approach could be to set up a common database, where the data could be centralised and accessible to different regulators in order to address the different regulatory requirements. However, building this requires trust, and the ability to check the quality of the data and the capability to handle submissions. It was moreover noted that data issues need to be addressed at the EU level, as they appear to be difficult to solve at the national level. There also needs to be a dialogue between the industry and regulators, in order to ensure that everyone has the same understanding of the objectives. Such a centralised approach at the EU level could also be used in regulatory areas other than reporting, such as prospectuses. A third approach is that, in addition to ESMA's work on streamlining reporting requirements, the EU Commission is currently launching a workstream on financial data standardisation. Data standardisation would help to streamline requirements, templates and formats and also enhance the interoperability of the financial data at the EU level.

A fourth proposal that was made for improving rulemaking is that the EU Commission should try to consolidate regulation inside sectors or 'market silos'. Since management companies tend to manage many different types of funds, there could be one piece of legislation covering these different instruments; the same could apply to market infrastructures, and this could notably help >>>

>>> to eliminate some unjustified inconsistencies across regulations. There could also be a more holistic approach of some horizontal topics such as reporting or investor information in order to avoid possible inconsistencies across regulations e.g. PRIIPs / UCITS / prospectus. ●

Securitisation: is the EU's level of ambition sufficient?

1. The current situation of securitisation markets

The US market is mature, whilst APAC is emerging and Europe is still in recovery. Year to date, issuance in the European securitisation market has been around €160 billion, expecting to end up at around €200 billion, against €190 billion in the previous year, and only a third of issuance is placed with real money investors. There is a good market consensus that a sustainable volume is €150 200 billion. The market is looking the same as it has over the past few years: more than half the issuances are destined to fund residential mortgages. Banks are using synthetics, and there is a real need for them to be part of STS. In August 2016, Moody's rated the first Italian NPL securitisation. The ECB is a dominant and active investor, taking up to €2 billion per week.
However, the recovery of the securitisation market is not being seen in the required form, that which reaches a different investor base and spreads the risk to a broad group of different investors. Most transactions placed are only senior tranches or are retained for funding purposes. The current state of affairs in the markets cannot last forever, and the negative and zero interest rate policy will ultimately be detrimental. Some form of market normalisation is anticipated, but this process will face several difficulties; there has in particular been an evaporation of liquidity.

The securitisation market is 'slowly dying', because securitisations are not the obvious choice for funding banks; it is not clear why a securitisation takes a month and a half. It is the necessary creation of the related separate and autonomous company, and this is a specific feature of securitisation, which explains its cost. Thought should also be given to the STS regulation which creates a safe harbour, since banks need to be incentivised, in the sense that when a bank is defaulting, the securitisation is not defaulting, and there can be a proper alignment of interest.

However, CFOs are not ready to take on that cost today.

2. One should define the respective roles of covered bonds and securitisation to achieve an effective and sound distribution of the potential costs of funding banks, between issuers, investors... and tax payers

The RMBS market and the covered bond market are beginning to plagiarise structures and features from each other, but they are regulated and supervised in materially different ways. There needs to be a reasonable use of the covered bond market as a funding tool for certain parts of the bank portfolio, while securitisation would be used for other parts of the bank portfolio, and synthetic deals for asset and liabilities management and some specific exposure, which may not be amenable to cash securitisation. The asset backed commercial paper market also needs to function in order to address notably short-term SME exposures.

3. Key elements of the current political debates on securitisation

The first set of meetings in the EU Parliament is in September 2016, and it is hoped that completion will be achieved by the end of 2016. Broad support for more transparency is clear from the amendments. There is also support for supervisors to have a clearer role. As time goes on, problems in the negotiation process will increase: there are differences of views in relation to the retention rate and third party certification. All political parties in the Parliament are constructive, although left wing politicians are typically 'a bit more critical'. More organised lobbying will help.

Ideally, a sound financial institution would be treated differently from an unsound one. However, since financial institutions in bad situations 'tend to gamble' when using securitisation, such a differentiated treatment might incentivise this tendency. The financial sector is constructive, but it can also be destructive, and it is the job of the Parliament to consider what it can do to contribute to financial stability. Adjusting the retention rate could be considered, but this requires a specific judgement by the supervisor. To use securitisation effectively as a tool, there also need to be regulations on data. Financial stability has to be integrated across >>>

>>> many different aspects: accounting and other leverage calculations, underwriting criteria, and origination; all need to be looked at.

4. Leveraging the low risk lend-to-distribute model specific to the EU

There is broad, general support for regulation to ensure a healthy, functioning market. A discussion of the alignment of interest is critical, particularly in parts of the market with an originate-to-distribute model; however, the vast majority of the European securitisation market has been a lend-to-distribute model.

In this context risk retention has a role to play: over the last number of years, 5% has emerged as a reasonable level. Levels in excess of 20% 'start to make people nervous'. Misuse of securitisation can destroy financial stability, but securitisation with the right origination features can be helpful.

Broadly, the ABS and RMBS securitisations rated across Europe through the crisis have performed very well, as expected: less than 2% of the junior tranches have had any material loss; it is also not true to say that RMBS caused the housing crisis in Europe.

5. Attracting issuers and investors to the securitisation market

Securitisation is necessary to free up spaces in bank balance sheets; however, whatever is decided on must be something that will actually be used. One official noted that if regulations are not investor friendly, there would be 'no market, only regulation'. There is a balance to be struck between due diligence and technicality. There is already a securitisation market for ABCP that is very safe, which is a perfect example of how securitisation can be useful with a good regulatory framework; if STS regulation harms existing markets, it will be acting against its intended function: to preserve markets that function well and revive other markets within a sound framework.

Leading up to the financial crisis, one of the contributing factors was the globalisation of the capital markets and technology evolution, which led to a bubble focused on US sub prime. Globalisation can be very difficult to manage, but it also allows investors around the world to help fund needs and distribute risk more widely. There is an acceptance that global capital flows are wanted, and thus there is a need to establish how to create harmonised, reasonable regulation and support the proper use and allocation of that capital. ●

Leveraging the role of asset management in funding the economy

1. Challenges and opportunities facing the EU investment fund sector

Growth in Europe is currently low, but could be improved through more efficient and integrated capital markets. There is no shortage of capital in Europe at present, but a significant amount is kept in cash and savings, despite record-low interest rates, and investment is weak.

Factors currently hindering growth include the ill functioning of bank intermediation (in some EU countries bank balance sheet improvement has not been sufficient and increased regulation impacts all banks) and also of the intermediation of capital via markets (e.g. although fund investments are growing only 10% of assets are going into EU corporates). The current low demand for capital and corporate investment is another element. There are also questions of macro policy. Opinions are split on whether the ECB's radical monetary policy is supporting growth. Whether fiscal policy supports consumption more than investment is another issue and a strengthening of policies such as the Juncker Plan could be envisaged in this perspective. Finally, macro risks related to a possible fragmentation of the EU or EMU have to be considered, although the general macro outlook is improving cyclically.

Delivering the Capital Markets Union (CMU) should be the highest priority for key European stakeholders, several panel members considered, in order to develop alternative sources of financing. Asset management is crucial in this context, but a different approach to the sector is needed for the CMU to be successful. End-investors, whether they are individual savers, pension funds or investment companies need to be placed at the centre of regulations and fiscal policies, making sure that their capital is treated fairly, an industry representative declared. There is a significant demand from European investors for assets such as infrastructures, SMEs and green finance through fund investments, but the financial >>>

>>> community as a whole is failing to take a holistic approach to this issue from the end-investor perspective. There is also concern over how an effective CMU can be delivered in the wake of the Brexit referendum, given the number of funds based in the UK, a panellist emphasized. Moreover, the sector has grown and there is a strong interest from the EU public institutions in addressing the potential systemic risk associated with those activities. Other instruments such as corporate bonds, which are under-developed compared to the US also require examination.

2. Relevance of current EU fund ranges for supporting sustainable funding

Ensuring that there is an appropriate range of effective products and sufficient trust in the asset management sector is essential. The EU fund sector is currently very fragmented and suffers from high costs which diminish returns. EU funds are considered to be on average 7 times smaller than US ones, which impacts on economies of scale and costs and there are four times more funds in the EU than in the US. This is potentially due to a predominance of and preference for local funds in Europe. Another issue is that households are sold more Alternative Investment Funds (AIFs) than UCITS. Potential solutions to fragmentation and cost issues include a more consistent implementation of investment fund rules across EU jurisdictions; increasing investor education; as well as a consideration of the degree to which distribution channels are open or closed, taxation issues for the end-investor, and the availability of cheaper and simpler products.

Solutions for developing long term investment include developing ELTIFs (European Long Term Investment Funds). However, ELTIFs raise liquidity issues, and require more investor education about long term saving and the need to give up some liquidity benefits in exchange for higher return. Tax incentives are also needed to support the ELTIF market, as is the case for municipal bonds in the US. Moreover in Europe there is no safe harbour from the impact of the OECD BEPS initiative, aiming at stopping multinationals from shifting revenue to get double non taxation, on funds that invest in SMEs and infrastructure, meaning that these funds may face double taxation. Allowing liquid funds such as UCITS to have a greater amount of illiquid assets under certain conditions could also be considered, a panellist suggested.

A further solution could be to achieve an appropriate balance of active and passive management in fund investments. The market needs both, for efficient capital allocation and price formation: active management seeks to invest in the best companies and has a positive impact on stock prices and benchmarks, whereas passive management ensures that firms receive capital in perpetuity so long as the company is in the index. Some suggest that passive investment is not passive but 'index' investment, and requires significant activity in terms of getting the right benchmarks and achieving appropriate corporate governance and work around Environmental, Social and Governance (ESG) criteria. But the optimal balance between the two is not easy to achieve.

Finally, investment in alternative funds by high net worth investors may also require facilitation in order to improve their asset allocation. They are close to institutional investors in terms of size and ability to make decisions, and need to be appropriately categorized in regulations.

3. Developing cross border fund distribution

Europe is considered to have a solid and longstanding legal framework for investment funds based on UCITS and the AIFMD directives, both of which include a passporting regime. Analyses have been made by the French AMF on why there is so little cross border investment in the EU and these issues are due to be addressed in the context of the CMU action plan. Research indicates that obtaining a passport is cheap and simple, but funds are not effectively marketed cross border. Challenges include the way that distribution networks are organised in Europe, mainly with closed architecture, and the lack of investor confidence, particularly with regard to foreign funds. Cross-border distribution is also hindered by double taxation issues and marketing barriers, with different interpretations of rules across EU jurisdictions, thus leading to differing marketing documents and reporting.

Research offers proposals on how to tackle those issues. A first solution is to favour the development of open architecture notably with the support of digitalisation. Developing confidence in foreign funds by setting up common marketing rules with a pan European marketing regime is also proposed. Harmonised marketing rules would still require the local supervision of documents referring to funds distributed in their jurisdiction, including foreign ones, a regulator stressed. Some other panellists emphasized however that this hub and spoke model might raise issues if domestic supervisors have different local concerns to address. A third proposal is to reopen the debate on the supervision of market conduct for distributors acting under the freedom to provide services regime. At present these distributors are controlled by their home supervisor and specific MiFID II rules are designed to deal with cross-border issues, but any actions or sanctions are very difficult to implement across jurisdictions in practice. A stronger control by the supervisor >>>

>>> of the jurisdiction where investors are located would enhance investors' protection hence confidence. A further challenge is to achieve more forward looking regulation that can accommodate new distribution developments.

