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# EXECUTIVE SUMMARIES OF THE SESSIONS

Key outputs from the sessions

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# CHAPTER 1

# MACRO-ECONOMIC AND POLITICAL CHALLENGES

## Outlook for the EU27 economy

Europe is doing better politically and economically. Despite a firm cyclical recovery, which is broad-based across countries and sectors, the EU faces deep-rooted structural weaknesses and imbalances. Faster progress on structural reforms is the most effective way to improve the business climate, raise productivity growth and reduce unemployment. A more practical approach to EU capital market activities is also required to stimulate economic growth.

### 1. The ongoing recovery provides an opportunity to reform

#### 1.1. The euro economic expansion is continuing and becoming increasingly resilient

The euro area recovery has strengthened over the last year. The dispersion of growth rates among the euro-area countries is at its lowest level since the launch of the euro, so the recovery is encouragingly broad-based.

The economic expansion is now firm and driven by domestic forces and the labour market has notably improved. The euro area economy has enjoyed 17 consecutive quarters of growth, and this momentum should continue. Years of investor pessimism are now morphing into cautious optimism.

#### 1.2. But there is no room for complacency: the EU still faces deep-rooted imbalances

Unemployment levels have fallen significantly; it has been a job-rich recovery. Employment in the euro area has increased by almost 7 million since mid- 2013. Together with increasing household wealth, this supports the private consumption outlook. However, there is still concern about youth unemployment, which has not greatly improved.

Several countries have limited buffers to cushion them against shocks and they could face higher borrowing costs when the current monetary stimulus is gradually reduced. They need to rebuild buffers and put public debt-to-GDP ratios firmly on a downward path.

Convergence to the EU or euro area average is very strong and making steady progress. However, in the original 12 eurozone members, convergence stalled a long time ago. There is actually economic divergence. It calls into question the promise of higher incomes through deeper economic integration, one of the original motivations for the monetary union. This lack of convergence is closely linked to slower productivity growth in countries with lower initial income levels. However, amongst newer members with lower initial income levels there is convergence. In those economies that do not suffer from structural rigidities, there is a formal process underway whereby lower per-capita incomes have more room to converge. That does not occur when countries are characterised by structural rigidities and weaker productivity growth.

#### 1.3. Lagging countries need to implement structural reforms to make their economies more flexible and productive

Recent IMF research shows that structural reforms tend to have a larger impact in countries with lower initial levels of productivity, so reforms can boost productivity more in the countries that need it the most.

The EU Commission makes country-specific recommendations (CSRs) to Member States, but the implementation record across Europe is very weak. There are many product-market reforms which would be very easy to liberalise, such as entry into markets and distribution networks, both retail and wholesale. They entail a fiscal but not a budgetary cost.

In the energy market, Italian firms pay substantially more for their electricity than German firms. That should not be a characteristic of an advanced economy in a union like the EU. Many other retail sectors could be liberalised, such as professional services. Equally, the discrepancy between Greece and Denmark regarding the cost of prescription drugs is huge. That is caused by barriers to entry and restrictive practices.

However, these issues are well known and there is no lack of effort by the Commission. The issue is vested interests and the difficulties that governments have to liberalise. There are other more difficult structural reforms, like labour-market reforms, that may have budget implications. It is disappointing that progress is very slow on this. The last five years would have been better if there had been more structural reforms, rather than reliance on accommodative monetary policy and demand management. When necessary, there could have been a more balanced policy framework

### 2. A more practical approach on EU capital market activities is required

#### 2.1. Ensuring that existing rules further the goals of the CMU and are sufficiently proportionate to stimulate rather than stifle economic activity

One weakness of the upswing is that, while savings rates are extremely high, investments are low. Investments are notably low among SMEs. They need much better financing and much more availability. The Commission therefore has launched the Capital Market Union (CMU) with many appropriate initiatives.

Much more needs to be done to reach the desired situation of pension funds, life-insurance companies and others letting financing flow notably into securitised vehicles coming from the SME sector. In many countries there is a lack of infrastructure on the ground for securitisation; the current regulatory framework is not appropriate and leads to disincentives that hinder EU banks and investors. In the US, by comparison, it is possible to go ahead with an asset servicer and a rating agency, assets are then bought and investments are made. Europe has a long way to go on that. In such a context, another regulatory approach is required at the EU level, notably to develop securitisation in order to favour the financing of SMEs. It should be more practical, and involve more on-the-ground discussions with investors about the barriers.

The SME sector is also hurt by risk weights that have become extremely high, making it difficult for banks to get returns. Many bank CEOs in Europe say that they are gradually reducing their SME lending because that is the only way that they can improve their return on equity. In addition, if the banking system and institutional money faced higher risk weights ("Basel IV"), SMEs would face significant financing problems in EU countries.

There have been marginal improvements in the last 20 years, but Europe does not effectively finance ideas and take risks like the US economy does. Europe does not grow small companies into big ones at a global level. One should also question why the Nordic countries are more successful in this respect than the rest of mainstream Europe.

### 2.2. Bank-based financing still remains too high on average in Europe

A more practical approach to the capital-markets area is required. After the financial crisis one voice in Europe believed the financial system in the region gradually needs to become more capital-markets-oriented. A year ago, the European banking system had €25 trillion in lending while US banks had $12-13 trillion. European capital markets have not been able to develop despite the CMU project.

There needs to be a starting point in terms of regulation and new rules, with infrastructure in place. Equity instead of debt financings need to be boosted at EU and national levels so the financial system can better serve and support growth. It is SMEs that possess the new ideas and they need financing conditions that make it possible for them to carry out their projects.

### 2.3. CMU is moving too slowly

EU public decision makers have set their high-level agenda reasonably well, but investors also have to be heard; they want to invest money, and see part of that investment placed in SMEs. The practical barriers, and some of the regulatory barriers, have to be taken away. There is also Solvency II, which was not fixed during the last round. SMEs still face structural barriers preventing access to public markets due to higher information asymmetries, high fixed costs, underdeveloped ecosystems and relatively low demand from institutional and retail investors.

The IMF is fully supportive of the CMU and works very closely with the Commission on various initiatives. In the most advanced capital markets within the EU, stock market capitalisation is 60%, indicating an excessive reliance on bank finance. There are problematic risk weights on SMEs, but the aim is to make banks safe and not have recourse to the public sector in the future. Diversifying away from bank finance is very important. The EU needs to move towards other avenues, such as venture capital or private equity. The CMU is the right initiative for that, but the building blocks are taking time.

One overriding objective of the CMU is to address the problem of countries too small to attract a global investor base. The CMU needs to aim for an integrated capital market, with a harmonised framework in terms of listing requirements, prospectuses, exchanges and so forth. In the US, each state can capture a nationwide as well as a local investor base, and that is what a CMU should aim for.

The securities that the public should invest in should be standardised, transparent and tradable. Where that happens, investors then start to flow in. That has happened with large corporates in Europe; the same type of marketplace has to be created for SMEs, which is more difficult. This is about securitising much smaller assets. There are many practical hurdles; though there should indeed be prospectus requirements, a more practical investor approach is preferable.

Smaller countries do not have sufficient liquidity in their markets. However, they are very reluctant to lose their national stock-exchange champions. Europe would be greatly helped by a concentration of liquidity on a pan-European basis in certain centres.

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## Deepening the EMU: when and how?

During this exchange of views dedicated to the deepening of the EMU, a broad consensus emerged on the existence of a window of opportunity to address the weaknesses of the euro architecture and more specifically on the need to complete the Banking Union and implement the Capital Market Union, which are essential to the strengthening of financial integration and private risk sharing in Europe. But there was no agreement among the ministers either on the level of ambition regarding the deepening of the EMU or on the priorities of a fiscal union.

### 1. A wide consensus on the current window of opportunity to further strengthen the Economic and Monetary Union

All the ministers were of the view that Europe is not 'at the end of the road', but at its beginning; that there is a unique and historic window of opportunity to complete the Eurozone. Due to the election cycle in Europe, the two leading countries of the Eurozone – France and Germany – are now ready to improve their dialogue, engage in discussions, and put some proposals on the table. There is also an economic recovery all over Europe; all the ministers believed that now is the time to improve the functioning of the Eurozone, and to address the issues that Europe has not been able to deal with in the past, because of the economic crisis.

The Chair observed that there is now an appropriate momentum that Europe is obliged to make use of. There is also a broad agreement that Europe needs to complete its Banking Union and work on its Capital Markets Union, which are important, if complex, issues. One official commented that the window of opportunity will only last for perhaps 18 months to two years, but this does not exclude the possibility of progressing step by step. There is also the need to be clear that the purpose of an increasingly integrated Eurozone is more growth and more employment for all European citizens, and improving their quality of life, as well as defending with stronger tools Europe's interests in relation to the United States and China.

### 2. A broad agreement on the need to complete the Banking Union and implement the Capital Market Union

According to all the ministers, it is important to strengthen financial integration and private risk sharing. One official pointed out that the first step towards strengthening the Euro area is to complete the Banking Union in less than one year; Europe needs to complete the resolution pillar as a matter of priority; it has indeed to make progress towards a European scheme for deposits; and it needs to reach an agreement on the Commission's risk-reduction package to further boost the financial resilience of Europe's banking sector.

Beyond this, particularly in the context of Brexit, Europe's capital markets should be further deepened in order to ease cross-border financial exchanges and improve the financing options for European economies; there should be more unified EU supervision of financial markets; and to enable the EU to have a degree of control over its financial stability, one official's country supports the European Commission's proposal on clearing services.

