EUROFI BRATISLAVA FORUM

REGULATORY UPDATE

SEPTEMBER 2016

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The regulatory updates in the following pages were drafted by the Eurofi team as a background to the sessions that took place during the Bratislava Financial Forum on 7, 8 and 9 September 2016. They were included in the programme of the Forum distributed in Bratislava.

For a summary of the Forum discussions go to **www.eurofi.net**

1. DEEPENING THE EMU & BREXIT IMPACTS

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

The Euro zone is a specific currency area composed of heterogeneous countries. Heterogeneity concerns capital income levels, per capita productivity levels, the productive specialisation of the economies, labour force, skills and demographic settings. At the same time the zone is characterised by a weak degree of federalism. In such a context, the convergence of living standards cannot happen faster than the increase of per capital productivity. When tensions are manifest, it is necessary to correct the imbalances leading to internal devaluation. This is something that has been applied systematically by the Baltic countries, Spain, Ireland and Portugal with some success.

Moreover, since the 2008-2009 crisis, internal capital mobility has stopped inside the Eurozone: the core Eurozone countries with a surplus have lent their surplus savings to the rest of the world and not to the other Eurozone countries and therefore these surpluses have not been used to finance investments in the euro area. This is reducing the capacity of peripheral countries to invest as well as their potential growth.

In addition, despite the strengthening of the fiscal and macroeconomic surveillance frameworks (six pack, two pack, Macro Economic Imbalance Procedure), significant discrepancies can still be observed: in France the percentage ratio of public expenditure to GDP (56,8%) in 2015 was significantly higher than the German Spanish figures of less than 45%. The level of public debt compared to GDP is still increasing in some euro countries -including Austria and France - except notably in Germany, Ireland, Italy and Belgium. The flexibility of the labour market is very diverse in the euro zone....

There are different ways of reducing structural divergences and competitiveness gaps in a Monetary Union:

- One line of action is to create a federal fiscal incentive for countries that really embark on credible structural reforms: more fiscal transfers with more conditionality would be the idea.
- A second line of thought, which is not exclusive of the first, is to rely on more financial markets to help the equalizing function. This is what happens in the United States for example when regions are sagging with low productivity investors can step in to improve production conditions. More risk-sharing would reduce the vulnerability of Member States of the Monetary Union to external shocks.

  The high share of private risk sharing in the US is also underpinned by a Federal Deposit Insurance Scheme supported by a public backstop, which is important for a complete integration of financial markets.

However in Europe things are less obvious because of the differences between countries: languages, legal and tax frameworks, conditions to entry into the markets etc. vary in the euro area and equalizing is more difficult to achieve. Moreover the legacies of the crisis create additional challenges for the implementation of the new EU crisis management framework and hinder the completion of the Banking Union.

Therefore, certain elements of inter-state transfers are probably indispensable to make the EMU work politically. This raises difficult economic and political issues.

A Fiscal Union can only be considered between States that are compliant with or are putting in place reforms to comply with the Stability and Growth Pact rules and that are achieving economic convergence (comparable levels for ratio of

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>>> public spending to national GDP, corporate margin ratios, job market flexibility, etc.). In sum, this can only be achieved with a high degree of acceptance of domestic structural reforms and trust among members of the Union.

In addition, a pooling of fiscal resources, whatever their nature and size might be, goes hand in hand with shared responsibility. In other words, this would mean yielding a great deal of national sovereignty in fiscal policy matters since a significantly stronger element of centralised intervention regarding the definition of national budgets would be required.

Once these economic and political conditions are in place or moving forward, it can be considered, for instance, that if the "new national budgets" are accepted by a central authority as adequate, the new debt would be the object of a mutualised treatment. Another possibility would be to pool the "sustainable" debt (i.e. less than 60% of GDP) of states that are compliant with the Growth and Stability Pact rules and are introducing structural reforms to ensure genuine economic convergence with the best-performing states.

To move forward in these areas, the confidence of the citizens is therefore vital implying that democratic accountability must also be strengthened.

In sum, politically the idea of creating a federal fiscal capacity is difficult as long as the core countries of the Monetary Union remain in very different positions in terms of competitiveness. But to the extent that structural reforms and fiscal disciplines may take place, some form of mutualisation of certain expenditures of the system must not be discarded systematically.

Deepening the EMU: what are the conditions?

There are reasons to be optimistic about the EU and the EMU, their future and resilience. The euro area is now entering its fourth year of recovery. Growth is above potential and the output gap is being closed. In line with past trends, GDP-per-capita growth is again similar to that of the United States. Income is spread across society much more equally in the EMU than in the US. A much larger share of the population in Europe than in the U.S has experienced real income gains during the last 15 years. The European labour market is another unexpected strong point. Our employment and participation rates are higher than in 2000, while in the U.S. they have dropped. Considering banks, capital for European banks has doubled by more than €500 billion since 2008. NPLs are high but 52% of these are provisioned.

Positive developments also relate to the creation of new and well-functioning institutions during the crisis such as the SSM, SRF, SRB, ESRB and the ESM. They make the EMU more resilient. Within the euro area, macroeconomic imbalances have significantly decreased over the last few years and economic policy coordination among the Member States has become much broader. Another positive element is the continuous support for the EU and the euro among citizens despite the many signs of euroscepticism and populism. According to the latest surveys, support for the euro is well over two thirds of citizens in the euro area. In the immediate aftermath of the UK referendum, public opinion polls in a number of euro area countries showed that support for EU membership rose significantly. Such support provides policy-makers with legitimacy to continue with further integration steps in certain areas. Such steps should also be considered in view of economic uncertainties and challenges.

However, an unqualified call for more Europe cannot be the answer. A European approach is appropriate only when a certain objective can be better achieved by working together across countries. If that is not the case, then a policy area should be dealt with on a level closer to the citizens. Applying these criteria to the EMU, important steps related to risk sharing would make the EMU more robust. They can be brought under the heading of stronger risk-sharing, which is under-developed in the euro area compared with the US, but also compared with the degree of risk-sharing inside large European economies. For instance, in the US around 80% of an asymmetric output shock is smoothed with the most important contribution coming from capital markets (approximately 45%) followed by credit markets (27%) and fiscal transfers (8%). In addition, banks as private sector institutions contributing to risk sharing, are backed by a Federal Deposit Insurance Scheme and supported by a public backstop, which is important for a complete integration of financial markets. In contrast, in the euro area only >>>

>>> approximately 25% of an asymmetric shock is smoothened with the euro area falling behind in terms of private and public risk sharing.

Against this background and in view of continuing challenges ahead, the euro area remains vulnerable to (asymmetric) shocks. Such shocks could push the economy off its current growth path. Simultaneously, in a potential lower growth environment there is limited room for manoeuvre to provide countercyclical policy support. Vulnerabilities such as different positions in terms of potential economic growth, competitiveness, crisis legacies such as public and private sector debt and legacy assets in banking systems are present in the euro area. Substantial structural reforms are necessary to overcome these remaining vulnerabilities and achieve a higher degree of convergence among euro area countries. In addition, more risk-sharing would reduce the vulnerability of euro area Member States to external shocks.