Investment advice is moreover essential for enhancing investor confidence, however increasingly fewer people receive any. The cost of advice continually increases and a current challenge is to provide advice to a wider sample of the population, particularly those likely to invest with appropriate guidance. Technology i.e. robo-advice or digital advice, in conjunction with human advisors, could fill the advice gap by reducing the cost of advice and facilitating access to it and also giving individuals a better view of their entire financial situation in a more reliable way.

4. Improving pre contractual information

The purpose of the Packaged Retail investment and Insurance-based Products regulation (PRIIPs) is to rebuild trust in the financial sector and ensure clarity of pre contractual information rules, so that retail investors can make informed decisions. The recent ECON Committee's blocking of PRIIPs attracted attention, but discussions are underway on how to progress. Detailed guidance is needed so that investors are aware of the complexity and risks of the products they are buying. This requires in particular an improved methodology on future performance scenarios which demonstrates to them that they can potentially lose or gain money, depending on market evolutions. There should also be greater transparency in terms of risk and cost.

The elimination of past performance disclosure from the documentation is a problem, some speakers emphasized. On this aspect, the PRIIPs RTS (Regulatory Technical Standard) is inconsistent with the Level 1 approach and the objective of improving investor confidence. Past performance is not a good predictor of future performance, but it is factual and gives basic information on whether the fund has met its investment objective in the past. ●

Encouraging long-termism in the financing of the economy

1. Enabling longer term investment requires many elements

Three questions were proposed: how to upgrade the incentive to have all the financial tools for such a long-term investment strategy; the issue of regulation aspects; and rewards for long-term investment.

There is a need to understand the broad picture in which this is happening. The investment strategy is now a priority in European discussions, and a representative of a public authority noted that the Juncker Commission has been committed to raising the level of long-term investment from the outset, which is imperative.

Europe needs investment oriented towards equity investment; and it is also very difficult to discuss long-term investment without relating it to taxation; Banks have a role to play in judging and managing credit risks successfully that cannot easily be taken on by other market participants; if non banks are to take over a significant portion of funding, the regulator should follow the principle of 'same business, same rules'.

The Commission has already succeeded in incentivising the allocation of institutional investors towards the long term: it has recalibrated capital charges under Solvency II for infrastructure investments, and is now going to complete this by seeking to adjust the capital charges on investments in infrastructure corporates.

Too often, fiscal policy is proposed instead of structural reform, and there are things that can be done in the area of long term investment, but the Juncker Plan needs to be the scale it is now, because Europe is not addressing fundamental uncertainties about investing long-term in Europe. It is extremely important to associate local authorities with the policy of investment in the Juncker Plan through the EIB.

2. Longer term investment: general issues to be addressed

There is an emergency, and Europe cannot wait for economies to converge; the immediate priority is to solve the question of investment. In the longer term, a single capital market should make the need for a Juncker Plan redundant, but in the >>>

>>> interim, there is a need for the slightly more proactive approach of the Juncker Plan. However, in this debate, some consider that there is a common acknowledgement that Europe is not succeeding in the way the task demands: there is more 'naming and shaming' than acting, as well as looking at short-term short-cuts while leaving long term issues for another day.

It is not possible to look at long-term investment in isolation from the broader economic conditions: people are not investing in these investments because there is chronic uncertainty about the long-term prospects of the European economy. Institutional investors need to be helped to take more risks; in this field, the public sector partially has the role of providing re-insurance. Due to the financial crisis and the repercussions of COP 21, there is an increasing awareness amongst the public that they have to be intelligent about their use of their money: to finance long-term projects, and also to help the financing of the ecological transition.
A participant on the panel added that there is a mismatch between the innovation capacity of the financial market and what is expected from a retail investor. PRIIPS will not necessarily be the solution, but there is awareness that this needs to be upgraded, and that there is a great deal of room for improvement.

3. Taking stock of two aspects of the EU Commission's policy towards long term investment

The Juncker plan is performing quite well, and it is on track with respect to the interim deadlines that the Commission set itself. As it has started well, the Commission will be thinking of ways that it can leverage it up. There is an investment hub that allows people to identify projects, and investment portals that allow the funds to be linked efficiently to those projects; as such, the Commission is trying to build up an infrastructure that maximises the use of the money. This work has been mostly focused inwards on the EU, but the Commission will now try to attract outside investment, by encouraging external investors and having discussions notably with the Chinese. The Commission is also building ELTIFs; if the taxation treatment of these funds is not correct, they will 'take off' but not deliver on what Europe wants them to do.

The Commission has had a good start, and is encouraged that it can increase the size of this project and try to make the plan as attractive as possible to outside sources of private investment. The plan has two primary objectives: to raise funds, and to match these funds to projects, with a third objective being to improve the investment environment.

4. Challenges posed by long termism to prudential regulation and accounting standards

Europe lacks long-term investment because it is using the wrong paradigm, and believes itself to be facing 'the end of history' in which it will not need a Juncker Plan. There needs to be a new paradigm: agile regulation, acknowledging that business is good for society, as opposed to reaction adaptation. Soundness begins with culture and governance, continues with business models and strategy, and ends with talent. The future of the financial sector is 'either digital or dead', and there is a need to make sure that there is proper investment in the long term sustainability of the financial sector.

In a digital world, investing in IT and software becomes a must, and should not be made more expensive than it already is. Software has historically been classified as "Intangible assets" thus leading to a full deduction of its value in terms of regulatory capital requirements. Intangible assets may probably not be fully available with complete certainty, in terms of a gone concern basis. However, an agile regulator should look at the whole picture, particularly at a time where the value of such assets in many cases exceeds that of tangible ones, and reflect on what others are doing to address the very same issue without putting at risk the soundness of the system, nor penalizing investments in this key area, such as accounting some elements as other asset categories or premises or equipment. There is an urgent need to identify how success is to be measured. However, there cannot be any form of investment without investors trusting in investees; the IFRS Foundation tries to provide this confidence by establishing good financial reporting standards. However, standard setters have been struggling to identify the conditions necessary to recognise expenses as an asset. The IASB cannot do much to help in terms of prudential regulations, but can only make sure that there is good accounting and that, if an entity invests in IT or development, this is an asset from the perspective of accounting.

Transparency applies to long-term investors as much as it does to short term investors. Investors do not need to react on a short-term basis to market 'noise'; there are ways to deal with volatility in the accounts, but it is very dangerous to ignore it. The role of accounting is not to create positive incentives, but to be neutral; however, it can be useful in reducing, or avoiding the creation of negative incentives. One risk that accountants can address is the investment risk on information.

In some member states, lending is still declining; even in Germany, it is growing at a rate which is 3% >>>

>>> less than is usual in a recovery phase. There are three main reasons for this: weak demand, stronger competition because of financing by other capital markets, and banks having less interest in lending because of rising regulatory requirements. An extreme reduction of the banking sector would withhold financing to an important part of the corporate sector, particularly the SMEs. One possible solution would be to provide subsidies and state aid for financing to SMEs, and the second would be to foster securitisation.

The securitisation process, and the possibility of the insurance industry to invest in such securities, is probably one of the main supports to developing long-term investment. Solvency II probably still needs to be reviewed. Long-term investment depends not only on the decision of the EMU and the capital union, but on whether a European perspective is able to be put forward on other problems, such as securitisation.

If there is to be investment, there is a need for simple rules and trust. Long term investors in Europe could be rewarded via taxation regimes. An industry representative added that there is a need to recognise infrastructures as a class asset, and to acknowledge the role of counter-cyclical actors, such as NPBI, national, public and financial institutions. Another industry representative added that there is a need to support corporate finance, especially in the Basel IV package. However, there is also a need for a proper convergence between supply and demand: when there are good assets, all of these must be bought by insurance companies and by pension funds. ●

Securities market infrastructures

1. Potential impacts of new technologies on EU market infrastructure models

Technology poses new questions in terms of its impact on the way that market infrastructure models work in the EU. Blockchain technologies for example, which are starting to be tested for securities transaction clearing and settlement in some markets, have the capacity to be enormously efficient and quite disruptive. However, they raise many questions around legal, governance, operational and functional issues. There are also multiple blockchain technologies and different standards, and it is difficult to identify which standard may best support further European integration; moving too fast in the market infrastructure area may lead to fragmentation. The ECB will therefore monitor these new technologies, rather than implementing them in its infrastructure such as TARGET2-Securities in the short term, focusing on use cases and assessing the efficiency gains that can be expected, while ensuring that regulation does not stifle innovation. New technologies such as blockchain indeed need more stability and standardisation before they can be introduced on such systemically important platforms as those of central banks, which might take another ten years.

Central banks are also assessing the potential practical implications of digital currencies. If digital currencies are issued and accounts are widely offered to citizens, this could significantly impact the handling of monetary policy and how monetary transmission works.

2. Regulatory and market-driven evolutions affecting CCPs in Europe

2.1. Progress made regarding the regulation of CCPs

The observation of the market indicates that EMIR has facilitated much progress in the clearing area and has enhanced the stability of CCPs, notably with central decisions on clearing and the approval of margining models by ESMA. It has also succeeded in moving a very national part of the financial sector to the European level, which is a further step towards an internal EU capital market. Having a European level regulation in this space is important because regulatory competition will likely arise among CCPs even if there are small differences. The global dimension of the market has moreover been taken into account with the equivalence agreements negotiated with various third-countries.

There has also been an emphasis on supervisory consistency with the implementation of supervisory colleges for CCPs. Stress testing is also very important in this context. ESMA has conducted a first stress test of European CCPs focusing on counterparty risks, where many lessons were learned concerning the impacts of possible stress scenarios (multiple clearing member defaults, simultaneous market price shocks) on CCPs as well as their clearing members. A second stress testing exercise is being prepared, which will also focus on liquidity risks. ESMA was commended for its >>>

>>> 'pioneering approach' in terms of CCP stress testing. Work on the next stress-testing exercise will also involve the Central Bank.

An area where further progress is needed is defining an EU recovery and resolution framework for CCPs, now that international guidelines are available, considering the central role that CCPs play at present in the securities and derivatives markets and the related financial stability implications. The objective is to provide the measures allowing a CCP to stay open for business, potentially under new constructs and with a new management team, in a case of significant stress. In developing the framework, the differences between recovery and resolution of a CCP and of a bank need to be taken into account; the tools proposed in particular ought not to focus on the relatively small balance sheet of CCPs.

2.2. Prospects of further consolidation in the EU clearing area

The market structure in Europe is changing with major merger proposals on the table that may affect the clearing space. The potential competition issues that this may create are being examined by the EU Commission, whereas the ECB is more concerned with efficiency and efficiently functioning markets. There is no regulatory objective to further consolidate securities market infrastructures in the EU; this should be left to the market, but over concentration could be a concern. Market integration is the primary objective of the Authorities regarding market infrastructures.

With the current central clearing obligations of EMIR, benefits can however be expected from a larger scale with better opportunities in terms of netting across transactions. It must also be realised that CCPs are operating in a global market and therefore there is a need to assess to what extent European CCPs are able to compete with very large CCPs in other jurisdictions.

2.3. Possible consequences of Brexit for Euro-denominated clearing

Many politicians argue that with Brexit, Euro clearing should move to the Eurozone. The ECB has a location policy for payment systems which has been indirectly vindicated by the courts, but not for other infrastructures. The decision was made not to appeal against the first judgment of the General Court in 2015 annulling the Eurosystem clearing location policy, requiring larger CCPs clearing Euro-denominated transactions to be located in the Eurozone. It is difficult to say how the position of the UK will evolve in this regard. This issue however concerns the definition of the EU passport rather than Brexit. There cannot be a single EU passport without a single authority that ensures the unicity of the interpretation of the law. Thus a passport goes along with the recognition of the competency of the European Court of Justice (ECJ) in order to maintain the unicity of interpretation. No decisions have yet been made regarding the way this issue should be addressed.