One of the most common debates on the future of EMU concerns the idea of risk sharing and risk mitigation, and in the view of one official, the best way to mitigate risk is to share it. Societies and communities have become increasingly global in order to mitigate risk, and have done so through mechanisms that increase the number of channels of risk sharing, and this official regards it as worrisome that some modern developments will distract the world from integration. The same is true for financial fragmentation: the best way to combat financial fragmentation is to complete the Banking Union, and completing it is key to the success of the monetary union itself; so this needs to be addressed urgently.

This also concerns the fiscal capacity of a monetary union; in this official's view, it is very difficult to conceive of a monetary union without a Treasury. Concrete steps need to be taken to create this key institution within a monetary union, with an automatic stabiliser as a starting point.

In another official's view, Europe needs the same rules, the same supervision, and the same crisis management for banking and for finance. The Banking Union makes the Euro area more attractive, as was demonstrated by the decision of Nordea to move their headquarters from Sweden to Finland but more needs to be done, as progress with the Banking Union has been very slow. To make further progress, it may be necessary to make clearer what risk reduction means.

The Capital Markets Union is still 'work in progress': insolvency legislation has emerged as the crucial element that is in need of some harmonisation. Here, as in many other fields, it is important to have the right level of ambition, and not to 'make the perfect the enemy of the good'.

There is also a debate regarding Non-Performing Loans (NPLs), and whether or not to take a European perspective on this. One official stated that they are convinced that there should be a European perspective, because this is a systemic problem, but each country should also deal with its own issues in this area. Banks, during this very difficult process, became more domestic, which is very detrimental to the success of the Euro area.

To break the bank-sovereign 'doom loop' once and for all, Europe needs to address the problem sovereigns can pose for banks, and in doing so, risk reduction and risk sharing must go hand in hand. Further reduction of risk would be achieved by reducing the concentration of sovereign risk on bank balance sheets. Diversification rules on bank holdings are thus necessary to increase banking sector stability, although such rules can limit the sovereigns' ability to finance themselves. Sound fiscal policies and public debt reduction are a key precondition for a sound and healthy demand for sovereign bonds, but only by sharing risk in the form of a truly European safe asset can Europe achieve continuous market access for sovereigns in face of the diversification requirement.

### 3. Different levels of ambition regarding the deepening of EMU have been expressed

An official stated that the financial crisis has shown that Europe's economic union has elements missing that ought to protect it against a dangerous situation, and reforming the EMU means putting these elements into place. The most important goal is to achieve agreement about the strategic vision, and to 'set the rules of the game' for decades to come, although Europe is not ready for treaty changes.

Another official stated that the first goal of deepening the EMU is to protect the monetary union from asymmetric shocks; a good example of this is unemployment insurance. This helps convergence and is robust, but is too country specific and idiosyncratic, and gives rise to moral hazard problems. Portugal, among other countries, is implementing very ambitious reform programmes; but Europe should not make the common mistake of believing that any reform can generate its own demand. Both supply and demand need to be addressed, and Europe needs to generate conditions and allow time for the ambitious and successful reforms that have been implemented in European countries to achieve success.

Another official stated that the first step is to complete the Banking Union and further strengthen EU capital markets; the second step is fiscal integration, meaning tax convergence and the creation of a budget for the Euro area. Europe must also be very clear that the purpose of this budget is the funding of innovation, education, and new technologies, with the ultimate goal of producing more innovation and growth within the Eurozone. The third and last step will be economic integration, because adjustments cannot be made through exchange rates; Europe needs to find internal adjustment mechanisms. Structural reforms are required to improve the productivity of Europe's economies and ensure that markets work properly but a greater coordination of economic policies at the Eurozone level is urgently required to improve the level of growth and employment. The question of whether there should be a Finance Minister of the Eurozone, in this official's view, should be decided at the end of the process.

In another official's opinion, the key is to maintain the right balance between moving ahead and making sure that those present carry the people of Europe along with them. They need to ask where Europeans can do more together, and where they can be more effective together than separately. There should be a discussion about how to collect and use EU money in ways that allow for flexible response and support stability but more than anything else, the Euro area needs economic reforms and prudent fiscal housekeeping at the national level.

### 4. Different priorities regarding the Fiscal Union

An official stated the first question in relation to the fiscal issue is about the tax resource, and whether there should be a European resource, or a sharing of national resources that will fund the fiscal capacity of the Eurozone. The second key question, which is directly linked to the first, is the level of fiscal capacity; if Europe wants its fiscal capacity to be efficient, in this official's and in Emmanuel Macron's view, it needs a strong fiscal capacity, or otherwise it risks a limited Eurozone with limited ambitions and results.

The third question is the purpose of that fiscal capacity, which in this official's view, encompasses three purposes: (i) to address the question of asymmetric shocks, (ii) to deal with the issue of investment – in innovation, Big Data, new technologies, universities, education, and everything else that is linked to the future of the new generation – and (iii) the question of solidarity, and whether this should be considered in the context of fiscal capacity, such as whether there should be a common answer on unemployment.

Another official stated that the European Union should be regarded as a coordination device from an economic perspective. Included in this device are some key aspects of integration, convergence, and fighting against asymmetric shocks. As it stands, the EMU is creating divergence instead of convergence, but with confidence reinforced and clear mechanisms of shared risks and responsibilities, it would be possible to foster integration within the Euro area and create a fiscal capacity, which is in the interests of each country in the European Union to complete this coordination device with a fiscal capacity.

If convergence is an important issue within the Union, it must be understood that this is a very long process, and a long term perspective needs to be taken. Europe should not keep on challenging institutions, but should stick with them and complete them. Investment is also a critical issue in relation to fiscal capacity: it is vital to reduce some of the moral hazard problems that exist when sharing is increased. All European countries need to increase their production capacities, and if they do so, they will also reduce the extent of risk aversion that is felt in relation to making this step forward.

An official stated that private risk sharing is not enough; public risk sharing also has a role to play in strengthening the EMU. The central fiscal capacity for asymmetric shocks is another very important piece of this 'mosaic', because Europe has to compensate for the loss of national monetary policy and help Member States during the cyclical downturn. However, he stated that fiscal capacity does not replace the need for fiscal discipline; fiscal rules are a very delicate issue, as is enforcement. There are only two ways to improve rule enforcement: either a stronger centralised authority or more market discipline and there is no better approach than to go back to basics. A reform of the Stability and Growth Pact (SGP) might also be very difficult, but it is better to change the rules due to their "flexibilities" than to avoid doing so.

Another official stated that it is very important that European governments should take responsibility for their own countries; countries need to reform because it is in their own interest, not because the EU has told them to do so. There is also a very important debate about transforming ESM into a European Monetary Fund (EMF); in this official's view, an EMF is about finding a base to make better use of market discipline, and to make private creditors share the burden, if necessary. The official was not convinced by the need for a fiscal union that is about 'sending money to each other', but those countries that like the idea should go ahead with it and demonstrate that the system works.

The official stated that they also agreed with a previous speaker that Europe should coordinate, rather than enforce, policies. Defence, security and migration are the most important areas of cooperation; Europe should make full use of its fund reform, and should also consider how it can make better use of the EU budget for those important purposes. In general, a right balance needs to be found between solidarity and responsibility, as well as between risk-reducing and risk sharing. The most important thing is that Member States should take a high degree of responsibility for their own economies and their reforms.

Another official stated that there are points of agreement between the panel members: they agree with the need to take an inclusive approach, and to increase investment within the Eurozone, particularly compared with China. The official also agreed that the starting point of a stronger Eurozone is reforms within each Member State.

An official pointed out that they are convinced of the necessity to continue with further integration; to them, the 'endgame' is fiscal union. They agreed with the previous speaker who proposed that an initial group of countries should form this fiscal union, and that taking a step by step approach is important. Although the endgame is fiscal union, European countries first need to 'do their homework' by addressing legacy issues such as NPLs and implementing structural reforms, notably to improve the business climate and foster the potential growth in their countries.

Regarding fiscal capacity, the official recalled that during the Slovak Republic's presidency, they proposed an unemployment insurance scheme, which was a scheme that would help European publics to understand the role of the Eurozone and of the monetary union. The official noted that they are not proposing permanent transfers; this is not about structural unemployment, but about cyclical shocks and sometimes helping countries that require assistance. They added that they agreed with the need to address the investment gap that exists between Europe and, for instance, China: money needs to be put into transportation, new technologies, and digitalisation, via joint funds.

In response to a question regarding how to not only complete the Banking Union, but also how to improve the effectiveness of its existing pillars. The Chair pointed out that home bias has increased tremendously during the crisis, so there is less financial integration today than 10 years ago. Addressing this has to be high on Europe's agenda.

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## Economic and financial priorities for relaunching the Eurozone and the EU

### 1. A window of opportunity to complete the Economic and Monetary Union (EMU)

Europe is coming out of a crisis, growth is picking up, but potential output growth is weaker than hoped. Much of this is due to a downturn in public and private investment which is nowhere near the levels Europe was seeing 10 and 20 years ago. There is an obvious need to further integrate markets, to deepen and complete the EMU, including the Banking Union. The issues that need to be discussed are potential growth, the role of investment, reducing the fragmentation of markets and increasing the coherence of monetary union. A public representative stated that Europe does not have room for complacency; it needs to make progress, and the Juncker road map is important for doing so.