Further risk-sharing can be achieved through (private) capital markets and through the (public) fiscal channel. In that context, more work needs to be done on the Capital Markets Union to facilitate and strengthen cross-border capital flows. More financial market integration will lead to greater capital flows, deeper financial market integration, and promote private sector risk-sharing. This would require harmonising insolvency, taxation, and company law issues. Admittedly, this will not be an easy task. Completing the Banking Union is equally important, including a European Deposit Insurance Scheme (EDIS). The latter is controversial because the current systems in the euro area countries are different, cannot be merged overnight, and need to be made more comparable first. Some countries also need to reduce the legacy burdens of their banks ("de-risking"). Still, after a transition period, EDIS would make the currency union less vulnerable.

With respect to the fiscal channel, it could be useful to establish a limited budgetary capacity for the euro area. EMU does not have such a fiscal capacity that can be used in case of asymmetric economic shocks in some countries. A fiscal capacity that does not lead to permanent transfers or a mutualisation of debt would improve the functioning of the currency union. Comparable instruments exist in the US, where states have access to so-called rainy day funds. Once the crisis is over, the funds have to be returned.

A higher degree of risk-sharing would need to go in tandem with further risk reduction. Euro area Member States should continue to strengthen their resilience against economic shocks and lower macroeconomic imbalances. This reduces the likelihood of having to resort to public risk sharing. The completion of the Capital Markets Union and Banking Union are important in this respect as more private risk-sharing and risk reduction lowers the need for fiscal risk sharing.

2. KEY VULNERABILITIES IN THE EU FINANCIAL SYSTEM

Improving systemic risk policy in the insurance industry

The International Association of Insurance Supervisors (IAIS) is contributing to the global regulatory initiative to identify global systemically important financial institutions (G-SIFIs). Its focus is on potential global systemically important insurers (G-SIIs).

To this end, since 2013, the IAIS has developed an initial assessment methodology based notably on their size, complexity, interconnectedness and the extent to which they undertake Non-Traditional Non-Insurance activities. The IAIS goal is to identify the insurers whose distress would cause significant disruption to the global financial system and economic activity. Furthermore, to reflect the distinct features of the insurance sector the IAIS also developed the related framework of policy measures for G-SIIs consistently with the general framework published by the FSB, with adjustments, which reflect the specific features of the insurance sector.

This methodology – as revised in 2016 - encompasses a five-phase approach, which includes a structured quantitative component (phases I and II), and a more nuanced qualitative assessment phase (phase III). All these elements are then combined and subject to exchange with prospective G-SIIs (phase IV), after which the IAIS makes its recommendation to the FSB (phase V).

Indicators that were once included within the Non-Traditional Non-Insurance (NTNI) category are now distributed within the revised methodology, between the Interconnectedness category and a new Asset Liquidation category. Indeed, in 2015 following a consultation document on the Non Traditional Non Insurance activities the IAIS decided to discontinue the NTNI approach, and focus on substantial liquidity risk and macroeconomic exposure, and their related systemic risk transmission channels.

More generally in the 2016 Methodology, the IAIS has reclassified indicators according to the systemic risk transmission channel with which they are associated. The IAIS has also modified certain indicators used in the former methodology to address issues related to indicator responsiveness, their connection with systemic risk, and data quality. The 2016 Methodology also introduced the use of absolute reference values, in order to better assess the systemic importance of the pool of insurers analysed within the broader insurance sector or financial system. Certain indicators have been moved toward the phase III.

On this basis, the Basic Capital Requirements (BCR), combined with the HLA requirement for G-SIIs, deliver a key component of the IAIS' G-SII policy measures. From 2019, G-SIIs will be expected to hold regulatory capital that is not less than the total required by the sum of the BCR and HLA requirements. The combined BCR+HLA required capital is determined in two stages. In the first stage, an "uplift" is applied to the BCR as it was specified in 2014. The uplift is essentially 33%. In the second stage, the HLA is calculated using a combination of a "bucket" and a "factor-based" approach. G-SIIs are first placed into one of three buckets – a "Low," Mid" or "High" bucket – depending on its G-SII designation score. The additional factor-based approach is taken with separate factors for Traditional Insurance and Assets, Non-Traditional Insurance business and some Non-Insurance business, Non-Insurance regulated banking, and unregulated banking. Commencing in 2015, the BCR is reported by G-SIIs on a confidential basis to group-wide supervisors, subject to access by the IAIS. Beginning in 2016, the HLA will also be subject to confidential reporting.

In the meantime, however, the methodology is being challenged. The MetLife case in the US - whatever the result of the related US Government appeal - puts pressure on the IAIS to ensure that the method for assessing the systemic significance is effectively transparent, gives consideration to the relative costs and draw-backs entailed by the financial institutions designated as systemically important, and, more importantly, is based on an appropriate risk analysis.

Some question also the current adequacy >>>

>>> of the competence, accountability and governance of the international bodies (i.e. FSB, IAIS) involved in the issue, notably given the specificities of the risk in the insurance area or the novelty and complexity of systemic risk.

In this context, the conclusions of the IMF 2015 Global Financial Stability Report relaunch the debate on the need to further consider the international framework defined to identify potential global systemically important insurers (G-SIIs). Indeed, the report stresses that the size/diversification of insurance groups can be a source of stability. Finally, and even more importantly, the report wonders whether the attention of the international framework should not rather focus on a macro-prudential approach regarding the insurance sector as a whole, going beyond the solvency and the contagion risk of individual firms.

Furthermore, some stakeholders have been advocating the adoption of an activities-based approach. This would impose enhanced Board supervision on certain activities that supervisors may consider to be particularly risky without designating as systemically important the entire companies that conduct them. This is the approach currently privileged for asset managers.

There are insurance activities critical for society and the real economy, e.g. providing certain types of annuities, where all providers are exposed to the same root causes that could potentially trigger a disruption of the activity regardless of the size of the insurers. Thus it does not matter if the activity is pursued by a small number of large insurers or a large number of small insures. Despite this, the largest and often best diversified insurers are in the focus of the institutional approach.

In response to these concerns, the IAIS has set up two working groups to examine the possibility of an activities-based approach.

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

The financial crisis exposed deficiencies in the scope, quality and accessibility of capital markets data that are critical to enable both officials and market participants to assess and monitor threats to financial stability, and for policymakers to develop mitigants to them.

Over the past few years, there has been significant progress in order to remedy these deficiencies.

The implementation of Trade Repositories (TRs), which emerged after the crisis as a key tool for facilitating the collection and maintenance of data, is a first major area of improvement. TRs are now operating in the key derivatives markets around the world. They are however fragmented across jurisdictions, with a focus primarily on monitoring risks domestically or regionally rather than on the monitoring of systemic risk at the global level. Moreover key questions remain about their usefulness which appears to be limited by the difficulty of sharing data across jurisdictions, due in particular to formatting and standardisation issues, and by data quality issues (accuracy, completeness of the data).