The outcome of Brexit negotiations will strongly impact the legal environment of CCPs based in the UK. If the UK decides to remain in the single market, current legal arrangements regarding the EU will not change and will be quite clear. But if the UK leaves the single market, it will possibly be considered as a third-country; in that case the legal arrangements of UK based CCPs may be more difficult to define, as illustrated by the recent equivalence assessments with the US which took five years to complete. The third-country arrangements of EMIR may however need to be modified. When EMIR was reviewed prior to the Brexit referendum, ESMA recommended that the third country arrangements for CCPs could be made more granular, because the current system is too binary: jurisdictions are either considered equivalent or not with regard to EMIR, whereas legal systems are hardly ever equivalent in all aspects; this has made equivalence processes related to EMIR difficult up till now. A full registration process should be pursued, because that gives a greater possibility of being responsive to specific CCP risks. ●

Addressing key legal and fiscal obstacles to CMU

1. Lifting legal and fiscal barriers is essential for achieving the CMU

Insolvency laws and taxation are fundamental barriers to capital market integration in the EU. Legal and fiscal barriers also limit the efficiency of EU capital markets. These areas are very sensitive, as previous work by the EU Commission (EC) has shown, but are believed to be more problematic for the Council than for the Parliament. There is >>>

>>> a risk that ambition may be insufficient when tackling them, which would not allow the building of a single market for capital. A sufficiently high level of political commitment is therefore needed to address these issues which are essential for achieving the Capital Markets Union (CMU). Arbitration and coordination are needed at a high political level, as well as showing that insolvency and tax reforms will support the viability of the EU and Eurozone by fostering more risk sharing across the EU.

2. Insolvency regimes

2.1. Main issues

Differences in insolvency frameworks constitute an important cross border investment barrier that creates uncertainty for investors about the legal outcome of any future problems concerning their investment and the related risk and reward. Such uncertainty impacts capital flows, the amount of capital that goes to different jurisdictions, and the cost of capital for companies within those jurisdictions. There is also a significant potential economic benefit from improving insolvency regimes. A recent survey quantified that if recovery rates of asset values, which currently range in the EU between 30 and 90%, could converge towards 85%, then the Eurozone GDP could increase by between €41 and 78 billion.

Many differences across Member States' regimes reflect the inefficiencies of local regimes, but some others reflect socio economic preferences; one of these preferences is the balance between protecting business and creditors, which can also change over time. The detailed evaluation of insolvency regimes across countries is not easy for investors such as asset managers, who lack the local coverage and resources of bank networks to estimate whether some countries' insolvency laws and processes will allow them to recover a sufficient amount of capital in a given timeframe. The three elements sought are: an effective restructuring regime that protects creditors' rights; speed of the process; and whether the process is at minimal cost. Appropriate speed in particular is essential for ensuring more certainty of the outcome.

2.2. Possible way forward

Improving the consistency of insolvency rules seems necessary in order to foster more cross border investment; however, insolvency frameworks tend to be linked to civil law and cultural preferences and are mostly in the remit of justice ministers. Moreover there tends to be reluctance from Member States to converge on common best practices which they do not necessarily consider more beneficial.

Having eliminated options such as a full harmonisation or a 29th regime, which do not seem feasible, the EC has opted for a step-by-step approach supported by a benchmarking exercise aimed at defining the criteria of a good resolution outcome. There are indeed major differences that have been measured between Member States in terms of the length of insolvency procedures or the time necessary to enforce a contract. Improvements are being made by some countries, but these efforts are largely uncoordinated.

Keeping 28 different regimes is not the best approach for investors and supervisors in the longer term, some panellists thought, and is not consistent with the on-going harmonisation of investment products. Some were therefore in favour of moving towards a greater consistency of insolvency rules. The suggestions made included improving the consistency of the less controversial parts of insolvency regimes and progressing from there with an appropriate governance of the process; focusing on minimum standards in order to allow investors to achieve a minimal level of understanding of related risks in all 28 Member States, thus improving certainty and reducing tail risks for investors; focusing on fostering greater harmonisation of procedures in terms of speed and transparency, which are easier to harmonise than rules and developing appropriate centralised tools (e.g. databases) to support common proceedings; and finally focusing harmonisation efforts on the cross border element in order to improve company group proceedings.

The creditor hierarchy is also being dealt with by the EC; a proposal will be made in this regard by the end of 2016. The EC is also developing a proposal on minimum harmonisation in debt restructuring and discharging aiming at making it easier to handle bankruptcy processes and allowing failing businesses to get back into business.

3. Taxation

3.1. Main issues

Taxation is also a difficult issue at the EU level, because it is considered by Member States as an area of national sovereignty. It is problematic because there are different administrative procedures for claiming withholding tax across jurisdictions and long timelines, which make the use of local intermediaries essential and create major inefficiencies. Moreover, every country is beginning to have more complex and different tax reporting systems, and this is likely to increase without a common solution.

Several taxation issues affecting the asset management sector in particular were >>>

>>> discussed. Tax treaties are negotiated bilaterally between Member States, creating complexity for investors operating in multiple markets; moreover tax rates are determined for a given client segment but not for a pool of clients, making the tax outcome of pooled investments uncertain. A further issue concerns the implications of the OECD Base Erosion and Profit Shifting (BEPS) initiative, aiming at stopping multinationals shifting revenue to get double non taxation. BEPS may lead to double taxation for cross border investment by pooled funds into private asset classes, such as infrastructure, venture capital or private equity, wiping out a large part of the illiquidity premium; and the European Anti-Tax Avoidance Directive (ATAD) does not create a safe harbour in this case. These issues could potentially be solved by the creation of a holistic EU framework for funds investing in private asset classes. A panellist however considered that if the objective of developing cross border investment has not yet been achieved with UCITS notably it is mainly because of domestic bias and lack of trust in foreign funds for which the protection of local supervisors is needed.

3.2. Possible way forward

The EC is working with Member States to establish a common approach on managing withholding taxes. Some speakers considered that optimising withholding tax procedures should be possible without touching tax rates. Solutions could include making a centralised clearing process available to all jurisdictions, implementing a standard registration process for investors in every country and simplifying procedures. Some were sceptical that progress could be made regarding withholding tax due to political sensitiveness in this area. Implementing a common corporate tax could be an easier priority; a proposal that was made during the previous legislature still remains to be discussed in the Council. Public pressure would need to be applied through the national decision makers to emphasise the need to resolve these tax issues.

The EC will also work on the debt equity bias. Developing equity is essential for diversifying financing and for developing a private sector risk sharing capacity across the EU. This is however also a sensitive issue because unless that bias is addressed on a fiscally-neutral basis, there will be a loss of revenue from restoring this taxation bias. Fiscal measures will be discussed with Member States alongside the Common Consolidated Tax Base (CCTB) proposal. ●

How far should securities post-trading harmonisation go?

1. Addressing the remaining barriers in the post-trading area

1.1. Much progress is being made in the harmonisation and standardisation of post-trading

Efficient and resilient post trade infrastructures are key elements of well functioning capital markets. The removal of the Giovannini barriers to cross-border clearing and settlement, initiated by the European Commission (EC) in 2001, has progressed. The EC has committed in the CMU action plan to finalise the removal of these barriers and other more recent ones. Moreover, recent legislation – including MiFID II, EMIR, and CSDR – should foster the further harmonisation of post-trading functions, but many of these new provisions are not yet implemented.

Many structural changes are also underway in the post-trading market. TARGET2Securities (T2S), which will be fully implemented in December 2017, has been very beneficial in driving harmonisation and standardisation forward, leading to improvements such as standardised settlement timetables, matching rules, and omnibus accounts for cross border transactions and a single settlement finality regime. CSDs are also migrating to T+2 in October 2016, and many changes have been made in domestic markets such as Spain. The EU post trading market is expected to become more competitive as a result of all these developments. A broad review of these developments and an assessment of the impacts that can be expected on the remaining post-trading barriers will be conducted by the European Post Trade Forum set up by the EC.

1.2. More harmonisation is needed and an appropriate approach still needs defining

One panellist suggested that the fully harmonised cross border securities market that exists >>>

>>> between France, Belgium and the Netherlands shows that more harmonisation of post-trading processes is possible – e.g. regarding corporate actions – beyond the significant improvements made in the context of T2S. Moreover, the fact that cross-border execution costs have still not been significantly reduced is frustrating. Another panel member observed that one explanation is that the new capital market regulations have increased fragmentation by creating more competition, notably in the field of market infrastructures.

In addition, the Call for Evidence output shows that there are still significant domestic legal and fiscal barriers within EU securities markets that hinder cross border investment. Implementing the CMU requires more harmonisation and making procedures more consistent, a speaker declared. This does not mean giving up tax sovereignty and aligning taxation levels, but standardising processes, such as those related to withholding tax. Similarly, a common standardised procedure could be employed regarding insolvency, even if some elements remain at the national level.

Some panellists, however, considered that full harmonisation should not be a goal, and favoured a more incremental approach: they felt that full harmonisation is not necessary for launching the implementation of the CMU and could hinder its progress with over-challenging objectives. Rather, the industry ought to start with relatively easy issues such as prospectuses and asset-backed securities, building momentum; this would help to strengthen the business case for tackling more difficult legal issues later. More could be done also regarding, for instance, the re-use of collateral, the protection of omnibus accounts and pre-insolvency procedures; this would facilitate market functioning and help to achieve many of the desired results of harmonisation, without digging into the details of insolvency and securities laws. However, at this stage the EC does not exclude that the CMU post-trading programme might be quite ambitious. This will largely depend on the outcome of the European Post Trade Forum, which will be disclosed in March 2017, following consultations with the main market stakeholders.

2. Opportunity of further harmonising EU securities law

When investing cross-border, investors are confronted with different securities laws, which impact the characteristics of the securities they hold. The EC wants to deal with the uncertainties surrounding securities ownership that this may lead to, as part of the CMU action plan. The possible options for achieving legal certainty in a consistent way will be assessed, as well as the rules that should apply to third party effects of assignment of debt claims.

Some panel members were in favour of further harmonising securities law in order to simplify cross border transactions and reduce costs for investors. A common set of laws would help to reduce the need for local intermediaries who currently bridge the divide between often conflicting member states' legal systems, a panellist emphasised. At present, 13 intermediaries are required on average for executing a cross-border transaction in the EU, which increases costs; another speaker commented that this is partly due to market fragmentation, which has increased in the EU post-trading market. Moreover, the stronger harmonisation of securities and insolvency laws will enhance the protection of cross-border investors, ensuring that assets can rapidly be located and made available in the event of – for instance – the insolvency of an intermediary. This will also favour more efficient collateral processes, in addition to the improvements brought by T2S.

Some other panellists emphasized that a pragmatic and proportionate approach is needed with regard to securities laws. Harmonising them would be very difficult, and is not advisable due to their strong connection with civil or common law traditions. In addition, differing securities laws are not a significant barrier to cross-border order execution within the EU at present, and the impact of these differences is 'rather overrated'. Tackling insolvency laws and procedures is far more urgent, a panellist declared, because they have a significant impact on the functioning of T2S and CSDs in particular; further harmonizing tax procedures is also important for some processes, such as corporate actions. The way forward should be to tackle conflicts of law, some suggested, building on the acquis communautaire; this may, however, be a broader issue that goes beyond securities law.