The Euro was a major step for the European Union. There was a belief in some circles that the Euro was doomed to failure because it did not satisfy the requirements of political resoluteness and planned economic governance to compensate for its divergences and lack of complete prerequisites. In one official's view the EU relied too heavily on monetary policy. Supervision took place at a national level, with a large number of 'cosy' relationships between governments and domestic banks; fiscal policy was also nearly completely within the remit of national governments. The international financial crisis thus found Europe wanting and unprepared, with macroeconomic imbalances that were not being addressed. This then led into the crisis, and then the Euro debt crisis.

'Consolidation', or austerity, was tried, but in a number of countries led to a popular reaction, and Europe therefore started talking about growth friendly consolidation. The EU became fully growth oriented with the Juncker Plan and the European Fund for Strategic Investments (EFSI). In this sense, Europe had 'lost 10 years' through very weak growth.

There is currently an incomplete architecture within Europe, and rather than talking about visions, experts should talk about the Banking Union, the Capital Markets Union and a more effective economic policy coordination. Trust needs to be instilled from a political angle due to the constant risk of moral hazard, and it needs to be borne in mind that no country wants to finance others' debts unless their own finances are in order.

Jean Claude Juncker has said that the EU should 'start repairing the roof while the sun is shining', but the EU also needs to identify its path forward. There are many instances in which the EU is in a quandary as to the question of public investment. With public investment, governments are not sure how to spend money on capital projects; fiscal rules hold the EU back. The official added that Jean Claude Juncker mentioned setting up a task force on subsidiaries and proportionality; for small countries, and this is a very important question.

Another official stated that the euro has been such a strong element in holding the union together; there should also be a high priority for fulfilling the incomplete Economic and Monetary Union, which also applies to the Banking Union and Capital Markets Union. One area that should be amended is the creation of a common insurance deposit scheme, as 'a euro [should be] a euro' in every country not only when an individual has cash, but also when they have money in an account.

European countries have three different ways of working together: first, old fashioned methods of bilateral or intergovernmental corporation, sharing sovereignty, and having clear responsibilities of exclusive competencies, which is at the national level and should be accountable under democratic control of the national parliament. Secondly this should not be confused with the responsibilities that have been transferred to the European level. Europe should not believe that competences have been effectively transferred to the European level, when they are still largely de facto controlled at the national level. Thirdly if the goal is further European integration, there needs to be alignment of sovereignty and responsibility on the one hand, and legitimacy and accountability on the other hand.

An expert added that the EU now needs to ask itself whether it is going to be serious in fighting against fragmentation, in the governance of the future strengthened European Supervisory Authorities, and in other fields. The world is very dangerous, and has changed dramatically; the EU has to be serious in acting together in a sovereign manner. If the EU denies that it wants to create something together, it will be defeated on the world stage.

### 2. Fostering investment is a key priority

Weak investment remains a major concern for Europe. Boosting productive investment, and notably public investments, is an urgent priority. An expert stated that investment and innovation should come first in all policies, which in the EU does not currently happen. They hope that in the financial sector, companies, institutions, the European Parliament, and elsewhere, the talents of 100% of the population will be better employed by closing the gender gap.

European economies are recovering, but it is surprising that investment is still so weak at this stage. The problem is both on the corporate and public sides, but is more acute on the public investment side. Public capital formation is very weak and remains far from pre crisis levels, and if this is maintained over a prolonged period, it may lead to a deterioration of public capital and diminish longer-term potential output. Corporate investment is performing somewhat better, particularly in the core. Europe's embrace of the knowledge economy remains a concern, having been overtaken by emerging economies, particularly China.

The EIB will increase risk appetite, particularly under EFSI and the investment plan for Europe, and continue to deliver more equity and risk sharing with capital constraint commercial banking to try to stimulate lending by commercial banks to SMEs. There should be more direct lending to innovative mid-caps. Hopefully, the EIB can undertake more PPPs and particular credit enhancement to try to increase private sector investment in infrastructure through credit enhancement. On the public investment side, the EFSI has been designed to maximise the efficiency of public spending and to stimulate private market-based investments. The recovery will not be fully sustainable without a recovery in public investment; on the potential output growth rate, the latest estimates from the ECB are 1% for the Eurozone and between 1% and 1.5% for the EU, compared with 2% for the United States.

Weak investment is a major concern for Europe, and the appropriate policy mix of different structural reforms, both at EU and national levels, is the right way to tackle this investment gap. The Juncker Plan promises to be an efficient instrument in addressing the regulatory and administrative barriers to investment through the combined actions at EU and Member State levels, and the Commission has launched a number of initiatives to improve the investment environment.

For there to be more investment, removing barriers to create a more investment friendly regulatory framework is necessary. It is also essential to have a public component. Two days ago, there was political agreement on EFISI 2, which will extend its duration and increase its investment capacity. In addition, the European Investment Advisory Hub will play a bigger role in providing technical assistance to project promoters at a local level, so that even more regions and sectors will benefit from EFSI. A macroeconomic stabilisation function in the Eurozone also needs to be set up in order to build up a stronger EU investment capacity; the EU Commission should propose a concrete roadmap in this respect by the end of the year. If Europe chooses to deepen the EMU, there also needs to be an effort from Member States to understand the need of pooling resources.

Recessions, particularly asymmetric economic shocks, are bad for trust; recovery and convergence can help create a positive dynamic. The EIB has effectively doubled its balance sheet in the last decade over the crisis years to approximately €600 billion, as a quasi-form of debt mutualisation; member States trust the institution to spend it wisely because of good governance and a clear set of rules that the investments being financed make economic sense. Additionally, if the EU is going to risk share and increase public investment, the rules have to be very clear that there will be good, solid and well-assessed investments. The Chair commented that trust is based on rules and the legitimacy and accountability of politicians and institutions. Rules should be adhered to, and where there are no rules, these should be created and legitimised.

An official added that Europe is a market economy, whose markets are functioning less efficiently than in other large jurisdictions; an inefficient market transmission requires more units of money to achieve the same results as a better functioning product and labour markets. This is an issue mostly dealt with at a national level, and the progress that has been made in this respect needs to continue. Secondly, the EU has been growing for 17 quarters in a row and 12 quarters in a row above potential; it will close the output gap in the next quarter or two. The EU's participation rate is higher than the US, and there is little margin to take from the participation rate in order to improve productivity. The official hopes that the increased optimism seen in the Euro Barometer materialises, and that people will have more children; without migration, European countries will face difficulties.

### 3. Further integrating EU banking and financial markets in order to contribute to more growth

An industry representative stated that there is a need to find the right balance between integration and diversity. Integration needs harmonised rules; harmonisation, however, should not lead to a 'one-size-fits-all' model. A big threat to that is the output floor in Basel IV. However, there are fragmentation issues that can be addressed by removing obstacles to the Banking Union that contradict the funding principle of the free flow of capital. In order to reduce the fragmentation of the banking market, Europe needs European champions: large banking groups are better placed to take on risks and contribute to the financing of the European economy due to diversification effects. As such, there is a paradox: the Banking Union needs a simplified structure, but has been confronted with national and European public authorities as well as a multiplicity of supervisors, which has created legal uncertainty and instability.

Differences across countries are to some extent natural, and not necessarily bad. On the other hand, there are certain differences due to unresolved legacy issues: non-performing loans, low cost efficiency, over banking capacity and inappropriate business models, which deepen the fragmentation in the banking sector; these should be addressed. The first line of responsibility lies with the banks that have to adjust their business model to the new environment, and public authorities, regulators and supervisors must provide the proper incentives. Much has already been done on the normative perspective; what remains to be done is dealing with the remaining national options and discretions in the banking regulatory framework, and building the third pillar of the Banking Union.

Policy makers need to be pragmatic, and remember that the Capital Markets Union is not a panacea; it will take time to evolve. For some time, banks will remain the main channel of financing for companies. Solving legacy banking sector problems and implementing measures to reduce risk throughout the EU should be a priority. It is important to keep in mind that subsidiaries hold the deposits of local businesses and citizens. The responsibility for these still lies with the national governments.

On the other hand, the capital and liquidity waivers are discretional and may be applied differently to each banking group and subsidiaries in different Member States. This may lead to regulatory arbitrage and deeper fragmentation. The precondition for deeper integration in the EU is trust, and trust is built on sound rules that take into account the interests and concerns of all parties involved. A public representative added that what ultimately creates a level of common trust is realising the level of interdependence that sharing a currency and institutions provides.

### 4. Advancing an open and connected Capital Markets Union for European growth

Europe is in much better shape than before. However, Europe is well below the pre-crisis level in terms of capital flows; this is the result of fragmentation, which does not just mean fragmentation in the financial market but also fragmentation in regulation and supervision. It is very important, for example, that the EU should look at wider institutional frameworks like insolvency law and repossession procedure. Europe has segmentation in national budgets, and has not yet come to terms with pooling risk sharing, which affects investors' decisions. The completion of the Banking Union has been suggested; this is very important, along with completing the Capital Markets Union.

Where there is fragmentation, one way for investors to feel comfortable is to invest in securitised products and diversify risk, if the former are well packaged. A deeper, well-regulated and well-understood market for securitisation will help to tackle the problem of NPLs, which also create segmentation in Europe's financial markets. In looking at banking and financial market risk reduction and sharing, Europe must always start with risk reduction, because Europe is not yet ready for risk sharing. However, the European institutions' ambition and plan is exactly the right strategy, and has to be pursued in earnest.