Progress has also been made towards further standardisation, in particular through international efforts to establish standard identifiers such as the Legal Entity Identifiers (LEIs). LEIs are currently being progressively implemented across the main jurisdictions and market participants. There are also plans to roll out unique product and transaction identifiers (UPIs and UTIs).

Data governance and access to data at the international level are further areas of improvement. The FSB target to remove all barriers to sharing data by the middle of 2018 is considered as an important step towards the further harmonisation and usability of OTC derivatives data reporting. On-going domestic data protection initiatives that may hinder the sharing of data are however a matter for concern in this regard. The mechanisms needed for sharing data and expertise on data management at the international level and for ensuring that data standards are appropriately maintained and updated are other issues that still require further investigation.

3. FUNDING THE EU ECONOMY

Challenges posed by ultra-low interest rates

The ECB has engaged in a very bold expansionary monetary policy, particularly since the beginning of 2015. It decided to buy monthly 60 Billion Euros of public and private securities for a period of 18 months. These unprecedented amounts have been raised to 80 Billion Euros in May 2016. They represent close to 2/3 of the total issuance of Eurozone sovereign debt.

Of course, fiscal reforms engaged notably in peripheral countries have played an important role in the acceleration of the convergence of interest rates in the Eurozone. But the ECB has decisively contributed to the rapid setting of a lower and more homogeneous interest rate pattern in the Eurozone. It is in particular remarkable that the ECB has helped to reduce interest rates on loans to non-financial corporations.

A monetary policy that is too accommodative for too long may however have several drawbacks and shortcomings.

Firstly in Europe there has been no rebalancing of savings and consumption so far.

Yields - close to 0 or even lower – on riskless investments should, normally, deter economic agents from saving and induce more consumption, which would support growth. But, contrary to the hopes of many, "financial repression" does not always result in an increase in consumption especially in Europe.

When the yields fall or, sometimes even disappear, because of monetary policy, it would be logical to see savings switch to equity instruments that can provide, over the longer term, more satisfactory returns, all the more so if investors believe in an upturn of the economy. This happened in the US as a consequence of QE, where equity markets rebounded exactly in line with the creation of liquidity by the Fed, triggering a "wealth effect" which contributed to more consumption. But in the Eurozone, this process doesn't seem to work: no significant shift to equities, nor wealth-effect has happened so far. Indeed European savers are not the same as those in the US. They are mostly risk-adverse, their savings are mainly in relatively safe assets and they are not inclined so far to buy shares. Moreover the tax system often does not sufficiently encourage equity investment. More worryingly, the shift of repressed financial savings to consumption doesn't seem to have happened either. Indeed, probably due to existing uncertainty, a significant number of savers are trying to offset lower returns by further saving.

Secondly very low interest rates have a negative impact on the profitability of banks which may have negative consequences for the financing of the economy and the transmission of the monetary policy in Europe.

EU banks are very sensitive to the spread between their funding costs (deposits and borrowings) and the return on their assets. Clearly the ongoing decline in interest rates which is accompanied by a significant flattering of the yield curve, weigh on the profitability of retail deposit banks that traditionally benefit from maturity transformation activities. The consequences of this decline of profitability are manifold.

If banks are not profitable, they will not lend more, which goes against the objective of the monetary policy to support credit. It seems therefore essential that monetary policy and regulation are well adjusted in this respect.

The balance sheet of insurance companies and pension funds is also a matter for concern. Such institutions have to meet the long term liabilities of their retiring clients, with assets (like sovereign bonds) that carry no return.

Another important issue is that there are less incentives for investors to buy bank shares, which is reflected in the low price-to-book ratio in the EU banking sector.

Thirdly, resource allocation tends to lose its efficiency when interest rates get very low. Indeed, the only projects that can be financed are the ones which are viable with very low rates. Less profitable and more risky investments (but perhaps socially more beneficial) may be left aside. Furthermore, investment duration is bound to be reduced in an environment of low interest rates.

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>>> Fourthly, an evolution towards negative interest rates does not seem sustainable over time. Indeed interest rates are the price that a saver is entitled to expect for having accepted, for a given period of time, to postpone immediate consumption. To say that such a price should become negative goes against common sense, abolishing the notion of time and could bear grave consequences for the future. It is for example difficult to see how one could calculate expected returns on an investment with a negative rate. This could have important consequences in particular for long term investment projects that involve high fixed costs and high risks.

Finally, systematic liquidity creation does not appear to be the major solution for relaunching growth in many European countries that are mainly hampered by decelerating productivity growth and insufficient structural reforms.

Leveraging the role of asset management in funding the economy

Asset management is expected to play an increasing role in Europe with the objective of the Capital Markets Union (CMU) of developing capital markets in order to further diversify the financing of the EU economy.

Several regulatory initiatives have been conducted over the last few years in order to strengthen and further harmonise EU investment fund ranges. The two EU investment fund frameworks (UCITS and AIFMD, the Alternative Investment Fund Manager Directive) have been completed with labels concerning Social Entrepreneurship (EuSEF), Venture Capital (EuVECA) and Long Term Investment (ELTIF). Despite these new European frameworks and the successive updates of the UCITS directive, the EU fund market remains quite fragmented with a high number of funds and a small average size compared to the US (where there are 3 times less funds and an average size five times larger than EU ones). This fragmentation increases management costs and lowers potential investor returns limiting the appeal of EU funds for EU and non-EU investors.

Additional regulatory measures have been proposed by the EU Commission (EC), notably in the CMU action plan in order to further support the development of asset management in the EU.

A first group of recommendations were made regarding EU venture capital funds, proposing to allow AIFMs to manage EuVECA funds and creating a range of pan European venture capital fund-of-funds which would help to increase the size and attractiveness of EU venture capital funds. Other proposals made by the EC include revised calibrations of Solvency II regarding ELTIFs in order to support the development of these new funds and an assessment of the need for a coordinated approach regarding loan origination funds. The EC is also conducting a detailed assessment of the barriers to the cross-border distribution of investment funds.

Consultations are in parallel being conducted regarding the possibility to grant AIFMD passports to third-country AIFMs and non-EU Alternative Investment Funds marketed by EU AIFMs as part of the review of the AIFMD directive. Many observers however believe that sufficient reciprocity on the part of third-countries should be a pre-requisite for moving forward these latter proposals.

Against this evolving regulatory backdrop, a key question is whether the appropriate fund ranges are available to contribute to the long-term goals of savers and the CMU, so as to address retirement savings and sustainable growth in the EU. In addition to fund frameworks, the range of investment management approaches available to investors is important in promoting CMU's goals of sustainable growth and investment. Both active and passive management are needed for example in order to achieve appropriate costs and returns for investors, many observers emphasize.