3. Impact of new technologies on post-trading

Distributed Ledger Technology (DLT) has the potential to increase post-trade efficiency by speeding up clearing and settlement processes, and reducing the number of intermediaries. Market infrastructures are currently testing prototypes in specific market segments such as the gold market where there is currently a great deal of inefficiency. One panellist, however, pointed out that there is not yet any wide scale use case of DLT in the market, due to AML and CFT rules[1] in particular, which would need to be changed. The only real applications of DLT thus far are internal ones with databases for which there are no regulatory restrictions. >>>

>>> Consequently, current T2S developments will not include any DLT.

Several issues that need to be addressed regarding the use of new technologies, and more specifically DLT in the post-trading space, were emphasized by the panel members. Safety is a major concern and is often underestimated. DLT may increase cyber risk in particular, due to the exposure of ledgers to cyber-attacks, and these risks have a global dimension. Safety standards therefore need to be developed for the implementation of DLT in market infrastructures to be conceivable; it is crucial, for example, to be able to protect the notary function in CSDs which is essential for the market. Continuous innovation is a further challenge. Vulnerabilities may be created by introducing new innovations before ongoing changes in the post-trading space, such as the migration to T2S and the implementation of CSDR, are fully absorbed and the market is stabilised. Finally, some additional issues relating to governance and investor protection and identified in the von Weizsäcker report on virtual currencies and DLT in particular were cited: i.e. how DLT works legally, and whether there is certainty.

Some suggested, however, that these various risks and challenges should be weighed against the potential benefits of DLT, and should not prevent its development if it can be made to work in a way that significantly benefits the markets.

ESMA is currently looking into potential benefits and risks that DLT could bring about when applied to securities markets from a public policy perspective, taking into account regulations in the post-trading area, which appear as the primary scope of application of DLT. Whether DLT should be harmonised is a valid question, because it is theoretically easier to harmonise something that is emerging, but this is not necessarily a regulatory issue. The EC also is currently observing the development of DLT, while trying not to 'step in prematurely' on the regulatory and harmonisation sides. In any case, if regulatory intervention were to be required at a later stage, this would be based on principles and would not involve detailed requirements. ●

1. Anti-Money Laundering (AML) and Combatting the Financing of Terrorism (CFT) rules

Developing capital markets in Central and Eastern Europe

1. Central and Eastern European (CEE) economies are mainly bank-financed at present

Financial intermediation in the CEE region is mainly bank based, supported by a strong presence of both local and international banks and ample bank liquidity, which has risen with the flow-back of liquidity from Russia. In most CEE countries, the banking model has been rebalanced over the past 10 years, making banks stronger: they are now more domestically financed, while international ones still benefit from the support of their parent banks.

CEE capital markets are underdeveloped in comparison to Western European ones, and also relative to the size of the economies. Stock market capitalisations do not exceed 30% of GDP, and liquidity is low. Government bond markets are growing but there are very few corporate bonds, due to attractive bank financing. The situation, however, varies somewhat across countries: Poland is the strongest market and has the largest market capitalisation. Hungary is smaller, with a market cap vs GDP ratio of around 15%, but there are reasons to be optimistic: a new strategy is being implemented at the stock exchange, and there is a remaining potential for privatisations. Slovakia and the Czech Republic are in a specific situation: trust in capital markets is low following some scandals in the 1990s, and privatisations have never been carried out through the stock market, which has not permitted the 'kick starting' of capital markets. A common characteristic of all CEE markets is the high proportion of SMEs and the need to bring more of them to the capital markets, which requires an appropriate market infrastructure.

This limited development is due to several factors, including market fragmentation across the CEE region, significant counterparty credit risk, and a low level of financial literacy. Economies are also still growing, and many firms do not need capital markets in their early stages. Moreover, there are only a few large companies in the region. A major factor, though, one speaker emphasised, is that CEE capital markets are quite recent – mostly having been set up 25 years ago – and they have been widely exposed to international competition from the outset, unlike larger Western European markets, which originally grew in relative isolation. >>>

>>> 2. More capital markets development is needed in CEE despite the absence of a funding gap

There is currently no evident funding gap in the region. Since 2009 the saving rate and the formation of deposits have, each year, been higher than the investment rate, which means that the credit demand is relatively low and can easily be met with the existing financing supply. This is true for most CEE countries, although economies and banking systems differ.

More capital market development would help to diversify and support the financing of CEE economies, although needs vary depending on company sizes and projects. There are investors ready to invest in the CEE region, despite recent changes in some pension fund systems that may reduce their investment capacity. Generally speaking, larger companies in the region would benefit from more access to capital markets. The largest ones issuing 'big tickets' exceeding €500 million can easily find additional capital market funding notably in London, but medium-sized issuers with tickets of €200 million or less find it more difficult, because this requires tapping local capital markets. These medium sized issuers are usually able to get sufficient bank funding at present, but would be the first ones impacted if bank liquidity were reduced.

Smaller SMEs require in depth knowledge, which is more easily provided by banks, but diversifying the financing of some of them – notably with equity – would help to strengthen the resilience of their funding to possible shocks, as well as encouraging more transparency in their management. Additional funding options are also needed for long-term projects, e.g. infrastructure projects, for which new banking rules and IFRS 9 accounting rules are making bank lending more expensive.

Moreover, a broader funding gap cannot be excluded in the future. Banks are increasingly constrained by prudential requirements; non-performing loans (NPLs) in domestic CEE markets and the countries of the parent banks may also have a negative impact on bank lending, although the situation seems to be improving; and the Russian market might also re-open at some stage, and start draining liquidity.

3. Many challenges will however need to be overcome for developing CEE capital markets

3.1. CMU and further opportunities and threats related to EU integration

Some panel members emphasized that domestic CEE capital markets should be developed in such a way that they can be integrated into the European capital market. This would make them more resilient to external shocks and allow them to develop synergies with larger EU capital markets. Firstly, many EU rules, notably CMU ones, are likely to be also relevant at the domestic level and to benefit local players; for instance, securitisation may allow local banks to increase lending, and reviewed prospectus rules will help local issuers. In addition, combining domestic and European approaches will diversify and complete the access of firms to capital markets, providing them with more opportunities for entry into the market, for example through local or international private equity or venture capital (VC) firms, and for exit – e.g. through an IPO, possibly with dual-listing. For growing SMEs in particular, one speaker emphasized that given the limited capacities of domestic venture capital funds and private equity players, there is a need to facilitate investment from outside the region, which requires consistent market regulations and IFRS standardisation in order to limit complexity and additional costs for investors.

Some speakers argued that CEE markets are already integrated into the EU market to a large extent, using international trading platform technologies, IFRS reporting and dual-listings; however, they were concerned that further integration might destroy fragile domestic market ecosystems because of the cost and difficulty of implementing EU rules. Proportionality could, however, be a help to limit these impacts. Additionally, SMEs will not benefit from further market integration, a panellist declared, because most cannot obtain cross-border financing. Liquidity for SMEs will mainly be provided by local investors, for whom having some local rules is quite acceptable. One element that would need to change though is the way of calculating indexes, which are mostly based on volume and should better take into account the limited number of large companies in emerging Europe.

3.2. International competition

One further concern is that CEE markets could be 'killed off' by international competition before they can develop, a speaker warned. Recently, the deals involving bigger companies in the CEE have all been conducted by banks based outside the region, especially in London. If big banks are allowed to 'cherry pick' the biggest stocks from the local markets, these will never develop. There is a lack of local investment banks and intermediaries because they cannot make money on bigger deals. Moreover, Anglo-Saxon private equity and VC funds are overactive in the region and overpaying the market. A panel member pointed out, however, that many other banks are focusing on the region and are able to handle >>>

>>> smaller capital market transactions; clients are offered different funding options, but usually prefer bank solutions because they are quicker and cheaper, at least for the time being.

3.3. State support

Some panellists were in favour of ambitious state support in order to further develop small capital markets in the CEE region, with measures such as mandating privatisations to go through the capital market; this is how Poland was able to build a relatively strong capital market. Others agreed that some State intervention is useful, such as for educating investors and issuers or implementing tax incentives, but considered that initiatives should mainly come from the private sector, possibly in cooperation with the public authorities. ●


eurofi

4. NEW TRENDS

The fight against terrorism financing, money laundering and tax evasion

1. A key priority for the Slovakian EU presidency

The Fourth Anti-Money Laundering Package was launched in May 2015. It sets high standards to prevent money laundering; Member States have committed to implement the package at the end of 2016, at latest. The EU Commission has also adopted in July a proposal to further reinforce EU rules on anti-money laundering to counter terrorist financing, and has, in parallel, also presented a Communication that responds to the recent Panama Papers revelations.

Slovakia considers this topic to be their top priority, and three meetings at the EU Council level have been arranged. The documents of the EU Presidency relate to two packages: the first is combating terrorist financing, and the second is dealing with the reaction to the Panama Papers. Those two packages should be combined by the end of October. The most difficult issue that Slovakia needs to deal with is the definition of 'beneficial owners in particular in the context of trusts'.

2. A global approach is needed

Banks serve an important role in detecting and preventing money laundering, terrorist financing, and crime in general. An industry representative stated that, while there is more co ordination between banks and governments than previously, there is a need to improve that co-ordination and information-sharing to make it more dynamic, iterative, and real-time. There is also a recognition that customers benefit from their institutions collecting the data that they need to effectively manage financial crime risk. Although the EU's policy is as good as any other region's, there needs to be a global approach and particularly a global harmonisation of unique identifiers for individuals and ultimate beneficial owners. At the present time, anti-money laundering efforts are focused at an entity level, but there is a concerning trend whereby increasingly restrictive bank secrecy requirements are making it more difficult for information to be shared cross-border even where it is for the purpose of combating money laundering or other illicit finance.

An industry representative noted that there is a need to be proportionate: it is impossible for banks to follow some money trails. There are not enough resources or public support for financial institutions to investigate every transaction, and a level of materiality needs to be involved, or efforts to combat financial crime are less effective, the cost to the economy becomes extreme, and there is unwarranted intrusion into people's lives. Three prerequisites need to be in place for the EU to perform well in relation to this issue: sharing information between the public and private sectors, enhancing private to private information sharing; and having a proportionate response, so as to not create excessive financial exclusion.

3. With more cooperation with governments, freer contacts between banks and similar obligations on the social media companies, the situation would improve

Anti-money laundering efforts have significantly improved during the last five years. In the United States, banks have to file suspicious activity reports with a unit of the Treasury Department called FinCEN; last year, an industry representative said his bank filed over 100,000 suspicious activity reports. FinCEN received 1.7 million suspicious activity reports, which gives an indication of the scale of the work. Ultimately, the effort is 'a lot like looking for a needle in a haystack', although this institution is becoming much more sophisticated.

The representative's institution's anti money laundering efforts are better today than they were a year ago, and much better than they were five years ago. Another industry representative stated that, at the corporate level in a number of major banks, there are initiatives to see whether it is possible to build an industry-wide transaction monitoring engine in SWIFT because most payments go through SWIFT. A centralised utility in this area would be appropriate. Restricting issuance of high denomination banknotes would help; if the maximum denomination were a €20 note, it would take a large number of suitcases to carry significant amounts of money; with a €500 note, it >>>

>>> does not take many. Laws restricting the maximum amount that can be tendered in cash for any particular purchase are useful, but this gives rise to issues of privacy and intrusion, and society will not be ready for this without education.