### 5. Conclusion

Europe is faced with an incomplete architecture, and is confronted with a huge political choice regarding where and how sovereignty is exercised, in the context of a 'baroque' institutional architecture. Without cross-border investment, there cannot be the degree of risk dispersion that is necessary in balance sheets. The differences in national rules and regulations in liquidation and resolution cases are striking; complete harmonisation is out of the question, but the EU must find a means of dealing with this, in order to make sure that it does not become an additional cause of fragmentation. This can only be achieved if there is political and economic trust.

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## Challenges and conditions for a normalisation of EU monetary policy

### 1. It is time to discuss policy normalisation and the unwinding of the asset-purchase programme

#### 1.1 QE has contributed to economic growth and deflation risk has disappeared

The asset-purchase programme and the ultra-accommodative monetary policy of the ECB have contributed to four areas of great progress. First, borrowing costs in the euro area are no longer an impediment to overall financial conditions, which are as easy as they can get for households, companies, banks and sovereigns. Every interest rate in the eurozone is about zero. This was done deliberately by the ECB, which has competently achieved appropriate financial conditions.

Secondly, financial fragmentation has been an issue since the onset of the crisis and there is now much greater homogeneity in terms of the monetary-transmission process than there has been for a long time.

Thirdly, the economic recovery in the Eurozone has sometimes been undersold. The second quarter was the 17th consecutive quarter of positive growth in the euro area. Since the third quarter of 2014, growth has consistently been above potential. The recovery has been in its reflationary phase or growth trajectory for 12 consecutive quarters. Europe may be at the peak of the current cycle. There is reason to believe that momentum can be continued, but this is still a significant achievement, where monetary policy has played a role.

Fourthly, the main rationale for starting asset purchases was a fear in 2015 that the eurozone was sliding into a negative spiral of falling prices, postponement of spending and a further fall in prices. That deflation risk and all indicators of the market prices deflation risk have completely gone.

Given those four factors, now is the time to talk about unwinding and policy normalisation. There is a highly expansionary monetary-policy stand, with regard to standard measures and non-standard measures. Some of the unconventional measures were discussed under the headline of deflationary risk, which no longer exists. Speakers shared the view that the ECB and other central banks have been successful in preventing a period of disinflation spiralling into one of deflation. This is a clear success.

#### 1.2 The strength of the euro is not a reason for postponing normalisation

The exchange rate appreciates in anticipation of policy normalisation, but that is no reason to postpone policy normalisation. The strength of the exchange rate is mainly endogenous. It is a reflection of the strength of the eurozone economy, and not due only to factors exogenous to the eurozone. If it were only due to the weakness of the rest of the world, it might be more problematic, but it is mostly endogenous so there is less reason to worry about exchange rate developments than there would otherwise be.

There has to be gradualism in the winding-down process, so the exchange does not overshoot and unnecessary volatility is not created. That is something to be aware of but it is not so existential that it should change the path.

#### 1.3 Sustainable adjustment in the path of inflation consistent with achieving inflation rates below, but close to 2% over the medium term should guide the withdrawal of the asset purchase programme

Success rested on the use of both conventional and unconventional measures. Normalisation should not only be discussed in an instrumental way; it is also important to discuss the economic basis and look at the inflation rate and its long-term development. Unlike the Federal Reserve, which has a dual mandate, the ECB has a single mandate with regard to the inflation rate. There is a discussion worldwide about downward natural trends in the inflation rate. There may be different reasons for that, such as a savings glut and the effects of changes in income distribution, but it will also have effects on central banks.

The basic mandate of Central Banks is to avoid deflation and high inflation, but it is difficult to translate this mandate into numbers. There are different approaches here. For instance, the Swiss Central Bank has an upper limit but no lower limit, while others are discussing a range. The ECB definition of price stability has proven its worth in the past and has to be seen as a medium term goal. There is therefore no reason to change it.

It is also necessary to look at core inflation, which does not include energy prices. No Central Bank is able to control energy prices. In the coming months, it may be important to remember to distinguish between stability in the core inflation and a trend in the right direction, where the overall inflation rate fluctuates according to energy prices.

#### 1.4 The longer ultra-loose monetary policy conditions persist, the more the risks increase

Prolonged monetary easing comes with diminishing returns. Growth and inflation is also influenced by structural factors.

Loose monetary policy is not sufficient to achieve sustainable economic growth. Lack of structural reforms can limit the effectiveness of the policy measures over time.

The longer ultra-loose monetary conditions persist, the larger is the risk of unintended side effects. Loose monetary policy has stimulated risk-taking in financial markets, so asset prices can grow out of sync with real economic developments. The imbalances created might become unsustainable once monetary conditions are normalised. Furthermore, market discipline has been reduced by the abundant availability of liquidity, distorting the risk compass of investors and contributing to a misallocation of resources.

As time passes, the costs and vulnerabilities of these measures are increasing, while the benefits are decreasing. They also have a consequence on the distribution of wealth. As the risk for financial stability grows the longer the Central Bank has to implement a loose monetary policy, it is important to identify and implement appropriate macro-prudential policies in order to react to a potential bubble in some asset classes. Asset-price bubbles in Europe are not a general problem, unlike in the US.

The ECB's decision to buy corporate bonds was the right decision at that time. However, today, the distortion effects outweigh the positive effects of stabilisation. While there is a positive market effect for corporate bonds, it is increasingly difficult to explain why big companies are being supported. Every action taken by a central bank has a certain distortion effect.

## 2. The challenges to deal with in normalising ECB monetary policy

### 2.1 What does normalisation mean?

The Central Bank is concretely talking about winding down its programme of asset purchases. That is not the only instrument in its toolbox. However, everyone in the Council agreed that interest rates would not be touched until well after the programme was wound down. In any discussion about normalisation in the field of unconventional policies, there is a discussion about timing, volumes and structure. It is not a discussion about putting the brakes on expansionary monetary policy but rather about slowing down the acceleration.

### 2.2 The stock of assets on the balance sheets of the ECB will remain elevated for a significant period of time

The stock of asset purchases residing on the balance sheet will be maintained after phasing out monthly net purchases. There will be a continued presence in the markets, because that reinvestment policy will gain importance over time; more and more transactions will have to be conducted in the spirit of reinvesting the current stock.

In the market generally, attention is mostly on flows rather than stocks, because flows mean trading opportunities. However, there is empirical evidence from the US that while flows matter, it is more about stocks. The stock of assets residing on balance sheets will remain elevated for a significant period of time, and will influence prices in the market. When talking about timing, all aspects of growth can be seen coming back. There is buoyant internal demand and it is a very clear message that Europe will reach its goal in the medium term.

Accommodation in such a buoyant environment is even more expansionary, and therefore acceleration can be slowed. The decision to phase out unconventional measures will be implemented gradually. And there will still be conventional measures and the stock will keep growing or stabilize, supporting growth and price stability goals over the medium-term.

### 2.3 The precautions to be taken and the way forward

Normally in advanced economies, monetary conditions in one part of the world are affected by what happens elsewhere. This is even more so when in the presence of unconventional monetary policies. The evolution of exchange rates reacts to the short-term state of the economy and, in the long run, to the prospects of productivity. However, monetary affairs also play a role; for instance, the evolution of the euro exchange rate in recent years has been a reaction to the evolution of unconventional policies on both sides of the Atlantic.

The comments about the normalisation of monetary policies fundamentally apply, principally, to the US. It is critical that the ECB should introduce normalisation only after the US has done so. Otherwise, financial conditions will be indirectly affected by what has been done in the US.

The decision to unwind the QE that monetary authorities are confronting can be put in the context of confronting two possible mistakes. The first is well-known: acting too soon. The second is doing too little, too late. If action is taken too soon, it can lead to recession and deflation in the near term. If action is taken too late, bubbles are created, resources misallocated and debt is built. This hurts long-term growth.

Policymakers - mindful of potential short term costs - are careful to avoid the first mistake. They should think not only in terms of damage but also of the probability that the mistakes will be made, so there can be a very good diagnosis of what is going on and the extent to which that diagnosis is reliable. The dominant view in the world is the secular-stagnation hypothesis: it is a world of very low interest rates and, therefore, policy should not be normalised because these interest rates need a very lax monetary policy. However, estimates of the natural interest rate are very unprecise. Inflation is low, but it is not understood why.

There is much imprecision and uncertainty about the real state of the economy, so the possibility of the staying lax too long is high. In the US, there is evidence that lax monetary policy has created huge increases in debt, asset-price bubbles, and distortions in the risk premium, the bond premium and in high-yield markets. There is evidence in several indicators of financial conditions that may be stressed for certain non-financial corporates when interest rates start to go up.

In such a context, the second mistake, of acting too little and too late, is a significant risk. However, the US should be acting first because the EU is later in the cycle of economic recovery. Equally, the EU is still not a full economic and monetary union, so normalisation brings problems.

There was general agreement on the panel that the risks of being behind the curve are greater than being ahead of the curve. The decision that the ECB is about to take is one that the US took in 2013-14, when it started to wind down its asset-purchase programme. The eurozone is further in achieving its goals than the US was in 2013-14.

One measure to gauge the question of the two mistakes is the Taylor rule. In 2015-16 the Taylor rule was significantly below Europe's policy rates. That gap was filled by the asset-purchase programme, which has a shadow interest rate and, therefore, a further rate reduction that is not measured. Today, the Taylor rule is no longer below the main policy rate, so the rationale for asset purchases has gone.

One speaker was concerned about the ECB being dependent on the actions of a different central bank because then it would not be complying with its mandate. Global economic factors have to be taken into account, and what kind of underlying facts and impacts there are in the euro area, but what counts for the ECB is price stability. The international context is important because many basic developments are international ones. However, because the Fed has a dual mandate, whether the economy is improving is something of great relevance; it perhaps should have moved more quickly. The ECB has a single mandate and it might be necessary for a more encompassing interpretation of this mandate; otherwise, there could result negative financial stability effects.