Appropriate distribution processes, advice and pre-contractual information are other important factors for encouraging more investment. The new MiFID II rules and those concerning Packaged Retail and Insurance-based Investment Products (PRIIPs) will notably impact investment funds, bringing changes in the requirements governing investment advice (regarding independent advice in particular) and product disclosure (with an objective to harmonize client information and investor protection across Member States and investment product categories). While there are benefits associated with these new rules in terms of investor information and protection, some observers point out potential unintended consequences related to these new requirements: e.g. complexity of delivering additional information for wrapper products, potential limitations in the access to advice, disincentivisation of open architecture distribution models...

Encouraging long-termism in the financing of the economy

On the occasion of the Göteborg Forum in 2009, Eurofi published a paper[1] identifying the factors that could act as impediments to high and stable levels of long-term investment and the savings flows that finance such investment. The Eurofi working group noted at that moment that long-term investment represents an investment that aims to achieve a high long-term risk-adjusted rate of return, typically involving either equity participation or buy-and-hold strategies in long-term debt instruments, thus for which the short-term volatility is of limited relevance. In the same paper Eurofi warned however, that the volatility of fund flows caused higher transactions costs to be borne by the funds and their long-term shareholders and also generated volatility in the financial markets. The paper also underlined that end-investor's decisions were often not in their own best economic interests. Eurofi pointed also to accounting reporting tools / standards that were not able to offset the impact of the volatility produced on the accounting statements, and to the fact that certain balance sheet items were particularly ill suited to a fair-value accounting treatment and that accounting standards should make it possible to factor in the diversity of financial intermediaries' activities.

Finally, in 2010 Eurofi proposed[1] a EU action plan to remove the disincentives to long-term investment. encompassing notably similar tax treatment for debt versus equity financing, a European regulatory framework for a long-term investment vehicle for households, an optional prudential and accounting framework for financial institutions, that would enable them to factor in the long-term characteristics of some of their commitments, which include a specific approach for valuing the assets they hold on the long-term, and a toolkit to reward stable investors.

On July 24, 2014 the IASB published a version of IFRS 9 regarding accounting options for financial instruments by which financial assets are measured at amortised cost whenever the objective of the entity's business model is to hold the financial assets to collect contractual cash flows, and the company does not apply the fair value option to eliminate an accounting mismatch.

At the EU level, on 30 September 2015, as part of a package of measures related to the Capital Markets Union initiative to remove barriers to investment in the EU, the Commission made a number of amendments to the Solvency II Delegated Regulation among which Qualifying infrastructure investments which will now form a distinct asset category. Investments in European Long-Term Investment Funds (ELTIFs) will benefit from the same capital charges as equities traded on regulated markets. The artificial volatility in the prudential balance sheet which was an additional obstacle to long-term investment by insurers was also removed in the Solvency II Directive.

In July 2016 the G20 decided to promote investment with focus on infrastructure, in order to support growth objectives and the 2030 Agenda for Sustainable Development. Hence the G20 endorsed the G20/OECD Guidance Note on Diversification of Financial Instruments for Infrastructure and SMEs.

However, the IMF in its February 2016 working paper

- "Institutionalising counter-cyclical investment; a frame-work for long-term asset owners" – stressed again that asset-owners' investment-portfolios shifts
- at the global and regional levels - respond pro-cyclically. In order to encourage these investors to further contribute to market stabilisation while further generating returns, this paper proposed elements for a framework, which (i) feature governance practices to mitigate 'multi-year return chasing;' (ii) propose benchmarks best suited to long-term investors; (iii) minimize principal-agent misalignments; (iv) focus risk management to minimize long-term shortfall risk rather than short-term price volatility; and (v) propose adopting inbuilt stabilizers so as regulations do not amplify pro cyclicality at the worst times.

1. http://www.eurofi.net/wp-content/uploads/2012/11/2009-Goteborg-How-can-long-term-investment-favour-financial-stability-in-the-EU.pdf and http://www.eurofi.net/wp-content/uploads/2012/11/For-an-EU-action-plan-to-remove-the-disincentives-to-long-term-investment.pdf

Addressing key legal and fiscal obstacles to CMU

Removing national barriers to cross-border investment is an important objective of the Capital Markets Union (CMU) action plan. The EU Commission (EC) indeed considers that the removal of such barriers, which deter investors from diversifying their geographical portfolios, would yield significant benefits to capital raisers, investors and the EU economy as a whole. More integrated EU capital markets would also increase the attractiveness of EU Member States as investment destinations for third country investors.

Insolvency law and fiscal rules are two key areas where rules are notoriously divergent across Member States.

Insolvency rules

Inefficient and divergent insolvency laws make it difficult for investors to assess credit risk, particularly in cross-border investments. In addition, much time is wasted with inefficient insolvency procedures, which impact businesses as well as the banks which lent to them.

A recommendation published by the EC in 2014 set out common principles for national insolvency procedures, aimed at reducing the length and cost of insolvency proceedings for SMEs (e.g. use of standard forms, use of distance means of communication) and encouraged Member States to implement early restructuring procedures and give a "second chance" to entrepreneurs. These principles however have only been partially implemented by EU Member States.

The EC is due to propose in the context of the CMU action plan a legislative initiative on business insolvency drawing on the experience of the 2014 recommendation. The objective of this initiative is to address the most important barriers to the free flow of capital within the EU related to insolvency regimes, building on the domestic regimes that work well. A question that is still debated however is whether there should be further harmonisation of such rules within the EU and what should be the focus of possible harmonisation efforts.

Fiscal issues

Tax issues may also have a significant impact on the achievement of the CMU.

They first impact cross-border investment. Differing national tax approaches, e.g. regarding withholding taxes applied in addition to domestic taxes, may indeed hinder cross-border investment due to the complexity of procedures to claim relief from these taxes. Discriminatory tax obstacles to cross-border investment by life insurance companies and pension funds have also been emphasised. The EC has proposed measures in the CMU action plan for tackling these issues by 2017, notably with the adoption of relief-at-source systems for withholding taxes.

The preferential tax treatment of debt resulting from the deductibility of interest rate payments is a second issue that has often been emphasised as a barrier to the further development of equity issuance. This problem is due to be addressed by the EC in the context of the work on the Common Consolidated Tax Base.

Another issue related to tax are the fiscal incentives for venture capital and business angel investments into SMEs that the EC has planned to assess in 2017 in order to promote best practices across the EU.

How far should securities post-trading harmonisation go?

Facilitating cross-border investing and ensuring that capital markets function better and more efficiently across Europe are key objectives of the Capital Markets Union (CMU).

Clearing and settlement processes and post-trading infrastructures such as CCPs and CSDs, which allow to safely move securities from sellers to buyers in return for payment are essential for the development of capital markets on a domestic and cross-border basis.

Many barriers to the cross-border clearing and settlement of securities are due to be >>>

>>> removed with the implementation of EMIR, CSDR and MiFID II, completing the work conducted since 2001 regarding the Giovannini barriers. Many provisions of these legislations however still remain to be implemented. Moreover major changes are underway in the post-trading area with the implementation of TARGET2-Securities (T2S) which is expected to lead to significant modifications in the EU securities markets infrastructure and the way cross-border transactions are processed. Further transformations are expected to happen over time with the implementation of fintech solutions, such as blockchain, which may also potentially lead to new harmonisation needs.