The issue is how to make spending on this issue more efficient. In the United States, at least, there are constraints on sharing information even with other banks, which presents a significant problem. Conversations about how to reform this system are happening at the moment, but only to a very limited extent. Europe is rightly very concerned about privacy. Information sharing between banks and government and sending information between authorities is crucial with regards to anti money laundering efforts; the Directive that is currently tabled raises the possibility of sharing this information between the public and private sectors.

An industry representative commented that money is a 'digital message', sent through systems that banks monitor and it is 'curious' that countries do not place similar obligations, as they do on banks, on large social media companies, which also transmit digital messages. These companies are very efficient at targeting advertising at their consumers, but do not want to engage more with monitoring; however it would be hugely helpful to get access to this digital ecosystem where people can be identified as suspicious because of the messages, for instance, that they are posting on social networks. ●

Consumer challenges raised by digital transformation in the financial industry

1. Digitalisation will provide the consumer with reduced cost, frictionless transactions, convenience and new use cases, all of them enshrined in a completely renewed relationship with their service providers

The biggest benefit to the consumer from the digitalisation of financial services is cost: digitalisation reduces the cost of the transaction to the consumer. Digitalisation will impact on the entire value chain.

The insurance sector provides particular benefits: for example, the ability of the insurer to use big data, the internet of things and data mining will mean that the needs of insurers regarding the information on the consumers will be met. With the consent of the consumer, the transaction will be one click insurance, and insurers' ability to price more accurately means that they will be able to offer more accurate and lower premiums. There is a need to foster innovation for the benefit of Europe's citizens. Premiums have already been reduced, and there is also less bureaucracy in the claims procedure, as well as a general incentive to behave better.

A new class of people have been brought into their financial system through digitalisation: people with smartphones, and people who have not traditionally been customers of this institution. New use cases are being created through digital transactions. Much of what is going on with fintech is happening through the financial services R&D process, because it has stopped working inside the traditional incumbents in the desired manner: fintech's method of engaging with customers and testing different product solutions is the best means of overcoming this problem.

2. Emerging consumer risks related to the digitalisation of financial services

The digitalisation of financial services is a 'double edged sword': individuals who are deemed to be higher risk will struggle to either afford the insurance or to find an underwriter who will accept them. Each innovation needs to be examined separately in order to identify its benefits and risks. On the bank side, there is a need to simplify products and make sure that many fields are already filled in advance.

Technology is growing fast, and an open mind is required. Preserving privacy is also important, and the regulations that currently exist regarding the primary use of data are accurate formulations. Customers are far more content for their institution to use their data to prevent fraud than for pure commercial purposes, or for selling this data. Firms are using digitalisation for commercialisation and their own organisational purposes, which helps diminish costs. They need to use internal and external data, but this provokes huge issues with security and continuity of service. Additionally, the requirements occurring during the life of a contract need to be borne in mind.

New practices have also come into the insurance sector, such as the use of connected objects to gather customer data and adjust price to risk, and >>>

>>> also new products appear based on customer behaviour. However, some vulnerable customers may miss those innovations; there is the risk of more precise profiling with big data and individualisation, which could lead to more exclusion; and in large parts of the sharing economy, the consumer is being rated too, which raises the question of when the 'right to be forgotten' should be applicable.

From the perspective of insurers and regulators, it is difficult to define the 'tripartite relationship' between providers, insurers and customers. Regulators and insurers are used to treating customers as personal, commercial or corporate, but the sharing economy 'completely destroys' these segments.

3. EU supervisors and regulators are monitoring and adapting to emerging risks

EU wide action on digitalisation may be beneficial, with a supervisory approach between the 28 member states that is as consistent as possible. The European General Data Protection Regulation was approved by the Parliament earlier in 2016 and will come into force in two years' time, when it will address level playing field issues. One supervisor stated that their main challenge is being able to update the regulation as soon as the market develops; in this field, the speed of market developments is particularly high. For the time being, the challenges are mainly supervisory, rather than regulatory. In some cases, personal data and customer information are gathered without the customers' knowledge, and some social media examples have arisen of customers being advertised without their consent.

Blockchain technology has a huge potential to displace a great deal of the regulatory reporting infrastructure that exists at present, and to give regulators much quicker and faster insight; this is something that regulators could consider. A representative of a public authority pointed out that crowd funding is one area that is outside his institution's regulatory remit.

The major difficulty from a regulatory perspective is updating regulations to keep pace with developments in the market. It is difficult to achieve the same levels of consumer protection when national legislation tends to differ significantly. The first challenge that EU supervisory authorities face is determining whether the innovation that they are looking at requires an EU response; with innovations based on digital transformation, it is likely that such a response is required. Digitalisation of financial technology is going to happen, and a way has to be found to regulate it in a way that protects and accommodates consumers and at the same time protects the interests of the financial system.

There may not be a level playing field in the accumulation of data, because the social media have much more data on customers than any bank has ever had; however, regulation can level this playing field. There will be much pressure on the regulatory side to deal with less traditional means of collecting data, and using this to make decisions about financial transactions. A public authority representative added that the private sector is better at promoting innovation than regulators: the role of regulators must ensure that there is a level playing field.

4. Consumer protection issues stemming from increasingly fragmented digital value chains

There cannot always be total confidence that customers have put accurate information about themselves on Facebook or other social media websites. Regarding the gathering of customers' information via online questionnaires, sometimes there is insufficient accuracy in the questions asked and the answers provided; this accuracy needs to be able to be verified. There are also an increasing number of actors involved in distribution chains, and there must be increased transparency about the links between these actors and their respective responsibilities.

Some risks are linked to location. Digitalisation does not mean that products must be standardised or globalised, but they must equate to local customers' demands and needs since questions will be asked in the relevant jurisdictions by the competent authorities and the applicable law.

5. Specific data protection issues

Identifying the potential severity of a data breach is difficult. The scope of a potential breach is increasing, and will continue to increase as digitalisation increases. As such, many organisations that handle data need to understand that this data must be handled in a very robust and secure manner. There are national and European regulations regarding the protection of personal data, which will affect the form that products take.

6. The challenges for financial institutions: designing the new customer led business models

The challenges concerning digital have more to do with the business and operating models that sit on top of what is generally considered 'digital', such as apps. Many, if not all, strata of society have financial needs that are arguably not being met. Customers' expectations are changing rapidly: models of operation need to be dextrous and agile enough to respond, and modern customers only want >>>

>>> to spend a small amount of time on their personal finances. There has been a massive shift towards mobile devices.

In the UK, the Retail Distribution Review has caused institutions to shift away from providing advice to customers. There is a huge opportunity for traditional incumbents to use the digital agenda to introduce meaningful change and significantly transform their activities, if regulators properly embrace this. Another panel member noted that fintechs act from a customer perspective, and then encounter regulatory issues. For example when they act, they contact the regulator for a 'yes or no' answer about whether to continue, but it is difficult for regulators to give this kind of answer. ●

Leveraging Fintech in developing EU capital markets financing

1. How can Fintech support capital market financing for EU businesses, particularly SMEs?

The banking sector and stock exchanges have been technology-based for decades operating for example online banking platforms and electronic stock markets; what is new is that the use of Fintech is accelerating and tipping points have been reached. The main part of innovation is however taking place in the Fintech start-up community and there is increasing industry cooperation, between major financial players and these start-ups.

There are two sides to what technology can do: either perform existing processes faster and cheaper or develop new business models. The use of a disruptive technology such as blockchain is being experimented in both ways. The main potential applications so far are in the post-trading area for improving the settlement of securities transactions, but this is mainly for larger issuers. There are also innovative applications in the pre-trade space with e.g. a private market for small companies using blockchain technology in the US and the use of blockchain being pioneered in Estonia to enable more efficient proxy voting in annual general meetings, based on the concept of e-citizenship. Other experiments are also being conducted in the area of smart bonds, which could make the issuance of bonds much simpler and cheaper for SMEs, but some issues remain to be solved regarding digital identity or the use of virtual currency for such concepts really to be able to make an impact.

Regarding the financing of SMEs, many Fintech start-ups are active in this segment, operating crowd-lending or crowd-investment platforms in particular that allow the reduction of the number of intermediaries in raising funding and possibly facilitate cross-border investment. At the beginning, Fintech start-ups mainly financed SME clients that banks cannot serve in a profitable way. Now they are also improving risk models using innovative data sets and machine learning. Moreover, with the development of cloud platforms and social investing, there is a new peer to peer economy emerging.

2. Can Fintech help to widen the access to and improve the quality of investment advice?

The main benefit of robo-advice or automated advice is reducing the cost of providing advice, particularly for small amounts invested. Access is another advantage: access is easier with 24/7 service, potentially also on a cross-border basis. Moreover digital access to advice and portfolio management services is attractive particularly to the younger generation and tech-savvy clients. Other benefits include the further transparency, consistency and reliability of the advice process.

Potential issues to be addressed include making sure that the quality of advice and information and overall investor protection are not reduced through the removal of human intervention. With robo-advice, the behavioural coaching aspect of human financial advice is lacking in particular, an investor representative stressed; there are questions about how robo-advice can ensure that the client maintains a long term perspective and disciplined approach in the investment e.g. in times of market stress. There also needs to be sufficient clarity about the risks being taken and the investment strategy proposed. Fintech automation may also be vulnerable to operational risk. Mitigating these risks requires making sure that proper controls are in place and that the platforms meet MiFID II requirements and definitions. Regulation needs to be technology neutral in any case. It is indeed essential that advice is provided in a way that protects the investor in accordance with MiFID, whatever way it is provided. It was also suggested that a regulated advisor needs to be signing off the outcomes, in conjunction with appropriate checks. >>>

>>> Another aspect that was emphasized is the cost of advice. An investor representative suggested that there should always be a cost for the investor, either direct or taken off future returns, in order to avoid problems experienced in the run-up to the 2008 crisis and that this cost should be transparent.

Moreover, the European Commission (EC) is also looking at possible implications of artificial intelligence developments in the area of investment advice. There are questions about who owns machine-produced data and about the liabilities involved e.g. if a robo-advisor is learning by itself and no longer making decisions solely based on the initially programmed software.

Several members of the panel suggested that robo-advice would evolve towards a hybrid model combining robo-advice and human advice, as this could allow better guidance and control and therefore could be an answer to much of the concern expressed. It was also suggested that every human advisor should have a robo-advisor available to them, offering the best of two worlds. In addition, new developments underway could improve the quality and reliability of robo-advice, such as experiments with gaming to define better risk profiles or tools to read emotions.

3. Different policy and regulatory initiatives are conducted at the EU and domestic levels to support the development of Fintech

For the EC, Fintech is a source of finance for innovation and can help to develop cross-border funding for start-ups and scale-ups, particularly with crowd-funding or crowd-investing models. With the Digital Single Market the EC wants to ensure that digital cross-border and cross-sector business models can be implemented without reducing consumer protection or financial stability. The Network Information Security (NIS) Directive moreover aims at building trust, notably addressing cyber-security issues. Initiatives are also coming in on the free flow of data (regarding data ownership, access and usability) and e-ID (electronic identification). Blockchain linking investors to start ups is another area of focus. The EC and also the European Parliament are exploring blockchain use and the need for developing technical and interoperability standards for blockchain technology, as well as the possible applications of smart contracts and e-ID in this area.