In the long run, negative financial-stability effects may have negative inflationary effects. If this is seen in a more encompassing way, it can be reconciled. This is one of the main points of the discussion that has to be had within decision-making bodies. It is also a good argument for the well-proven maxim for central banks: always move with a steady hand, with no abrupt changes. That is, not to be behind the curve, but central bank credibility is based on a certain amount of stability, which may mean gradualism.

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## The economic, financial stability and trade implications of Brexit

### 1. On-going negotiations and possible outcomes of Brexit negotiations

#### 1.1. Main options for the UK-EU relationship post-Brexit

In the view of one speaker, issues concerning Brexit negotiations need to be considered at three different levels: (i) the grander level of political negotiations, including issues of access and equivalence; (ii) supervisory cooperation, covering licensing issues, access to data, information rights, and possibly additional issues such as supervisory rights; and (iii) other supervisory aspects, including the acceptance and monitoring of internal models, booking models and business model design.

Two main options would seem conceivable in terms of access post-Brexit in order to maintain existing EU-UK trading relations and avoid breaking up existing value chains, given that at the starting point UK and EU regulations are due to be strictly equivalent. The UK could either join the European Economic Area (EEA), which follows the same principles as the Single Market or negotiate a third country relationship with the EU through a Free Trade Agreement (FTA). Indeed staying in the EU Single Market is not an option and existing equivalence agreements based on individual EU regulations are too patchy to support trade flows of the volume and nature of those between the EU and the UK.

Some panellists however believed that the EEA option would not work politically. Any ambitious FTA signed with the EU also raises challenges, notably for agreeing on how to deal with the evolution of regulations and ensure that they remain equivalent over time. In any case, there will be a need for a transition period.

#### 1.2. The UK perspective

Ms May stated in February that her goal is for the UK to have a very broad and comprehensive trade agreement with the EU after leaving the single market; the first underlying assumption in the UK's thinking is that it wants to broadly preserve the same trading relationship. It is clear that this will involve a new paradigm, but this framework can be developed on the basis of many decades' experience in the integration of global markets, including that of the EU single market, a speaker believed.

There is an 'axiomatic connection' between the operation of market access, the underlying regulations, and the supervisory cooperation that is needed to support this. The three go together. The challenge is defining a set up that ensures that in 10 years' time, when the financial services sector is facing new risk and innovation challenges, UK and EU rules will remain congruent.

The UK envisages a structure that enables a process of constant dialogue in relation to rule making, allowing sufficient convergence between the EU and the UK and also with international standards. This is needed to protect financial stability in both jurisdictions, to preserve a level playing field and avoid duplication. Possible disparities should be manageable with such a process without losing trust. There must also be transparent and reliable arrangements for supervisory cooperation regarding cross border risk which should work both in normal times and in crisis situations. The UK understands that there are legitimate concerns within the EU about having significant exposure of its financial system to a third country, which the UK will help to address. Finally, as with any FTA, there will need to be a dispute resolution process.

A panellist stressed that although preserving the current trading relationship on broadly the same kinds of activities post-Brexit is the UK's goal, this will only be achieved if it is also a shared goal. Europe also needs to clarify its goals for the new single market and how relationships with third countries will be managed. Any agreement needs to be reciprocal, not just for reasons of fairness, but because the UK hosts more branches of EU and foreign banks than almost any other jurisdiction in the world, which exposes the UK to considerable risk. Although the problem was not jointly created, the EU and UK need to work together to define how their markets will be operating in 5 to 10 years' time, otherwise the outcome will not be satisfactory for both parties.

#### 1.3. The EU27 perspective

Although possible options have been clarified, no significant progress has been made over the last year and the possibility of a hard Brexit is still on the table. Additionally, although the EU27 recognize the importance of building a good relationship with the UK, their highest priority is the future of the EU27 and issues such as the economic union and migration, a speaker stated. Enterprises and financial institutions will shortly need a clear view on the future scenario and will need to prepare for a hard Brexit if the current political process cannot provide an answer.

The first aspect stressed by the EU Council is that a country leaving the single market cannot have the same status as those that are in the single market. There has to be a difference. There is nevertheless the potential to preserve a fairly integrated EU-UK market, but this depends on the choices made by the UK and whether the UK is willing to meet the conditions for preserving market access to the EU. There has to be a compromise about taking back control in the areas of regulation, supervision, and jurisdiction and there can be no 'cherry-picking'. The main conditions are the following: (i) the continuation of a level playing field; (ii) for any future UK regulatory framework to safeguard financial stability in the EU and respect its regulatory and supervisory regime; (iii) a very close supervisory cooperation to ensure a continued similarity of regulatory frameworks; and (iv) effective enforcement and dispute settlement mechanisms that fully respect the autonomy of the European Court of Justice (ECJ) as the sole and final interpreter of EU law. The UK would also have to accept the 'full EU package' if it wants to maintain its present position vis-à-vis the EU during any transition period.

Another panellist stressed that even if a very good trade agreement is reached between the EU and the UK, the EU should not accept mostly relying on an offshore centre for the financing of its economy. In addition in case of a crisis, the EU needs to have sufficient powers to mitigate potential risks to its financial stability.

### 2. Addressing the impacts of a possible hard Brexit

#### 2.1. Macro-economic impacts

The frictions and constraints in the market caused by Brexit will come with a cost and less efficiency compared to the present integrated market, which will ultimately be borne by consumers and companies. Moreover, bilateral trade agreements with non European countries will not be sufficient for the UK to offset potential losses of market access to Europe. However, one speaker believed that some of the risks and impacts associated with a hard Brexit may have been somewhat overstated. Traditional economic mechanisms will come into play: the UK economy will adjust through the exchange rate, increases in costs and a real wage squeeze. These are real issues but not necessarily 'the end of the world'.

Another speaker thought that there is however a mutual obligation to minimise impacts, as the fragmentation of markets will reduce liquidity and increase risks, not only for the UK and the EU, but also for other jurisdictions in the world with which they trade. There is a need to avoid a solution that works well for supervisors but does not work for firms and businesses with an unacceptable level of extra costs.

A third speaker stated that these costs would mostly be "interim" costs and would stabilise over time. Most of the actors involved have developed ways that will allow them to continue to service their clients whatever happens, even if there is still a certain degree of uncertainty. What will need to move will move, although the timeframe might differ across activities, therefore, there should not be a major reduction of capacity, financing, hedging, or servicing clients.

### 2.2. Minimizing impacts on the financial sector and end clients

A panellist commented that the main concerns of financial institutions and their clients are contractual certainty, the preservation of core financial services' supply chains and access to liquidity, hedging and funding. Regarding legal aspects, English common law will probably remain the basis on which corporates engage in order to ensure continuity. Another challenge is that over the next 18 months to two years, the financial industry needs to deal with many other key projects such as MiFID II and the GDPR data regulation. Larger corporates have the ability to manage these different changes, but SMEs will be disenfranchised, which is the most worrying issue.

The first goal of the Brexit negotiations, another speaker claimed, should be to 'do no harm' to the different customers of financial institutions. To achieve this, the starting point is to ask what needs to be done to avoid expensive fragmentation of a global capital market, the cost of which will be borne by customers, not only SMEs but also multinationals, and making sure that Europe does not disadvantage its own banking sector. The European recovery must not be endangered by Brexit, particularly as the EU27 have a high degree of dependence on the banking system: around 80%, as opposed to 25% in the US. Europe needs to push for an economic, rational perspective, rather than potentially expensive political positions, taking into account the fact that the current level of access and integration cannot be maintained with the UK leaving the EU Single Market.

The speaker envisaged access to the EU consisting of four elements likely to provide clarity. (i) The scope of the agreement should comprise the capital markets system and the wholesale insurance system that provide the EU with access to global markets and global risk capital; (ii) it should be based significantly, although not entirely, on mutual recognition rather than just international standards which are on too high a level; (iii) access needs to be formalised via a supervisory and regulatory agreement that provides the degree of protection that both sides need notably from systemic risks; and (iv) if divergence occurs over a period of time, then an alternative solution needs to be found; CMU might be in place by then and could help in this perspective.

### 2.3. Potential impacts on financial stability

A speaker pointed out that three main issues need to be considered regarding financial stability risks: (i) the resilience of individual institutions and the risk they pose to the broader financial sector, (ii) the prospect of coordinated asset price falls, and (iii) the 'plumbing' of the financial system – i.e. the network of financial infrastructure – which needs to be both efficient and resilient. In this speaker's view, it might be possible for the EU27 to have the same degree of resilience as today if activities moved from the UK to the EU27, provided there are appropriate government backstops, but the EU27 could not transfer infrastructure without a loss of efficiency. An effective supervisory cooperation mechanism and a dispute resolution mechanism are also needed, which will be more difficult to agree on. Operational risk that will probably increase with the complexity created by Brexit also needs to be managed and if possible in a strategic way, rather than in a chaotic, tactical fashion, another speaker stressed.

## 3. Time constraints and the need for more certainty

### 3.1. The need for certainty and clarity on the outcome of negotiations

Several speakers emphasized the importance for the financial industry of providing more certainty on the outcome of Brexit negotiations in the coming three to six months, given that moving operations will take at least one year for most of them. In the context of Brexit, the public authorities in the UK and the EU are asking companies to provide them with their plans, rather than telling them first what it is the authorities' aim to achieve, which the industry finds very uncomfortable. Further clarity on the outcome and confidence in the negotiation process underway are needed to allow the industry to put in place arrangements that ensure that clients enjoy sufficient stability with the minimum of disruption.