Collateral management has also become a crucial part of the functioning of EU capital markets. The use of collateral underpins many financial transactions and its use has strongly risen since the financial crisis with risk aversion and concerns over counterparty and sovereign risk. The demand for high quality collateral on a domestic and cross-border basis is due to continue to increase further in the coming years with the implementation of Basel requirements and the mandatory clearing of OTC derivatives transactions; at the same time the on-going QE is draining a large portion of securities from the market affecting the availability of good quality collateral.

Actions have been put in place within the Eurosystem to facilitate the cross-border use of collateral and the T2S platform will help to optimise collateral management further. Private sector initiatives and services also contribute to fostering the mobility of collateral; these include tri-party collateral management services, platforms to source and mobilize collateral and collateral optimization and transformation services.

The EU Commission has committed in the CMU action plan to closely monitor developments in the post-trading and collateral management areas and to conduct a broad review of the progress made in removing Giovannini barriers; new issues that might have emerged with recent legislative changes and the development of new technologies (e.g. blockchain) and market practices (e.g. collateral transformation or optimisation) will also be taken into account. An expert group, the European Post-Trading Forum, has been set up in this perspective.

An important related issue is the legal certainty of cross-border securities transactions.

Ensuring the legal certainty of securities ownership, when issuers and investors are located in different Member States and / or if securities are held by financial institutions in different Member States is becoming increasingly important with the implementation of T2S and EU trading and post-trading regulations, which are expected to increase cross-border securities transactions. Another issue stressed in the CMU action plan is the uncertainty surrounding the law that applies to third party effects of the assignment of debt claims, which may complicate their use as cross-border collateral.

The European Commission has proposed to take forward targeted work on these issues concerning legal certainty in 2017 in order to define uniform rules which would help to clarify the laws that apply to any given cross-border securities transaction.

4. NEW TRENDS

The fight against terrorism financing, money laundering and tax evasion

Money laundering is a process by which the illicit source of assets obtained or generated by criminal activity is concealed to obscure the link between the funds and the original criminal activity. Terrorist financing involves the raising and processing of assets to supply terrorists with resources to pursue their activities. While these two phenomena differ in many ways, they often exploit the same vulnerabilities in financial systems that allow for an inappropriate level of anonymity and non-transparency in the execution of financial transactions. Tax evasion and avoidance deprive public budgets of billions of euros a year, create a heavier tax burden for citizens and cause competitive distortions for businesses that pay their share.

The international community has made the fight against money laundering, terrorist financing and tax evasion a priority.

The EU Commission has adopted in July 2016 a proposal to further reinforce EU rules on anti-money laundering in order to counter terrorist financing and increase transparency about who really owns companies and trusts.

This Commission proposal is the first initiative to implement the Action Plan of February 2016 for strengthening the fight against terrorist financing and is also part of a broader drive to boost tax transparency and tackle tax abuse. This is why the Commission has, in parallel, also presented a Communication that responds to the recent Panama Papers revelations.

The adoption of the Fourth Anti-Money Laundering Package in May 2015 marked a significant step towards improving the effectiveness of the EU's efforts to combat the laundering of money from criminal activities and to counter the financing of terrorist activities. It sets high standards to prevent money laundering, such as the requirement for Member States to put in place national registers of beneficial owners of companies and some trusts. Member States have committed to implement the package more swiftly than initially planned, at the latest at the end of 2016.

Countering terrorism financing

As announced in the Action Plan for strengthening the fight against terrorist financing, the Commission is proposing changes to prevent the financial system from being used for funding terrorist activities:

- Enhancing the powers of EU Financial Intelligence Units and facilitating their cooperation: the scope of information accessible by the Financial Intelligence Units will be widened, and they will have access to information in centralised bank and payment account registers and central data retrieval systems, which Member States will have to establish to identify holders of bank and payment accounts;
- Tackling terrorist financing risks linked to virtual currencies: to prevent misuse of virtual currencies for money laundering and terrorist financing purposes, the Commission proposes to bring virtual currency exchange platforms and custodian wallet providers under the scope of the Anti-Money Laundering Directive. These entities will have to apply customer due diligence controls when exchanging virtual for real currencies, ending the anonymity associated with such exchanges;
- Tackling risks linked to anonymous pre-paid instruments (e.g. pre-paid cards): the Commission also proposes to minimise the use of anonymous payments through pre-paid cards, by lowering thresholds for identification from €250 to €150 and widening customer verification requirements. Proportionality has been taken into account, with particular regard paid to the use of these cards by financially vulnerable citizens;
- Stronger checks on risky third countries: as mandated by the Fourth Anti-Money laundering directive, the Commission proposes to harmonise the list of checks applicable to countries with deficiencies in their anti-money laundering and countering terrorist financing regimes. Banks will have to carry out

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>>> additional checks ('due diligence measures') on financial flows from these countries.

Stricter transparency rules to prevent tax avoidance and money laundering

The July's proposal of the EU Commission should reinforce the measures introduced by the Fourth Anti-Money Laundering adopted on 20 May 2015 with the following changes:

- Full public access to the beneficial ownership registers: Member States will make public certain informations of the beneficial ownership registers on companies and business-related trusts. Information on all other trusts will be included in the national registers and available to parties who can show a legitimate interest. The beneficial owners who have 10% ownership in certain companies that present a risk of being used for money laundering and tax evasion will be included in the registries. The threshold remains at 25% for all other companies.
- Interconnection of the registers: the proposal provides for the direct interconnection of the registers to facilitate cooperation between Member States.
- Extending the information available to authorities: the Commission has proposed that existing, as well as new accounts should be subject to due diligence controls. This will prevent accounts that are potentially used for illicit activities from escaping detection. Passive companies and trusts, such as those highlighted in the Panama Papers, will also be subject to greater scrutiny and tighter rules.

Consumer challenges raised by digital transformation in the financial industry

Digitalisation will contribute in many respects to the diverse objectives related to the achievement of an effective EU single market for retail financial services, among which greater price transparency, levelled purchasing powers throughout the EU, a wider choice of products, including from other Member States, but also symmetrically the opportunity for providers of retail financial services to be able to offer their products directly across borders easily, reaching consumers in other Member States.

In addition, digitalisation – i.e. the use of internet, mobile phone, big data and artificial intelligence, emerging technologies such as blockchain, Internet of things, ... - which is by essence cross border - is also expected to allow financial services to evolve and even to experience unprecedented shifts, which encompass a possible commoditisation of traditional financial services, the emergence of new business models (Uberisation), and the revolution of customer advice as well as new forms of risk assessment, etc. Finally, nonbank digital players enjoy important advantages, including specific culture, fewer regulatory constraints, higher risk appetite, and to some extent greater responsiveness from individuals to their digital offers than to those of incumbents.