Regulatory sandboxes i.e. safe places to test new ideas in a live environment are a relatively new development supported by domestic regulators, notably in the UK where the FCA Innovation Hub has been live for nearly two years. Sandboxes are a subset of the FCA activity in the Fintech area, which also includes the development of Regtech solutions in particular. The first cohort of sandbox firms has recently been selected The services provided by the companies selected for a sandbox experiment have to be genuinely innovative, there has to be benefit to consumers, and firms need to be ready to test and share learning with the industry; sandboxes are open both to existing and new firms. Although there might be specific authorisation processes for new firms, firms remain liable to consumers in case problems appear and consumers should not lose out by virtue of being in the test. The firm also needs to have a proper exit strategy so that customers are not left in the lurch at the end of the test. A number of tools have been developed by the FCA to help firms in a sandbox. There will be more dialogue than normal between the FCA and small firms in particular in this context. ●

Enhancing the financial sector's contribution to the transition to a low carbon economy

1. The concrete involvement of the EU in the decarbonisation of the economy

COP21 is important, and a turning point in the changing paradigm: there are two main actors, governments on one side and long term investors on the other. The EU is engaging at the international level, and is taking extreme action at the European level. At the international level, the Paris agreement was an important step; ratification is an important priority now, with Marrakech coming up.

At the EU level, there are very active movements to promote the reduction in greenhouse gas emissions, with a target of 40% by 2030. The Commission has started a review of the emissions trading system. It has created new legislation on land use; and is planning policy initiatives on renewables, energy efficiency and governance for the energy markets. It has also dedicated a large amount of financial resources to promoting resource efficiency and the environment over the next seven years. To meet the COP21 target, there is a need for €32 billion >>>

>>> of investment per year in decarbonisation. If infrastructure and interconnectors are included in this, this will add another €200 billion by 2020. Such amounts will be completely unreachable if Europe does not use financial instruments and find intelligent ways of bringing the public and private sectors together.

The EIB has a particular interest in supporting climate action investments. In 2015, EIB financed a record of €20.7 billion, 27% of its total financing, for climate action projects including €2.2 billion in developing countries. The EIB expects to provide around €100 billion in climate related investment up to 2020; they were pioneers of green bonds in 2007 and are, to date, the world's largest issuer of green bonds. The EIB published a new climate action strategy last year, which is available on the internet. In addition, EIB has developed a collection of small scale, high impact instruments that de-risk investments for the private sector, examples include: the European Energy Efficiency Fund, and GEEREF, the Global Energy Efficiency and Renewable Energy Fund

The European Commission continues to support all the international fora and initiatives that try to advance these areas. The ESG principles have been included in policy and legislation for the first time at the European level, but although CMU is being discussed, green Capital Market Union is not. Yet this is the angle that Europe needs to take to make this transition, together with more public investment.

2. The need to encourage private long term investment in the decarbonisation of the economy

There are three elements that dominate this discussion: the need for domestic mobilisation, an enabling policy environment in all the countries engaged in COP21, and the need to encourage private long term investment in this area. Long term investors need to have long term assets, and the risks related to decarbonisation are such that they will persuade all the other actors in the economic system and industries to make a change. The environment is developing: there are some COP21 goals, but it is not yet clear what their implementation will look like. The green bond initiative leaves room for the private sector to take voluntary action, but it would be very difficult to have regulatory incentives today. In the long run, a number of long-term investors are likely to exit or partially de-select stocks that are carbon related. Stranded assets are another major question to be considered. There is a need for long-term investment in infrastructure to reduce carbon; financial investors are also going to decarbonise their financial assets, because this will be more convenient. Over the last couple of years, COP21 and a number of public and private initiatives have taken place, and a message has been sent by the investor community about the importance of these factors. However, defining and scaling these risks continues to be extremely difficult and complex.

One significant obstacle to investment in member states is regulatory instability; in a number of 'spectacular' cases, the regulatory environment has changed retroactively, which has transformed investments in renewables into loss-making investments. It is 'almost impossible' to address this issue, because it is not possible to force a new government or parliament not to change a rule when they wish to do so. Authorities, however, need to be educated regarding the risk attached to changing the regulatory environment too often, and encouraged as much as possible to adopt common good practices and standards. There also needs to be good investments before people will invest in them, with a much better understanding of what it is that investors invest in and what kind of returns they are prepared to take.

Governments can presently borrow at zero, or even negative, interest rates for the foreseeable future, which is a prime opportunity for them to reshape their own countries, both in terms of their exposures and to make them more profitable and more competitive in the long term; one panel member believed that although many countries are heavily indebted, European electorates will accept this strategy, particularly if a sovereign green bond framework were to be developed for the public sector.

3. Private sector approaches and needs to address climate related investment issues

One industry representative stated that his institution has a 'three pronged attack' strategy in relation to investment: integrating ESG within all of its processes, impact investing, and raising awareness.

Much analytical work needs to be done to understand how to build indices, which enable investing in stocks for the environment or environmental services. Existing indices have been doing well, but not massively well; defining and scaling these risks continues to be extremely difficult. Understanding these risks better will require increased focus by investors and credit rating agencies, something that has been initiated with targeted assessments of climate-related credit risks which are incorporated into a number of situations where financial impacts are most likely. It is also important not to have regulatory disincentives. >>>

>>> There are many initiatives in the green bond market space. ICMA has been particularly successful, and there have also been good Chinese initiatives from the Green Finance Study Group, Europe needs to maintain a leadership in the development of such financing tools. Developing a new asset class, i.e. the green bonds, to finance the carbon transition has had many benefits in terms of awareness and improving analytics as well as in meeting the demands of a categories of investors. However, it is not without creating its own risk and limitations. It is critical to bring "main stream investors" along in light of the overall funding needs.

Finally, the public sector has a role to play to fill the gaps left today by the private sector. An example is the mitigation of some of the risks associated with the climate related transition, where there may be an increased need for public guarantees.

4. FSB Task Force: mainstreaming climate-risk related information

The FSB's task force on climate related financial disclosure has been working for six months, and aims to finalise its recommendations by the end of this year, with the goal of solving the issue of long term investors. Information about firms is not consistent, and is not part of the financial documentation. If the task force is successful, in a few years' time, firms across the G20 will all dedicate a section in their annual financial report to climate related risks and their transition.

5. Current and future forms of cooperation between public and private financial sectors

Progress towards decarbonisation has been one of the biggest successes of EFSI so far: excellent results have been achieved in the SME sector, as well as in relation to the environment and decarbonisation. Later in September 2016, the Commission will make a proposal for an EFSI-2. In some cases, there is also a need to associate the use of financial instruments with grants.

Public banks are becoming very active, but there are pros and cons to this; it can be good to have facilitation, but on the other hand, private investors are very demanding. Additionally, there is a great deal of desire for green bonds. It is necessary to define very carefully the role of the public sector, because the private sector is quickly getting 'up to speed'.

There is a need for good projects on the ground, and as such, it is important to announce more technical assistance. Adding together all of the envelopes of technical assistance for supporting investment, under the current multi annual financial framework period, results in nearly €0.5 billion just for technical assistance. The EU needs to use better this money. ●

5. BANKING REGULATION

Banking Union: are the benefits being achieved?

1. Context – much has been achieved

The potential benefits of the Banking Union are improving confidence, breaking the 'vicious circle' between banks and sovereigns, reversing fragmentation; mitigating moral hazard, and reducing the risk of taxpayer's money being involved in bail outs.

There have been many developments: a single supervisory mechanism (SSM) has been built up in Frankfurt. The ECB directly supervises the 129 largest banks of the participating countries and indirectly all other banks; it has now functioned for almost two years and banks have substantially strengthened their capital positions. The Single Resolution Board (SRB) has been fully functioning since January, and these are steps in the right direction, but there is still some way to travel; and there remain some legacy issues.

One public authority representative commented that their country now has much more information than it had before, and welcomed the harmonisation of SREP (supervisory review evaluation process) decisions, capital and liquidity requirements, and onsite processes as well as internal model assessments.

There are 167 national options and discretions in the CRD4/CRR. The ECB has addressed 122 of these. It is now up to national legislators in Europe to deal with the remaining ones that do not fall within the supervisors' remit. Member States should refrain from raising obstacles so that a truly single rule book and uniform supervisory practices can be achieved.

2. Much still to do

However, other representatives commented that that 'the glass is still half empty'. Although much has been done, the process is still not moving forward fast enough: liquidity remains national which increases costs, and the Eurozone is not yet recognised as a single area: the more an EU bank invests in another country of the Eurozone, the more systemic it will be. Moreover, a panel member called for an action plan for dealing with the Non-Performing Loans issue to be devised and implemented. This issue is not only a question of balance sheets; rather, it is about what is going to happen to banks' clients in some countries, and the companies they work with. There also remain uncertainties about what the banks call 'Basel IV' (the finalisation of Basel III), and as – at the present time – European economies are funded by banks, there is a need for the Basel Committee to acknowledge the various ways of funding economies at their current stage. Moreover there is clear bank overcapacity in Europe and a great deal of potential to move towards a full Eurozone banking sector, but there is no obvious willingness to remove overcapacity from the market in Europe.

A public authority representative stated that Europe is in a transitory period, without Pillar III of the Banking Union (EDIS is not yet adopted), and the funding of the Resolution Fund is independent of national public money. Another stated that although harmonisation in microprudential supervision is welcome, some national tools in the area of macroprudential policy – such as liquidity requirements or capital buffers – are not signs of fragmentation, but rather necessary tools for financing the European economy. In such a context, the FSB is not yet convinced that, for systemically important financial institutions, intra SSM relationships is in a single territory. And banks operating in various countries of the euro area are penalised in regulatory terms.

A representative of the public authorities stated that there is a need to move towards an EU harmonised legal framework for bankruptcy and insolvency banking procedures, and this framework will require harmonised regulation. Another representative noted that by not having a Eurozone banking policy, monetary policy is obliged to take bolder measures, for longer, than would otherwise be necessary. Market players should not wait for the third pillar of the Banking Union -EDIS- to move, but should aim to make progress anyway, for example through resolving the hierarchy of creditors of banks, which can be done relatively quickly.

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>>> **3. Conclusion: there exists a need for urgency and for politicians to push for agreement**

Banks need certainty, regarding the regulatory environment, and it is very important that legislators and regulators finalise the many issues that are presently not settled, such as Banking Union. It is also important to have sustainable business models within banks.

By the next Eurofi event (April 2017), there needs to be trust and confidence among political leaders about the fact that institutions are in place and are working well, and further progress can be made. A Strategy for Resolving Europe's Problem Loans should be implemented. The Eurozone needs to be acknowledged as a single entity, and there needs to be clarity and certainty about banks' ability to finance the European economy and thus provide credit, in a reasonable, credible, way. Investors and companies need to be reassured that credit will be supplied. Certain questions need to be answered in relation to Brexit and sovereignty – namely, the public authorities' views on passporting, and the sovereignty and financial infrastructure in Europe – but it is not at all necessary for all the issues that Brexit raises to be resolved before progress can be made to complete the Banking Union. ●

Implementation challenges of EU banking resolution tools

1. Completing the EU crisis management framework

There has already been significant progress in relation to a lot of the elements of the European crisis management agenda: via the operationalization of the SSM, the SRM, and the SRB in 2016. There is now a new culture of bail in and a large number of limitations to state aid, and as a basis for this, there is common legal ground. However, the BRRD – although useful – is focused mainly on how to deal with the financial collapse of a systemic institution in a broad sense; the other elements of crisis management, which are an effective insolvency regime and a common deposit protection scheme within the Banking Union, have not achieved the same level of progress.