Some panellists were however concerned that the incentives of politicians and the industry are not sufficiently aligned: there might be a political incentive to make sure that nobody thinks that it is easy to leave the EU, whereas the industry's main incentive is finding solutions for things to work out.

### 3.2. Time constraints and the need for an appropriate transition or standstill

The time constraints associated with location decisions post-Brexit were emphasised. One speaker commented that the 'point of no return' at which financial institutions must take action will likely occur within three to six months; another stated that if there is no more certainty by March 2018, banks will take decisions based on the worst case scenario of a hard Brexit. Once banks start repapering clients and moving booking and risk management activities, the public sector's "room for manoeuvre" will be severely circumscribed. The specific time constraints however depend on the nature of the business: whether, for instance, a traditional banking business has its global booking centres outside the UK, or whether it will need to move booking from the UK as well.

The need for a transition period or preferably a standstill in Brexit negotiations in this context was advocated by several speakers, while politicians negotiate an acceptable agreement which may provide more certainty. In one speaker's view, most people in the industry believe that Brexit cannot be completed by March 2019, but pretend that it can be in the contingency plans that they present to regulators Another speaker supported the idea of a standstill because contingency plans are feasible but are pressured by the 'political clock'. More time is necessary for politicians and the public to realise the costs that a hard Brexit would cause, because Europe is so used to the present frictionless system that alternatives are difficult to consider and when costs materialise it will be too late.

# Longevity and ageing: opportunities and challenges associated with the PEPP

## 1. Rationale and objectives of the pan-European personal pension product (PEPP) proposal

The PEPP is a voluntary personal pension scheme that will offer consumers a new pan-European option to save for retirement.

It will give savers more choice when they are putting money aside for old age and provide them with more competitive products. It can be offered by a range of companies such as insurers, banks, occupational pension funds, investment firms and asset managers.

Technological developments will help to make simpler, more cost effective and transparent products, while capital markets will help facilitate a win win situation for citizens. The PEPP is positioned at the crossroads of industry and consumer interests. The current lack of cross border business in this area can hurt returns, because of high levels of costs and few benefits of scale. The increased cross border labour market in Europe helps to absorb economic shocks, but fails to address the absence of any truly long term orientated products.

However, there is no single market in the area of personal pensions: some Member States have a high amount of assets invested in private pensions, whereas others have a high deficit. Existing products demonstrate weaknesses including insufficient yield, locked in syndrome and no possibility of contributing when exercising mobility. The Commission believes that this legislative proposal could help address the pension gap in the EU and the problems of an ageing population and few young Europeans being willing or in a position to save. The market for personal pension products today is fragmented, with complex products concentrated in a few Member States and nearly non-existent in others.

Importantly, a solution like the PEPP is not just another investment product, but a long term investment made with a view to retirement and this is why it needs a quality label. It will be authorised by EIOPA and should open up the unexploited potential of capital markets for personal pension products. Perhaps the additional investments it attracts could be channelled into Europe's €2 trillion a year infrastructure gap. The industry mostly supports the PEPP, as a product that can help with the major problems of the Union. Whilst Member States are generally supportive to the initiative, a major challenge will be for PEPPs to obtain favourable or at least equal tax treatment in Member States. People see that this initiative could make the pensions of European citizens more resilient, while also increasing long-term capital investments as envisaged by the CMU.

Experiences from elsewhere could be inspirational. If Europe seeks to have similar levels of mobility to the US, it will need to plan for such an infrastructure 20 or 30 years ahead. The next generation are unlikely to take lifelong jobs or spend their lifetimes in one country. An appealing pension model has to look the same in many countries of Europe. Member States that are already well advanced in private pensions have seen that savers benefit from tax reliefs or other incentives, but there ought to be a broader conversation about what these levels should be. The financial education that comes with PEPPs will be hugely important so Europe must get started on this long journey.

## 2. Balancing the different interests across Member States

### 2.1 Key benefits

The proposal has the objective of facilitating an internal market for personal pension products and increasing the depth, liquidity and efficiency of EU capital markets. The core features proposed include a variety of savings, the facility to switch providers, different pay-out options and more transparency.

The Commission proposes the PEPP as a long term product with five simple investment options, the default being the safest, where the saver will recover at least the capital invested. Its investment policy follows the prudent person principle, which states that the provider will predominantly invest in a regulated market, but investments in other types of instruments are permitted. No early redemption is possible except in cases of personal hardship.

The Commission is considering allowing savers to switch to another savings option after five years.. Here it is trying to balance the interests of the provider, which needs time to make projections, with savers concerned about locked in syndrome and needing the ability to exit their product. Other timeframes, substantiated by evidence and impact assessments, could be discussed. While some would say that five years is a sufficient time period, others thought five years is too soon, as many long term products currently on the domestic market of their country take at least eight years to gain their full tax benefits.

In addition the PEPP would be portable between Member States, so savers will be able to continue contributing when moving to another EU country. PEPP will comprise national compartments fitted to specific national tax requirements. Today, some providers are offering products on a European scale, but they tend to be elite with high costs. With reduced costs, economies of scale and standardisation, providers should be able to offer these products more broadly, although some companies are concerned about the need to work with 28 different legal compartments to ensure their clients can work and live in diverse countries. However such a restriction risks closing the market to a large number of potential actors, according to a leader of the industry.

Keeping the clients informed is also an essential success factor. They must know about their annuities and warranties, and their cost. The Commission is proposing in this respect a PEPP Key Information Document, featuring all the information needed for the consumer to take an enlightened choice. This should create a level playing field, where different providers will be able to offer different variations and features.

### 2.2 Long-term capital accumulation

Only one third of the people in Europe -67 million individuals out of 243 million EU citizens aged 25/59 years- have a personal pension scheme and take-up is evenly spread. In the US, some two thirds of all householders have private pension schemes and 80% of private pension holders also have a company sponsored scheme. People that save for their pension thus often do it through different channels.

The structural pension system has two pillars –a pay as you go (PAYG) and a funded pillar. An appropriate balance of these pillars is a crucial element for the long-term resilience and sustainability of a domestic pension system. The best way to develop the funded pillar is occupational pensions, because costs are low and workers will participate, but such a model is not workable everywhere in Europe, for example in self employed sectors. The PEPP may make a difference, because it can overcome many of the problems experienced at a national level. Countries too small to develop a market for personal pensions need economies of scale to keep costs low, especially in the continuing low yield environment. The key challenge for the PEPP is to fill the gap of long-term capital accumulation dedicated to pension provision especially in countries where occupational pensions are not developed, or not developed enough. In this respect, the issue of costs will be crucial and is one of the key success factors.

### 2.3 Default options

The default options is the area where most costs for personal products can be overcome. Studies show distribution costs represent more than half the total costs. The default option is linked to possible technological developments and future business models intended to sell mass products. There is an opportunity here, though the authorisation process and supervision tasks are key factors.

In light of the current economic environment and the challenges for markets with long-term obligations, the role of risk-mitigation techniques, protecting the saved capital and at the same time fostering the right incentives to eventually arrive at better outcomes at retirement, cannot be underestimated. EIOPA believes the design of the default investment option will to a significant extent determine the success of PEPP. Furthermore the much needed conceptual link between the accumulation phase of the PEPP, (the savings phase), and the decumulation phase (phase when retirement income is received) is important. For EIOPA the most relevant outcome that counts is the right result of receiving adequate retirement income for the consumer.

In addition, it has centralised product authorisation with EIOPA, which will cooperate with national supervisors that will remain the main responsible when it comes to supervision. Experience from Italy shows powers of approval and supervision are linked, as when products change you need to re authorise aspects of them. A key factor here is the balance between standardisation and some degree of financial innovation. EIOPA is the right place for this coordination and for participating in these continuing discussions, and is confident that it will cooperate smoothly with EBA, ESMA and the national authorities.

## 3. Main challenges

### 3.1 Tax regimes and legal systems

The more than 28 legal and tax regimes existing in the EU today (sometimes there is more than one such system in a Member State) are likely to present a huge patchwork of issues that a provider would have to know about before developing a product, and communicating its costs to the customer. It is necessary to be transparent on this matter. There is a need to address differing national legislation if the product is to be successful and applicable everywhere. The level of guarantees, in particular, will depend on local legislative possibilities.

To create a level playing field, the Commission encourages Member States to grant the same tax treatment to PEPPs as they do for their most favourable existing pension products and to exchange best practices. Over time, this approach should bring divergent EU tax rules closer together. PEPP products are able to qualify for tax relief by tailoring a compartment to suit that Member State's national criteria.

The Commission has carried out a study of 49 personal pension products in the EU, which revealed that the situation is extremely complex with many different systems. The ambition of the PEPP is to close this gap by offering something that is open, flexible and transparent, leaving it in the hands of the provider to offer annuities, lump sums, regular withdrawals or a combination of all the three.

### 3.2 Returns and costs

The PEPP will be of no use if it is not understandable in various Member States. It must be felt to be a truly individual retirement product. It must therefore be long term, have a debt accumulation period, be partially financed through individual efforts and be transparent at the level of warranties and safeties. The problem is that trust is needed to do this and for that you need decent returns.