However, the digitalisation of the economy is expected to also pose many challenges to consumer and financial service providers, as well as their supervisors, notably in the possible context of regulatory competition triggered by the will of certain jurisdictions to attract emerging digital businesses. In particular, beyond the specific cyber risk, consumer protection needs – e.g. new privacy concerns, new risk mutualisation patterns in the insurance sector, issues emerging from the difficulty for EU individuals to identify what service provider they are actually in contact with, etc. - are constantly evolving or require being adapted to the digital context. Financial exclusion also raises new challenges in the digital context.

Supervision is increasingly cross sectoral. Operational risk is also developing since the various providers involved in new financial value chains are increasingly diverse and interlinked, and delocalised over the EU borders. In this respect, the actual sustainability of certain new providers/fintechs is not the lesser problem.

Many legislative pieces have already been recently produced, which address to a certain extent these issues: PSD2, PRIIPs, Mortgage Credit directive, Payment Account Directive, Insurance Mediation Directive, PRIIPs, but also the Regulation electronic identification and trust services for electronic transactions, etc. These issues are also being considered in the Commission's Single Market Strategy aiming to reduce barriers and >>>

>>> prevent discrimination within the single market, the Commission's Digital Single Market Strategy and the Network Information Security (NIS) Directive.

The ESAs have naturally an important role to play in order to at least coordinate national regulators and supervisors, due to the cross border essence of digital services.

More generally, digital disruptions pose the question of whether European institutions, at both national and EU levels will be able to answer new innovation and competitiveness needs while enhancing the trust of EU citizens in digital financial services.

Leveraging Fintech in developing EU capital markets financing

Technological innovation has been a key driver of progress in capital markets for decades but fintech and blockchain solutions offer new opportunities that could foster radical change in the sector. Such solutions offer several types of potential applications in capital markets: improving efficiency of back office operations, supporting access to financing solutions particularly for SMEs, facilitating access to investment advice or cross-border investment.

On the efficiency side, technology has the potential to significantly reduce costs and delays in capital market back offices, notably with the emergence of blockchain or Distributed Ledger Technology (DLT) solutions. DLT potentially allows transactions to be documented near real-time in a safe and decentralized way through copies of a ledger distributed and validated by a consensus process over the internet, without the need for intermediaries. There are many potential applications of this technology in capital markets but the one most often put forward is the possibility to achieve cheaper and faster clearing and settlement of securities transactions including in the SME market, which has the potential to save billions of euros at overall market level, provided the current scalability, legal and standardization issues can be solved.

Other fintech solutions often based on internet applications have the potential to facilitate access to finance, notably for small businesses and retail investors, by supporting effective interactions among key stakeholders in the financing value chain. Crowdfunding or peer-to-peer lending / investment platforms are the most widespread fintech applications so far, and developing an EU framework for their development is one of the objectives of the CMU. Fintech solutions enable to serve these clients in a cost-effective way by using new custom-built platforms and innovative decision making or scoring processes using advanced and innovative data analytics and artificial intelligence.

E-commerce platforms such as Amazon or Alibaba offering working capital lines and loans to small businesses and merchants selling on their platforms are a promising variation of this concept. Fintech solutions can also help to facilitate many existing financing processes such as factoring, supply chain finance or trade finance. Technology can also be used for example to facilitate the provision by issuers of standardized information on securities in various languages with automated translation and the access of investors to this information, which increases transparency while reducing costs. Technology also removes barriers to accessing markets with investors increasingly using mobile devices to access information and execute orders.

Fintech solutions may also help to facilitate investment advice or to better connect securities issuers and investors. Robo-advice are an example of this, allowing a cost-effective and consistent online provision of guidance on investment decisions and automated asset allocation based on an analysis of a customer's projects and tolerance of risk using algorithms or decision trees. Data aggregation and financial management tools connected with robo-advice facilitate the on-boarding process and KYC checks for the provision of advice by considerably simplifying data collection. Initially presented as standalone services, hybrid concepts combining on-line tools with human interaction or the use of robo-advice tools by investment advisors are developing in order to broaden the potential customer base beyond millenials. One issue often put forward with regard to robo-advice is the ownership of and access to investor data. Some observers suggest that customers need to own the data and be able to control its use in order to be able to share it with whomever and to whatever extent they wish, which is not the case in all jurisdictions.

These different concepts were mostly developed by fintech start-ups but incumbent players >>>

>>> and notably banks and financial market infrastructures are increasingly involved in the development of such projects either as partners or investors, in order to e.g. outsource some activities such as SME financing activities which are difficult to serve in a profitable way for large incumbent firms. Incumbent firms provide access to regulated markets, scale and wider connectivity. Some have also purchased fintech providers or implemented solutions internally.

Such developments need to be monitored by the public authorities to ensure that safety and customer protection are sufficient and that financial stability is maintained, but many observers emphasize that a proportionate approach is required in order to avoid penalizing innovative solutions by an outdated set of regulations and that a 'do no harm' regulatory approach should be used in the same way as what was done for the internet during the mid 90s. Regulatory 'sandboxes' have been developed in some jurisdictions for testing innovative products, services and businesses in a relatively flexible way. Some regulators however argue that eventually technology should be treated neutrally on a 'same business, same risk, same rules' basis, which requires rethinking the current rule set for the digital world, where decisions will increasingly be made by algorithms and artificial intelligence.

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

Climate change is affecting every country on every continent. It is increasingly disrupting national economies, affecting lives and increasing costs for communities and countries.

For investors, saver, issuers and financial institutions anticipating and mitigating such risk is critical. Transforming such financing needs into attractive and safe economic opportunities raises the important issue of the definition of adequate disclosures in order to achieve the appropriate level of transparency.

In this context, FSB's priorities for 2016 encompass addressing notably new and emerging vulnerabilities in the financial system, including potential risks associated with climate change. For example, the European Central Bank (ECB) together with the European Systemic Risk Board is developing an environmental stress test to be integrated into the financial sector's risk management to expose the financial risks of climate change.

Indeed, better access to data will enhance how climate-related risks are assessed, priced, and managed. Companies can more effectively measure and evaluate their own risks and those of their suppliers and competitors. Investors will make better informed decisions on where and how they want to allocate their capital. Lenders, insurers and underwriters will be better able to evaluate their risks and exposures over the short, medium, and long-term.

The successful development of financial markets and products, enabling climate related investments is also vital.

In this respect China, which holds the G20 Presidency this year, has introduced a "Green Finance Study Group" to identify market failures and institutional barriers to better mobilise private capital notably in the following areas:

- Greening the banking system;
- Improving and scaling up the green bonds market;
- Greening institutional investment;
- Developing ways for measuring the progress of green financial activities.

The EU Ministers of Finance discussed on "sustainable finance" at their informal ECOFIN meeting in April 2016, in order to put sustainable finance on the EU agenda. The Netherlands Presidency was of the opinion that private financial institutions can make an important contribution to sustainable development and that the Capital Markets Union agenda (CMU) should include greening investment.