In the current setup, if there is to be a resolution case, the costs will have to be borne by the SRF, to the extent that that this was appropriate. If the Resolution Fund requires additional money that is not in there, it can draw on national credit lines; if a member state cannot comply with this, the ESM will provide a programme and the necessary funds. Without clear guidance on risk-sharing within the Eurozone, with clear acceleration and a build-up in the SRF, all the topics related to BRRD implementation may remain 'more theoretical than practical'. Additionally, when implementing TLAC or MREL, multinational entities should be careful to tailor their requirements to the reality of the markets and the countries in which the banks operate.

2. Addressing the harmonisation of the parts of insolvency law that matter to the resolvability of financial institutions is a consensual priority

Insolvency law is essentially not harmonised – although all 19 insolvency laws in the Eurozone all follow roughly the same logic, they are not the same on a detailed level – and this creates problems, such as those related to the various creditor hierarchies. Full harmonisation of the creditor hierarchy is highly desirable but probably not achievable, due to the different legacies involved, but it is important for Europe to ensure it has adequate disclosure for investors and proper disclosure of where investors rank in the hierarchy. In the view of one panel member, regulations, which are directly applicable are generally preferable to directives, which need to be transposed into national law and therefore a potential source of further fragmentation.

3. Solving the NPL issue is an essential matter for the Banking and Monetary Union

In some EU banks, NPLs weigh on profitability and capital, hampering the ability of banks to provide new lending to customers and increasing investor mistrust; although precautionary recapitalisation is a possible solution, this in itself cannot solve the overall NPL problem. A public authority representative noted that mis selling is clearly an issue, and bondholders should not be 'let off the hook'; there is a need to deal with retail investors that have been misled in the purchase of bail-in instruments but giving the impression that, until the BRRD has come about, a bondholder has been protected to the same degree as a guaranteed depositor is very dangerous and factually wrong. An industry representative replied that mis selling falls within the remit of conduct risk, which is more of a matter for the SSM.

If NPLs are a legacy issue, economic growth and progressive treatment of it will make >>>

>>> it disappear without resolution. Non-Performing loans cannot be solved overnight. Supervisors are, however, responsible for ensuring that this is only a legacy issue, and governments need to have optimal legal and fiscal environments; banks also have responsibility for managing their NPLs. Panel members agreed that although the issues of risk sharing and bail in are very political, they need to be addressed. There is an important member-state dimension to the issue of insolvency law, ensuring that courts can work out bad loans quickly; at present, there are significant differences across member states.

A public authority representative stated that the most successful operations in terms of NPL resolution have been the Spanish banking transformation in 2012 and the Slovenian example. In those cases, EU state aid rules have been instrumental to ensure that losses on impaired assets were recognised and covered, and effective NPL management installed, but also that the bank in question was restructured and returned to viability. While there is no change in State aid rules, the BRRD has created an explicit link between a bank needing state aid and the conditions for resolution or liquidation to be fulfilled. However, all measures which have proven effective for dealing with NPL problems in specific banks and Member States during the crisis remain available under EU state aid rules and the BRRD – although some only in resolution, because of the legislative change introduced by the BRRD.

There is a lot of focus on resolution. While this may be important for systemic and large institutions, the debate should not lose sight of the fact that there are many options available that are not resolution (e.g. transfers of assets to a bad bank at market price, securitisation scheme), and that the key conditions for an effective solution to NPL problem are effective national insolvency frameworks, speedy judicial and out of court procedures, as well as proper NPL management. However, rules should not be circumvented when the first resolution case arises in order to protect the credibility of the framework.

4. Consolidation of the EU banking system may play a positive role in resolving NPLs

At present there are only a few truly pan European banks in Europe, despite the positive role that cross border banks can play in resolving NPLs. Cross border banks should have more diversification in risk exposures, as well as more fungibility in capital allocation and funding resources; cross border consolidation can enhance the resilience of the entity as well as the system. However, increased cross-border consolidation of well-diversified banks would not be a 'miracle solution' that will make NPLs disappear. Not all NPLs are the same, and this needs to be borne in mind.

A public authority representative stated that the European banking sector at present showcases low profitability, with systems that are largely national, with too many small banks and an environment in which fixed costs are very significant. An industry representative replied that they find it difficult to envision how a cross border merger could come about in the way that happened a few years ago due to the regulatory framework and the insufficient level of competitiveness of some EU Member States. Moreover, a lot of clarification is still necessary, particularly in relation to investor hierarchy; the NPL problem relates not only to the present situation, but also to the need to stop this situation from worsening, and avoiding a situation whereby banks in Europe trade at 0.4/0.5 price-to-book. Getting the consolidation process right is 'absolutely critical' to avoid a massive problem in Europe. ●

Conditions for moving towards an EDIS

1. A truly single currency requires a single deposit insurance system, but further supervisory steps are necessary before EDIS starts

The Slovakian Presidency is trying appropriately to keep the co-legislators focused on the technical work related to EDIS; the Parliament is working on its report, and the Commission is producing an analytical report on quantitative and qualitative impact, hopefully to be released in October. It is important to have a balance between responsibilities in the Banking Union. The Single Resolution Mechanism (SRM) became fully operational on 1 January 2016, and with supervision and resolution at the central level, it will make sense not to leave financial responsibility for deposit guarantee at the national level. With insurance, it is also best and cheapest for the entire banking system to have as big a pool as possible.

An industry representative stated that the Banking Union has two very robust pillars at the >>>

>>> present time – the SSM and the SRM – and with EDIS, the pillars will reinforce each other. The ability to move liquidity cross nationally is a significant issue; it needs to be addressed on more of a Banking Union basis. Member States already have national deposit insurance, so they will not face increased moral hazard; countries do not have any more supervisory authority over banks that would enable them to control their risk-taking activities, so moral hazard can only be considered in the context of the consolidated supervisor.

There is a clear link with sovereign risk, which needs to be broken; however, EDIS is part of the solution to the sovereign risk problem, rather than part of the problem. The fact that Europe does not have convergence in insolvency laws is a challenge for the second pillar of the Banking Union (SRM), but it should not stop Europe from completing the second pillar, and should not stop them from building EDIS either. Countries need to comply with the Directive on deposit guarantees, and the fungibility of liquidity within the Banking Union needs to be guaranteed. EDIS is therefore a key condition for allowing cross- border banks to operate as a single bank in the euro area.

A representative of a Central Bank stated that when their country takes over the Presidency next year, it intends to keep the EDIS project moving forward. However, this EDIS proposal came at a time when some Member States were still struggling with a large stock of legacy asset, and consequently, the concept of risk sharing among participating DGSs is being met with some resistance.

Conducting an impact assessment on the effects of the proposal, with the aim of determining the appropriate layout and functionality of EDIS, is important and merits serious consideration. This analysis should also be supported by the identification and reduction of the remaining risks on the balance sheets of banks present in the euro area. Moving forward, the proposed phasing-in of EDIS spread over three stages is important, and consideration could be given to extending the reinsurance phase to allow time for micro and macro prudential supervision to achieve its objectives. It is also possible to undertake further assessments once the reinsurance phase matures before proceeding to the co insurance phase.

A leader of the industry explained that EDIS is an insurance mechanism of the current national deposit guarantee schemes. As such, the premium should not be paid by the banks but by the domestic guarantee funds.

An expert stated that trust in banks is a necessary condition for European recovery, and a new institutional framework and new regulatory frameworks have been put in place to improve the situation. EDIS would ensure, in theory, uniform levels of confidence in the safety of deposits across Europe, and would also align the control of European deposit protection with liability. Moving resolutions to the European level is logical, but to fully restore trust, it will be necessary to revive not securitisation but Bank Structural Reform (BSR) and complete the Basel reform framework notably by introducing binding limits to leverage. Moreover risk reduction is also necessary.

2. According to some decision makers, a number of key requirements are still missing in order to move towards EDIS, which complicates discussions

European banks need to press ahead with de risking their balance sheets; it is extremely important to break the 'doom-loop' of the bank-sovereign nexus. The preferential regulatory treatment of government bonds should be abolished as soon as possible. A number of risk-reduction measures have not yet been addressed, and priority should now be given to the full implementation of the Deposit Guarantee Scheme Directive (DGSD).

According to a leader of the industry, with the DGSD, there is the same level of depositor protection all over Europe; a euro in deposits in Portugal is as well protected as it is in Spain. If an EDIS ever becomes effective, it should start from the same risk level in all participating Member States, which will include discussions about sovereign risk and NPL quotas.

A public authority representative stated that Europe should not 'rush into' EDIS and begin sharing all risks immediately. However, Europe has been able to set up the SRM already, and the impact assessment that Europe is awaiting from the Commission might help clarify the situation. The EDIS should probably cover all banks, and there is probably a need to take a closer look at smaller banks before EDIS is fully operational through the conduct of Asset Quality Reviews and stress tests; but this depends on how far the SSM has progressed in its goal of harmonising the supervision of smaller banks. It was also suggested that before the implementation of EDIS, there needs to be a common definition of NPLs; sovereign risk needs to be tackled and sufficient economic and fiscal convergence between EU Member States should take place.

3. Could EDRIS be a way forward?

The Commission's proposal of a supranational EDIS should not be seen as the only option; several aspects need to be carefully analysed, when >>>

>>> the final design is likely to differ from the first ideas proposed by the Commission. A public authority representative believed that a permanent reinsurance solution could be the more efficient approach. An industry representative added that useful proposals must be carefully analysed, such as the European Deposit Reinsurance Scheme (EDRIS) proposal, focusing on the first stage of EDIS. This is quite a useful proposal if the institutional protection schemes (IPS), which not only exist in Germany but elsewhere, are taken into account.

4. Conclusion

There needs to be a European answer for the Banking Union as a whole; however, there might be dissenting views regarding pace, or which steps should come first and in which form. The majority of actors and stakeholders agree that risk sharing needs at least to be accompanied by a certain level of risk reduction. However, to find an agreement on the "what" and the "when" will not be an easy task. ●

Implementing TLAC in EU legislation

1. Key challenges and key differences between TLAC and MREL

It was noted that one of the main differences between TLAC and MREL has been the scope: TLAC sets a global standard for G-SIBs while MREL is for all EU banks.

The EC needs to come up with an MREL application date by the end of 2016, whereas the TLAC process is in two phases: the first in 2019, and the second in 2022. Based on the delegated regulations, MREL is a function of resolvability with TLAC, there is a fixed minimum. The question of whether MREL and TLAC will be implemented symmetrically was discussed in view of level playing field concerns.

TLAC has been agreed at the international level for G SIBs only, whereas MREL has been agreed, in principle, in legislation for all banks. That does not mean that every bank will be given MREL but, in principle, all banks could. One representative of a regulator stated that another area in which TLAC and MREL differ is that of 'internal TLAC', while there is no 'internal MREL'. The EC intends to introduce TLAC as a Pillar I requirement, via a fixed minimum requirement through an amendment to the CRR. MREL, however, is planned to remain a Pillar II requirement and therefore a bank specific requirement, to be introduced via amendments to the BRRD. Indicative MREL targets will be defined in 2016 with a transition period to reach the level.

From the TLAC terms sheet, it is clear that subordination is required. The FSB has defined a set of specific criteria that liabilities must meet to be eligible as TLAC: only a proportion of the existing senior unsecured debt issued by continental EU banks will be eligible. The BRRD does not explicitly require subordination but focuses on the need to ensure resolvabilityAlso, TLAC has been set up as a minimum requirement;. Requirements are higher for the more complex banks, and it is difficult to have a system which is hardwired for the eight G-SIBs without then needing to argue with these banks' competitors that have a legal requirement of zero.