When talking about pension adequacy, many say you need to save early and a lot, full stop. The World Economic Forum recommends 10% of your active income for 30 years, but Better Finance's independent research shows long term pension real return rates are often too low, even negative at times. Pension products often significantly underperform capital markets, and can even destroy the value of savings over the long term.

A major concern is that the current design of the default PEPP proposed by the EU Commission does not protect the long-term purchasing power of savings at all, a leader of the industry said. Default investment options should encompass direct investments into equities, bonds and ETFs. This is the ideal retail product to do this for the very long term.

The PEPP may only change the dynamics of personal pensions if costs and charges are kept to the lowest level, while regulations protect investors. In the current proposal, any listed institution can offer a PEPP. Their capital requirements will differ, however, and when measuring these one must include the legislative regime with which the institution must abide.

### 3.4 Risks

The main drivers for returns besides market developments are fees and asset allocation. Too many products are invested in bonds, and more exposure to equities is needed. The CMU creates a more direct link between savings and the real economy. Europe is three times as big as the US in terms of bank debt and has capital markets half the size, and the experience of lifecycle management is that most money ends up in capital markets and will be there for the long term. This has an implicit benefit to liquidity and the stability of the markets. In the investable universe, retail investors want a product that looks at the long term but is also liquid, but less liquid asset classes might make sense to the portfolio for the longer term, such as venture capital and infrastructure.

It would not be easy to launch a PEPP tomorrow, even with Europe's experience. One needs to plan properly and know where this money is going to end up if we want to make sure that supply can adjust. Member States also need to find a way to enrol people early, either through education or tax incentives..

### 3.5 Competition, regulation and investor protection

How can a level playing field between different providers be ensured? How can there be consistent supervision and transparency, so that EU citizens have confidence in this product? The first thing a client looks for is trust; the second is cost. Transparency includes informing the client of the provider's duty of advice and costs, and thereafter earning their trust.

Investor protection features, with a simple, default and safe option, are key. The Commission proposes a default option that can be purchased without advice. Although it has to be safe, it also needs to allow investors the freedom to explore more options than just the default so that people can invest directly into equities and achieve a decent return. Rules such as RU64 could be applied so that, if any intermediary advises the client to take an option other than the default, he must put his reasons in writing. Such a system would assist less financially literate people to invest safely.

# CHAPTER 2

# FURTHER INTEGRATING EU BANKING AND FINANCIAL MARKETS

## Banking Union: how to make existing pillars more effective?

Progress has been made on the three pillars identified in the Banking Union roadmap. The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are operational, while EDIS is being discussed. However, the EU banking market remains fragmented and is not close to working as a single jurisdiction.

### 1. The Banking Union: high time for completion

The Banking Union has been effective; the SSM, the ECB and the Single Resolution Board (SRB) have hit the ground running, contributing to assessing the quality of banks' assets, pushing capital strengthening, trying to clean bank balance sheets and to set up plans for the orderly resolution and wind-down of banks, as well as dealing with crises. The Banking Union is Europe's best achievement during the last decade. Banks today are much safer and sounder than before the crisis not only because of stronger regulation, but also due to a more European approach to both banking supervision and resolution. The industry has been supportive over creating the Banking Union, even if it has caused stress. A large institutional element has been built in a very short period of time although it is true that none of the non-euro Member States have decided to join the Banking Union.

In order to progress, it is necessary to dig further into the daily implementation of the rules in the institutions created. In this perspective, EU Institutions are looking at and discussing regularly with the Chairs of the SSM and the SRB all the details that can make their work more resilient and efficient. The Banking Union is a textbook example of 'functionalist spillover': the more one area integrates, the more integration is needed in another.

The speakers agreed that the glass is now at least half-full; huge progress has been made, but a functioning supervision with a common supervisory approach cannot be created in only two or three years. Both the SSM and SRB are very young organisations and there needs to be a drive towards making things the same. Supervisors should not be complacent and lenient in their ambitions. Making the existing pillars of supervision and resolution more effective is urgent now that there is a positive economic environment in Europe. Much has already been achieved, but it is getting more difficult in the final miles. The SRB was perhaps lucky that there was no strong national tradition regarding resolution, but there is a strong national tradition in how to deal with failures of institutions. Supervisors will always rely on national authorities for their successes and failures. Not everything can be achieved alone, so the institutions will need to work together to overcome obstacles.

The Banking Union, though, has not yet lived up to its promises because it is still incomplete. Its third pillar, EDIS, is missing and this pillar will make money fungible. All the depositors across the EU should be equally protected wherever they are. This is crucial for the single currency and a truly European banking system. Because the Banking Union is incomplete the new system is inconsistent: in the event of failure, the negative consequences are felt mainly at the national level, so national considerations continue to affect supervisory decisions. There is a mismatch between European oversight and national liability that needs to be balanced.

With only two pillars, the Banking Union lacks a sound base if something goes wrong. The question at the heart of the basic debate is the following: if something goes wrong, what is going to happen to depositors? The Banking Union needs confidence, the trust of Member States regarding the efficiency of the SSM and the SRB – and notably their ability to adequately address their specific needs and concerns - has to be built. A great deal of the current difficulties to achieve a truly single rulebook can largely be explained by such a lack of confidence among Member States.

### 2. The EU banking market is still fragmented

Europe has delivered on stability, but can it also deliver on integration and making the Single Market and the Banking Union work? The Single Rulebook is not truly single; it is fragmented with national specificities. This does not allow the benefits of diversification to be reaped in terms of resilience and efficiency. There are many elements in the way of a smooth Banking Union, including insolvency law and tax law.

The Single Rulebook is not truly single as national rules continue to pop up, even after the establishment of the SSM. It contains national options and discretions (ONDs), providing governments and supervisors with leeway. Despite the removal of a number of these discretions by the SSM, some remain and more harmonisation is needed. Some countries still face issues, for instance, with national regulations with regard to risk management for significant banks or to liquidity reporting. This makes it difficult to create a level playing field and ensure there is a consistent approach to supervisory policies. In addition, capital buffers are still used by national authorities, notably to address macro-prudential risks, and the lack of single-jurisdiction status may impose additional capital charges on euro area banks. This discretion increases the cost of capital for EU cross- border banks and is incompatible with the idea of a Banking Union. Symptomatic is the treatment of additional capital charges for systemically important banks related to their cross-border euro area exposures, which are still considered as international exposures from a regulatory perspective and this hinders cross border consolidation.

The European regulatory hotchpotch makes supervisors less effective and less efficient. It is hard to treat banks equally and leads to more bureaucracy and higher costs, opening the door to regulatory arbitrage, and distorting competition.

In addition to that, Brexit will clearly show the need to deal with the fragmentation in supervision. While some UK banks might choose to set up subsidiaries in the euro area, others might set up branches, which would not be supervised by EU supervisory authorities and would be subject to purely national rules.

Regulatory arbitrage can be quite effective between third-country branches subject to national regulation and a national supervisor, and a bank subject to the Single Rulebook, and an investment firm. Added to that, there are different large-exposure rules across the euro area. Nine countries took the national option of creating specific large-exposure rules and ten did not. It makes sense to regulate this and to find a common denominator.

The SSM has harmonised the main tool of banking supervision, the Supervisory Review and Evaluation Process (SREP), where the SSM analyses each bank's business model, governance, risk management and risk to capital and liquidity positions. Other tools need to be improved, as some are applied in divergent ways, some exist only in certain countries, and some tools are twice part of the European toolbox. This can cause problems, and so tools should be harmonised. According to one speaker, the moratorium tool could generate bank runs if there were a problem of liquidity before and during resolution. This needs to be dealt with without asking the central bank to support banking institutions.

Great efforts have been made to create a common culture of supervision. This takes time because there are large overheads associated, but it is something that could be shared by the whole industry. Political support needs to be given to fight the home bias in prudential rules and in supervision on day-to-day practice.

The solutions with regard to Banco Popular and Monte dei Pasci provide the opportunity to draw lessons from the EU crisis management framework. Banks can now fail without disrupting the entire financial system. It is time to identify the elements that do not work and to think about what is missing. If a problem that did not exist in the past is created, it causes trouble. There are differences in insolvency laws between Member States and state-aid guidelines are not yet aligned with the bank recovery and resolution directive (BRRD). The Commission's banking communication from 2013 needs to be reviewed against the progress made. A harmonisation of insolvency laws is needed to achieve a level playing field.

One speaker suggested aligning calendars of the bail-in tool with the MREL, without which it was hard to see how the bail-in rule could be applied and how NPLs should be dealt with. Europe needs to accelerate the cleaning up, otherwise it is difficult to deal with the legacy with new instruments and bail-in tools. There must be a common approach at the European level in this respect.

In most of the legislation in place there are many national layers. Ideally, these will be removed and there will be a time when Europe has a much more harmonised legislative framework. Nothing in the macroprudential requirements prevents stronger coordination in terms of how these are used to trap capital or liquidity in individual legislations. In Pillar II or loss-absorbing capacity, much judgment and discretion is left to national supervisors. During the crisis, many authorities in all countries of the Union did ring-fencing. Ex post, it is difficult to reverse these measures.

### 3. Many changes are necessary for improving the efficiency of the Banking Union and to make it work as a single jurisdiction

The key challenges are to fully harmonise regulation and supervision and to improve the resolution framework by thinking more Europeanly, and making the Banking Union work as a single jurisdiction.