In this context the successful development of the Green Bonds market is one crucial means for the financial sector to contribute to the fight against climate change. Green Bonds enable capital-raising and investment for new and existing projects with environmental benefits. The Green Bond Principles (GBP) defined by ICMA, updated as of June 2016, are voluntary process guidelines that recommend transparency and disclosure and promote integrity in the development of the Green Bond market by clarifying the approach for issuance of >>>

>>> a Green Bond. The GBP aid investors by ensuring availability of information necessary to evaluate the environmental impact of their Green Bond investments; and they assist underwriters by moving the market towards standard disclosures which will facilitate transactions.

The green bond market has continued its march to maturity, with new geographies and industry sectors coming to the market, innovative bond structures being launched, and plans for a new service to rate bonds on their environmental impact. The qualitative development of the market has been accompanied by strong gains in quantity, with some $25billion of new green bonds already issued this year. These compare with a total of $41.8 billion for the whole of 2015.

More generally, according to Climate Bond Initiative:

- As of May 31st 2016, the outstanding climate-aligned bond universe amounts to $694bn in which the labelled green bond market makes up 17%.
- The climate-aligned bond universe with regard notably to transport and energy, has huge potential: $694bn in a $90trn bond market, when $93trn investment is required across the whole economy by 2030 for a +2°C world scenario.
- The Chinese currency is dominant (with 35% of the total amount outstanding), followed by the US dollar (24%) and the Euro (16%).
- 78% of the universe is investment grade; the majority of bonds have tenors of 10 years or more; the majority is also government-backed.

5. BANKING REGULATION

Implementation challenges of EU banking resolution tools

The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are key cornerstones of the Banking Union within the euro area.

However the EU resolution framework has still to be completed particularly with regard to burden sharing. Indeed, should the resolution process of a EU bank be triggered and bail in envisaged, it could only be at this stage at the solo level, i.e. national level. This means assessing the compliance with the minimum bail-in principle demanded to be able to use public support - set at 8% of total assets - and the compliance with the "no creditor worse-off than in liquidation" principle, in a context of diverse and inconsistent national rules regarding the hierarchy of creditors and accounting standards.

However the legacy of the crisis which notably takes the form of non-performing loans in certain EU banks, challenges the implementation of the new EU resolution framework. Indeed, in certain EU member states, the bail-in requirements of the BRRD which have taken effect since the start of 2016, should impact retail investors if any resolution were to occur. For example, in Italy, bank bond retail holdings are relatively large i.e. about one third of the 600 Billion of bank bonds and half of €60 Billion of subordinated bank bonds. The authorities are very concerned about social and potential confidence effects of resolution.

In addition Non-Performing Loans (NPLs) affect negatively investor confidence regarding the banks concerned since high levels of NPLs lower the banks' profitability and solvency and may also have repercussions on the whole EU banking system.

Solving the NPL issue is therefore an essential matter for the Banking and Monetary Union. However addressing the NPL issue requires to take into account its national more than Eurozone dimension. Indeed the economic recovery is not homogeneous in the euro area and bankruptcy laws are very different from one country to another.

Conditions for moving towards an EDIS

To ensure that deposits are truly safe everywhere across the euro area, the likelihood that a bank might fail has to be independent from the jurisdiction where it is established. And, when push comes to shove, depositors must be afforded similar protection wherever they are located.

The Commission proposed on 24 November 2016 a regulation to establish a European Deposit Insurance Scheme (EDIS) as a third pillar of the Banking Union, alongside arrangements for banking supervision and resolution. It would be mandatory for euro area countries and open to other member states participating in the Banking Union.

The European Deposit Insurance Scheme would be established in three successive stages. During the reinsurance period of three years, the national DGSs would have to be exhausted first before EDIS could be used, providing an additional source of funding with national schemes.

This reinsurance phase would be followed by a progressive mutualisation of deposit insurance over a period of four years. To reduce moral hazard, the EDIS proposal contains some safeguards. For instance, in the first two phases, the national

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>>> scheme has to comply with the obligations of the DGS Directive (adopted in June 2014), in particular with regard to the required annual target levels, before receiving any extra support by EDIS. The full insurance of depositors would fall under EDIS from 2024 onwards.

The Single Resolution Board (SRB) would be expanded to administer EDIS.

In the communication "Towards the completion of the Banking Union", the Commission envisages a set of measures to reduce risk in the banking sectors of the Member States, accompanying the introduction of EDIS. These measures, which include the handling of non-performing loans (NPLs), the prudential treatment of banks 'exposures to sovereign risk among others, are also designed to break the bank-sovereign link. According to the EU Commission, the implementation of both the EDIS proposal and the risk reduction measures should be promoted in parallel.

Completing the Banking Union makes sense according to many stakeholders and setting up an EDIS is an appropriate way forward: the place where you live in the Union should not play a role in how safe your savings are. In other words, money can only be truly single if confidence in the safety of bank deposits is the same irrespective of the Member State in which a bank operates.

But completing the Banking Union has to be effected on a solid foundation. Indeed several points should be taken into account: the 2014 Directive on Deposit Guarantee Schemes is not yet fully transposed and implemented; the resolution framework of the Banking Union still needs clarification (TLAC is not yet transposed in the BRRD, MREL are not defined for EU banks etc.); not all the banks that would benefit from the EDIS are submitted to a Comprehensive Assessment of the ECB (Asset Quality Review, stress test), and some Member States of the Euro area are not compliant with the Stability and Growth Pact rules and have not yet achieved sufficient economic convergence.

In addition, coupling two separate issues - EDIS and risk reduction measures (notably prudential sovereign treatment) - might complicate both discussions. As mentioned in the Esther de Lange's Report (June 2016): "the EDIS proposal is a controversial one and large differences remain as to which conditions need to be met for EDIS to advance as well as with regard to the design of EDIS. Overcoming these differences will be a matter of timing, conditionality and content: which steps can be taken when and under which conditions. The absence of an up-to-date impact assessment for this proposal is highly regrettable (...) It is of vital importance to ensure that no Member State participating in EDIS is (perceived to be) worse off compared with its starting position."

Next steps proposed by Mrs Esther de Lange, rapporteur of the EU Parliament on this legislative proposal are the followings:

- An impact assessment from the European Commission
- Concrete steps in the area of risk reduction
- More clarity on the calculation of the risk-based contributions
- Finding a broad majority position in both the Council and Parliament on:
    - Concrete timing of the phasing in of EDIS
    - Conditionality of the risk reduction
    - Content / design of EDIS

The Ecofin Council, fot its part, adopted in June 2016 a roadmap to complete the Banking Union. The Council underlined in particular that " it will continue constructive work on EDIS at technical level. Negotiations at political level will start as soon as sufficient further progress has been made on the measures on risk reduction. In this context, the Council takes note of the intention of member States to have recourse to an Impact Global assessment (IGA) when political negotiations on EDIS start."