2. More clarity is needed

A lot of key elements in the package are still missing: the legislative element is still ambiguous, and there will need to be agreement on the competence of the resolution authority. A representative of a finance ministry commented that an 8% bail-in is an ex post requirement rather than an ex ante requirement; this should be a key element in setting the MREL levels. A representative from a regulator remarked that if a crisis does occur, this will generally be where an entity's balance sheet is not very strong, and there will be a need to bail-in 8% in order to be eligible for public funding. If there is a need for an 8% bail-in capacity 'at the brink of death', it is difficult to argue that the entity does not need to have them 'in life'. However, according to established SREP calculation methods, the 8% level will be 'far more of a floor' than the leverage ratio in Europe. Another finance ministry's representative supported the regulator's view that 8% loss absorption capacity are required ex ante to ensure resolvability and ensure financial stability in a crisis.

A finance ministry representative noted a lack of clarity about the consequences of MREL breaches, or how this will relate to MDA, thus creating significant uncertainty. This uncertainty is compounded by the impression that the goal is to rewrite the rules, including the BRRD. Eligibility to MREL should not be restricted, and there is a need to reduce >>>

>>> uncertainty and provide more of an 'anchor' to the various stakeholders.

3. Next steps and way forward

Implementing TLAC is a complex endeavour; there has been a tight timetable, with commitments to implement TLAC in 2019 and implement MREL in 2018. Conversely, the US has had a draft rule regarding TLAC for a year, and a final rule is due in 2016 or at the beginning of 2017. A finance ministry representative stated that the new legislation needs to be built on three principles: ensuring that banks are actually resolvable, doing so with no undesirable side effects, and creating a 'level playing field' within the European banking sector and against third country banking sectors. An industry representative stated that TLAC should replace MREL, in order to meet this goal of a level playing field.

A public authority representative summarised that views among member states about the details involved have not been fully aligned; the European Commission has taken advice from both member states and experts, attempting to balance the pros and cons, and would ask member states to be quick to adopt the proposals that are put forward. The European Commission will move MREL to a risk-weighted asset denominator and address the MDA issue. It will not be possible to replace TLAC with MREL, because these are different in one important respect: TLAC has been designed for G-SIBs, not for D-SIBs, and MREL is a bank specific concept, applicable to all banks. However, the EC will aim to make these consistent. ●

Challenges posed to the EU by the CRR II/CRD IV

1. The late-phase components of the Basel reform package, such as the leverage ratio, the NSFR and the FRTB in particular are being completed

While the strengthening of capital requirements was a major element of the Basel package after the crisis, the late-phase components of the reform package are now dealing with issues that are relatively new. Liquidity and leverage are new concepts in the discussion, which makes it even more difficult to produce proposals.

The LCR is at an earlier phase than the NSFR, and has already been adopted, while the NSFR is being adopted and further developed. The crisis had made clear that there were liquidity problems even in well capitalised banks. It had previously been thought that if an entity had capital, they were liquid, but it has been learned that this is not the case; this is why tools like the NSFR need to be established.

It has also been learned that leverage matters, as do non-risk-weighted capital ratios. The leverage ratio tends to be less pro-cyclical than many of the risk-weighted capital requirements, and the crisis demonstrated the need to find less pro-cyclical elements in the 'international toolbox'. It is important to bear in mind that the leverage ratio is meant as a backstop.

The FRTB is not a new element, but it became very clear during the crisis that there is a need for further work on international rules for the trading book though measures were taken in 2009, immediately after the crisis. In the lead up to 2008, either things did not work because of a lack of understanding of fundamentals, or people were focused more on profit because liquidity was not a constraint. Before the crisis, regulatory ratios were not really binding on banks; it was the internal view that was driving the capital allocation and the activity of the bank. Now, regulatory ratios are designed to be more binding, to reflect potentially negative externalities.

As such, it is very important to get the relative weights and the absolute level of different regulations right. Given the number of different international work streams and policy groups, it is not surprising that there are inconsistent, miscalculated and duplicative regulations, which produce unintended consequences. On the industry side, there is a desire to consider how these policy silos and individual policies are made more coherent, and in particular, how unintended consequences can be addressed. There is also a need for clarity about how to plan for capital liquidity, and other topics; the precedent set by the Basel Committee needs to be borne in mind.

2. The context specific to the EU, in which the new rules are being implemented

There is a need to recalibrate regulatory ratios, or carry on until a more normal situation on interest rates is reached, although interest rates are likely to be low for a long time. In particular the issue of leverage in a negative interest context >>>

>>> deserves attention. This is compounded by the fact that the main difference between the US and the EU is that regulation in the EU is for 8,400 banks; implementation in the US is always later and only for internationally active banks. In addition, banks play a much larger role in financing Europe's real economy, so the impact of the Basel rules is different. The measures proposed by Basel need to be re-evaluated to fit the European frame.

Additionally, proportionality plays a much more important role in the European theatre than in countries such as the US, Canada, Japan, and others, and policy also has an impact: there are clearly political and competitive interests involved.

3. The concern raised by the implementation of non-risk regulations

There is a need not to create too large a group of institutions bound by non-risk-weighted standards. Awareness is needed about creating binding elements that are not linked to risk, and thereby creating incentives for banks to engage more in risk taking.

Properly calibrating the tension between security, unintended effects and burdens on bank profitability is important; leverage is a backstop, but it should not become a backstop to entire business models, or it will destroy them. There needs to be more integration between industry and regulators.

4. The expected impacts of forthcoming regulations

Preserving the existing EU specific SME supporting factor is key: there is a strong political will in the European Parliament and the European Commission to continue to support factories.

There has also been feedback that the trading book is too complicated for many institutions; there needs to be 'space left for manoeuvre' in this area. Rules are impacting where trading was the most profitable type of business, and care is needed in this area, because a CMU needs to be nurtured from that perspective. In particular, one of the key issues for investors will be confidence about their ability to trade and exit positions. Consequently, another way might need to be found to make the FRTB work, while excluding the exuberance in the market activity statistics exposed in the Liikanen report. Indeed, equity capital requirements have already effectively increased 10-fold for banks, and Pillar 3 disclosure requirements are forecast to go up 50-fold. Care should be taken to ensure that the different sectors of the economy are not inadvertently disadvantaged. Precision is needed regarding the different aspects of the metrics. Most people in the industry would prefer a situation where there is an observation period, and unintended consequences can be addressed.

Yet the EBA tried to make a number of analyses of the overall impact; the Basel Committee has also tried to do it for this package, without considering what is on the table yet. The EBA has determined that the banks higher on compliance with these ratios were actually lending more, and did not curtail their trading books.

5. Specific issues related to certain legislative pieces

'Proportionality' of regulations has a restricted legal meaning; it needs to be more concrete, and the way to achieve this is to link it to risk. In particular the distance-to-default should not be made shorter for smaller banks for proportionality reasons, because this will be unsettling in the EU. There also needs to be a good balance between proportionality for small banks and having a level playing field for all banks.

A regulator stated that there are two conceptual methods of achieving proportionality: the first is based on a separate parliamentary or Commission working group, which would identify the 15 to 20 key parameters upon which to drastically increase the spread of proportional supervisory measures. The second is the 'American approach': having either one or several cuts between very large banks and everything else, which would have undesirable side effects, but would be more manageable and more politically acceptable.

Clarity about which interpretation of 'proportionality' is being designed and applied is required and there is a clear mandate to work on proportionality, although one panel participant noted that the gradation of requirements is very difficult to achieve.

A banking representative noted that the NSFR is a new standard that has not been tested before, yet there is no observation period as with the leverage ratio; He demanded why this was so: there is a need to gather more information about the impact on the different business models. A regulator replied that there was no argument against an observation period being legally enshrined.

The function of transformation would never disappear: calibration is very important, and if calibration is excessive transformation and disintermediation will take place. Combined impact testing might be helpful.

Trade finance also needs to be treated differently since it is short term, self-liquidating and >>>

>>> relatively low default. Particularly given the peculiar shape of the interest rate yield curves at present, it is not feasible to be funding this on a long-dated basis. Number of anomalies need some revision and clarification such as whether exposures are committed or uncommitted, whether they are intermediated through financial institutions or whether they are made directly, and how bank guarantees are related to letters of credit.

Certainty is needed that leverage will retain its role as a backstop; favouring those who take more risk would have a counter intuitive result. There is a significant debate within Basel IV reform: most European regulators feel that the application of internal models is a good thing, but an overly discretionary application could be dangerous.

Much effort is being made to coordinate the European position at the Basel table, and progress has been made towards a common view on risk sensitivity. However, the decision making process within the Basel Committee has 'big problems': a more transparent process is needed, along with a stronger involvement by the Commission in coordinating Member States. ●

Forthcoming Basel regulations on credit, operational risk, FRTB weightings

1. Bank risk profiles or discretionary constraints imposed by national regulators are the main sources of the observed variability of bank risk

75% of risk weighted asset variability is either due to the specificity of a bank's risk profile or discretionary constraints imposed by national regulators. The BCBS aims at reducing the 25% of unwarranted variability as a top priority. This could be achieved by constraining modelling and enhancing its consistency, as well as by harmonising practices. EU banks consider that internal credit risk models are reliable, subject to a harmonisation of processes and intrusive validation.

2. Disposing of the unwarranted variability while remaining competition neutral and accounting for EU risk and business model specificities are the general policy priorities for EU banks

The financial system requires more resilience and lower risks. It needs to further restore confidence in the financial industry and models. Disposing of the unwarranted variability arising from an insufficient standardisation of supervision and regulation of models is notably appropriate. Constrained modelling is a reasonable way forward; however, a uniform approach would generate negative side effects since the regulatory framework needs to be competition neutral and be enough risk sensitive to meet the needs and specificities of the EU. However, the Basel Committee is dealing with minimum international standards and has to build something acceptable for all globally.

3. The expected role of the supervisors, the economic and competitive context and the cumulative effect of successive regulations should influence appropriately the assessment of the significance of the impact of the proposed Basel regulations

The regulatory changes proposed to the industry's capital requirements, would have a deep impact; but what the industry and public authorities consider 'proportionate' differs. This is due to the fact that since the financial crisis and the subsequent unprecedented overhaul of the banking regulatory framework, core equity Tier 1 ratios have doubled in Europe, resulting in a non profitable industry in the context of low interest rates and the fact that some countries in the EU may be "over banked ".

EU banks are reporting capital levels which have never been so close to the minimum requirements. This is part of why banks cause concern among investors. Some industry participants claim that, whenever pillar I requirements are high, they leave little room for supervisors to relax pillar II demands in order to facilitate bank recovery. The Basel proposals would increase the minimum requirements, which brings non-viability closer despite the current positive outcomes of EU Banks' stress tests.

The Basel Committee needs to consider further the 'significance' of the impacts of the proposed framework also by increasing the granularity of its analysis and comparing the effects of the >>>

>>> diverse floors and the current leverage ratio as regulatory back stops.

4. The disproportionate complexity of the framework for smaller financial institutions should be addressed

The revised standardised approach will have a huge impact on smaller banks in the EU through additional fixed costs and investments. There is also a danger that the EU banking approach would be one size, which may lead to proportionality issues. A solution would be the 'simple banking' regulatory toolbox that deals with systemically important institutions. There is a general willingness to search for proportionality in the legislation and the debate concerns the degree chosen.

5. Balancing regulation and supervision

Parliamentarians and certain supervisors could be tempted to move from a principle based to a rules based approach in order to avert free modelling practices, but preserving the trade off between the flexibility of principles and the rigidity of a rules based approach is encouraged.

The ECB's TRIM project will give better information regarding the factors which influence internal modelling in European institutions and so contribute to reducing undue modelling variability. ●


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