Implementing TLAC in EU legislation

An agreement was reached at the international level at the end of 2015 on the Total Loss Absorbing Capacity ratio, or TLAC, for Global Systemically Important Banks (G-SIBs) with a view to overcoming the "too-big–to-fail" issue and making resolution simpler and more predictable. TLAC still needs to be implemented in Europe, where the Bank Recovery and Resolution Directive (BRRD) adopted in 2014 provides for a similar concept designated as Minimum Requirement for Eligible Liabilities (MREL) applicable to all banks.

As provided by the BRRD, preparations at the level of the resolution authorities in the EU have >>>

>>> been ongoing to determine the level of MREL for each bank. Target MREL levels should be defined in 2016, with a transition period to reach the level. The Single Resolution Board (SRB) has announced that the features of TLAC would feed into MREL assessments, apart from the minimum amount, and will be applied beyond G-SIBs. In addition, Elke König made it clear that MREL will not be less than 8% total liabilities including own funds for the large banks in the Banking Union. In parallel, work is ongoing at the European Commission to implement TLAC and review MREL. The Commission's objective is to ensure a consistent approach towards loss absorbing capacity.

In its proposed Delegated Regulation (May 2016), the EU Commission specifies the criteria that authorities responsible for resolving banks will need to consider when setting the MREL requirement. In a working document, the Commission services propose that TLAC be a pillar 1 requirement for G-SIBs only, set at the TLAC minimum amount of 16% RWAs. In addition, an add-on could be required by the resolution authority upon due justification of the need for it and capped by the amount calculated according to the MREL delegated regulation formula (Pillar1 + Pillar2 + combined buffers) x2. For non-G-SIBs, the ratio would be a pillar 2 requirement, to be set by the resolution authority and capped at (Pillar 1 + Pillar 2 + combined buffers) x2.

According to EBA's interim report on MREL , the needs of subordinated debt issuance would be in the order of EUR 130bn to EUR 470bn without the subordination criteria. An additional EUR 340 to EUR 790bn would be needed if senior unsecured debt was not included (i.e. with the subordination requirement).

Such a requirement for subordination exists in the TLAC standard but the BRRD does not require subordination. Some Member States like France, Italy and Germany are introducing national approaches to address the TLAC subordination requirement. In parallel, the European Commission, supported by the ECOFIN Council, is working on a legislative proposal to harmonise the hierarchy of senior creditors at EU level in resolution and insolvency. This harmonisation objective is welcomed and supported by the SRB and investors but it may be difficult to find a middle ground that can reconcile the existing national hierarchies and thus secure sufficient support at Council level.

The whole set of issues related to MREL has to be addressed with great care, as very high, new requirements of subordinated debt or capital would not easily be absorbed in present market conditions and would therefore lead to financial stability concerns. Ultimately, the level of MREL required for a bank should depend on its resolvability and resolution plan. On this matter, the BRRD sets no direct or automatic link between determining the MREL level, and the 8% bail-in rule conditions access to the use of the resolution fund for absorbing losses or to recapitalise a bank. These are separate requirements, serving different purposes, and covering different populations of bail-inable instruments, notably because MREL requires eligible instruments to have a remaining maturity of 1 year while the 8% bail-in rule does not.

Article 45 of the BRRD mandates the EBA to carry out an MREL review by the end of 2016. Importantly, this work should take into account the TLAC standard and will feed the Commission's work on TLAC implementation and MREL revision. On 20 July EBA published a pre-report for comments by 30 August.

The Commission intends to make a proposal to introduce the TLAC standard into EU law in 2016, before its entry into force in 2019.

[1] Published for consultation on 19 July 2016, p.27 and p. 59

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

In 2008, G20 Leaders agreed on an ambitious and comprehensive strengthening of international bank regulatory standards.

A key element of subsequent Basel III standards is an increase in the level of capital. The minimum CET1 capital ratio has been raised to 4.5% of risk-weighted assets, and the corresponding Tier 1 capital ratio set at 6%. Under Basel II, the minimum basic equity capital ratio was 2% of risk-weighted assets. That is equivalent to a ratio of around 1% of risk-weighted assets under the new, tighter definition of capital. When combined with the macro-prudential buffers introduced, Basel III has significantly increased the level of high-quality capital in the banking system. These evolutions have already been implemented in the EU. However, Basel is defining >>>

>>> complementary tools still to be implemented at the EU level.

One of the causes of financial crises is the excessive build-up of on- and off-balance sheet leverage in the banking system. To constrain leverage in the banking sector and to provide additional safeguards against possible model risk and measurement error, Basel III also introduced a leverage ratio (LR). It also represents an approach simpler than the ratio of capital to risk-weighted assets which is expected to be more easily understood by market participants and more comparable across banks.

Another major driver of financial crises is excessive liquidity risk. Banks offer short-term liquidity to depositors and longer-term lending to borrowers; this fundamental role makes them inherently vulnerable to liquidity risk. Until the subprime financial crisis there was no international framework for limiting liquidity risks. Consequently, the Basel Committee has adopted two minimum liquidity standards:

- The liquidity coverage ratio (LCR), which requires banks to hold a stock of high-quality liquid assets that can be used to cover their net cash outflows over a 30-day stress period.
- The net stable funding ratio (NSFR), which requires banks to support their business activities with appropriate sources of stable funding.

The LCR ratio is being progressively implemented in accordance with the CRR timetable starting the 1 October 2015 and ending in January 2018. The CRR also allows the Commission to propose a legislation for a NSFR. First, the European Banking Authority (EBA) must analyse and report on methodologies and definitions for implementing the NSFR. On this basis, the Commission may, if appropriate, submit a proposal to Council and Parliament by 31 December 2016. A consultation document has been sent to the relevant stakeholders. Any queries can be submitted by 24th June 2016.

The Basel Committee, which is making efforts towards finalising its post- crisis reforms, is proposing however the revisions of the standardised approaches for market risk, which will include greater standardisation of traded market risk model requirements. The EU Commission has launched a targeted consultation in order to gather the views of selected stakeholders on the proposed options for implementing the principle of proportionality in the upcoming market risk capital framework.

These regulatory works have to be coordinated with two initiatives of the Commission, who launched a consultation on the potential impact of the Capital Requirements Regulation (CRR) and Directive (CRD IV) on the financing of the economy by banks with a view to gather the stakeholders' views and evidence, by the 15 July 2015.

Lastly, these numerous legislative works are undertaken at a moment when the Commission is looking for empirical evidence and concrete feedback on rules affecting the financing of the economy, unnecessary regulatory burdens, interactions, inconsistencies and gaps, and rules giving rise to unintended consequences. The objective is to have a clearer understanding of the interaction of the individual rules and of the cumulative impact of the legislation as a whole including potential overlaps, inconsistencies and gaps. Given the usual role of banks in the capital markets, this understanding is particularly critical at a moment when the EU is providing a specific effort to work out the main building blocks of the much awaited Capital Market Union, which is expected to alleviate the intense recourse to bank financing, specific to EU economies.

Forthcoming Basel regulations on credit, operational risk, FRTB weightings

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