Unlike in the US, things in Europe cannot be easily built top-down. This is the state of life in Europe. Even if, de jure, the structures are European, Member States, whether justified or not, continue to butt in. When that hampers the effective functioning of the system, it increases costs for European businesses, or causes legacy issues to drag on and that is bad. However, if it means using local knowledge for better resolution, using local or regional deposit guarantee schemes (DGSs) or institutional protection schemes (IPSs) within a European framework, or getting rid of failing banks, it is a good thing. It is important to discuss the way in which this national influence should be structured and the domestic needs taken into account within a more Europeanised structure.

It is also important to think more Europeanly for the sake of the overall stability and credibility of the system. However, some national knowledge and some discretionary power within the European context is a good thing. Europe should discuss the conditions under which national influence, which will not go away, can strengthen the European system.

Focusing on decreasing ONDs will make supervision more efficient, because the single supervisor is currently obliged to exercise its powers in different ways. Banking regulation and supervision urgently need to be fully harmonised. Legislators should make more use of EU regulations as opposed to EU directives. With every directive, there is indeed the possibility of gold-plating.

Regulatory reform should ensure that no difference of treatment should be made among the different creditors of a same group and that group support could be enforceable at the European level giving thus a solid base for group solidarity as the basis for consolidation. In other words, bank creditors of a banking group need to be treated in the same way in all countries. Some speakers noted that regulatory progress in the resolution area is urgently required to achieve this goal. The consequences of potential bank failures remain national. There was good cooperation during the summer between both pillars, which is good news. However, there is much more to be done for bank creditors to be treated in the same way in all countries. The issues around insolvency result in creditors being treated differently and more needs to be done on this subject. It is difficult, but the harmonisation of the bank-insolvency regime should be taken more seriously. Behind that is corporate insolvency, which is probably much more difficult than bank insolvency.

The resolution of EU banks will always rely on national authorities, according to an official. The SRB cannot do everything on its own; it will have to rely on others. On the two pillars, the SRB has to acknowledge that there is a legacy in the system that can be translated into NPLs that still need to be addressed. Many things still need to happen in building up MREL. It is doable, but still in a transition phase. Finally, the resolution pillar is built on insolvency laws. One insolvency law is better than 19.

More work is required on the fundamental side. Just adding another layer on top does not really make the base the same. Pillar II is harmonised, so the base is now being worked on. Much is being achieved on stability, but what is key is whether Europe is any closer to working as a common jurisdiction. The ECB report on financial integration conveys rather a negative signal on progress, while from the industry, there are complaints that the movement of capital and liquidity remains hindered.

There are three challenges regarding consistency: cross-border mergers, consistency between supervision and resolution, and consistency between the Banking Union and the CMU. Everyone is agreed that cross-border mergers within the banking and monetary union should be as seamless as domestic mergers; but this is not the case and represents an important deficiency of the monetary and economic union. There might be an opportunity to change some restrictions that exist legally, while others are in practical implementation. The CRR does not allow cross-border waivers of solo capital requirements and, looking at liquidity, conditions to grant cross-border waivers from solo requirements in the case of centralised liquidity management remain difficult to fulfil. In order to consider systemic buffers for G SIBs, intra-eurozone cross-border flows are treated exactly like external cross-border flows.

Progress must be made in managing the crisis between supervision and resolution authorities; integration needs to be streamlined and improved. There are capital requirements for Pillar I and Pillar II, and there is MREL and TLAC. There could be macroprudential requirements. Each of these decisions are taken separately and can create a question of accumulation for financial institutions and a question of purpose. It is not a simple issue, but the journey is not over yet.

The final challenge is on consistency between the Banking Union and the CMU. The aim should be very simple: to have a single market for savings and investments. With the

Banking Union, the CMU and some parts of the Juncker Plan, there could be a very powerful engine for the economic union, but the bridge must be built between separate regulation in each of the pillars and the economic purpose of the European Monetary Union.

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## CRD V / CRR II pending issues

**1. The EU is refocusing on idiosyncratic risks and tries to be up to the challenge posed by the interplay between the financial rules and the real economy**

An official reminded the audience that Adjusting CRD and CRR is one of the priorities of the Estonian Presidency of the EU Council. It is essential to achieve the general long term goals of financial stability and market confidence. In this respect the risk reduction package, and CRD/CRR particularly, should increase the competitiveness of the European market, and promote a sounder and competitive financial sector. As stated in Jean Claude Juncker's State of the Union speech, risk reduction and risk sharing go hand in hand, and completing the Banking Union is a matter of urgency. The packages that have been proposed, and which the Council and Parliament are now negotiating, take their inspiration from that determination.

For a number of very difficult years, the main issue has been financial stability, and over the course of a few years, Europe has created the three fundamental pillars on which its stability now relies: the single rulebook, the single supervisory mechanism, and the single resolution mechanism. The result that has been achieved is the result of the 'courageous' policy mix that was put forward in 2012 and 2013.

The package that is now being discussed tries to complete the work that was done before, but benefits from one fundamental point: that the types of risks that Europe is addressing today are not systemic risks, but idiosyncratic risks.

**2. Permanently strengthening requirements on banks has had an effect on the real economy**

The European Commission's proposal, in the view of one speaker, is very balanced and good. However, it is very important to not keep strengthening requirements on banks, because this has an effect on the real economy. It is now probably the case that Europe should now concentrate on idiosyncratic risks. There are a few things in the proposal that, in the speaker's view, need further work, primarily in the FRTB. In particular, the requirements of the standardised method raise many difficulties, and will for example put requirements on covered bonds that will hinder the development of the market and put liquidity into question. The most important thing is to keep models risk sensitive, and to make sure that well functioning business models are not destroyed.

**3. Further reaping the full benefits of a single market in financial services, specifically in the banking market, should remain a priority**

Deepening the single market in financial services, and specifically in the banking market, is extremely important. Building a strong, robust and resilient single market has always gone hand in hand with whatever progress has been made in banking regulations. The Council is now discussing two important pieces of legislation on BRRD and CRR; their common interest is to achieve, as quickly as possible, decisive progress on this legislation, and the Estonian Presidency is working very actively on this.

With these issues, a balance always has to be located between the additional financial stability that is intended to be brought into the system and the effective financing of the economy, which has to be preserved and enhanced. Benefits are expected from that, but also from moving further in the integration of the single market for banking services. Integrating the single market means more competition and more efficiencies, which need to be encouraged. In recent years, Europe has done a lot of work on harmonising its rules, creating a single supervisor and a Banking Union single resolution authority, but it is not clear whether the full benefits of all of those changes have been reaped. Banking activity in Europe, and especially cross border banking activity, has actually been receding over time; part of this is notably linked to the prudential framework.

The question is whether the prudential framework within the EU, and specifically within the Banking Union, is sufficiently conducive to the development of cross border banking activities. As with any kind of exposure, the more a financial intermediary has a balance sheet that is diversified geographically, the more protected they are from idiosyncratic shocks within the Eurozone. That is a safeness and soundness agenda that should be pursued generally, rather than only for a single asset class.

From ECB data published in February, it appears that currently, within the Eurozone, banks lent about €350 billion cross border to other entities within their groups, but this number has declined quite substantially since 2014. This may have been pursuing the goal of financial stability, but must have come at a proportionate cost to economic growth. While Europe is progressing towards the completion of the Banking Union, technical solutions are necessary to avoid asking for 'blank cheques' from host supervisors; however, the debate should not be too focused on tensions between home and host countries, or home and host supervisors.

In relation to liquidity, one industry representative expressed the hope that the cross border liquidity sub groups concept, which has been embedded in the regulation for quite some time, is further elaborated upon. Local regulators want local capital for the entities that they supervise, but that should be proportionate to the consolidated group requirement. Finally, in relation to MREL and TLAC requirements, there is also a need to strike the right balance: in the single point of entry model, there should be proper mechanisms in place to use the capital for up and downstream losses within a group, but doing so with solo requirements rather than a group perspective may have perverse effects. This speaker's institution hopes that the current review that is underway will enable some technical adjustments that are uncontroversial to improve the free flow of funds within banking groups.

One development that will favour the single market is the creation of a Banking Union. An EDIS, and a backstop for the Single Resolution Fund, are necessary – although not sufficient – to ensure the Banking Union is completed, and the faster it is created, the better it will be for everyone.

**4. Another objective for the proposed evolutions of the prudential framework, is to preserve the level playing field globally and within the EU**

The issue of the level playing field, and applying the same rules generally, is an issue with an internal dimension and an external dimension: the external dimension is what is done in Europe in comparison to what happens in other jurisdictions. The Council strives for international standards; it is heavily engaged in international fora, and should continue this as actively as it has done in the past. However, there is a need to make sure that those international standards do not overreach, and are upheld.

An industry representative added that the CRR/CRD package already contains elements that deal with Basel IV issues, and if the United States goes as far as indicated in the Mnunchin Report and decides not to transpose any compromise achieved in Basel into national US legislation, this speaker believes that the European approach should be to not transpose any elements of the FRTB or NSFR into European legislation.

The internal dimension is the debate on proportionality; the system is not built around tiers of banks. Banks have different characteristics, and it is good for the wealth of Europe to have different categories of financial actors. However, these different categories are interconnected, and looking at financial risk and financial stability should mean taking a holistic view, going beyond banking structures. As such, as far as prudential standards are concerned, uniformity should be the rule. However, there is scope for flexibility in relation to reporting requirements and governance issues.

Another industry speaker commented that proportionality, in the view of their speaker's institution, could be a combination of concentrating and focusing on the consolidated vision of the bank by the supervisor at the levels of solvency and liquidity, in the same jurisdiction and also at the level of cross border activities, with waivers in the fields of internal MREL, LCR, and NSFR. A third industry speaker added that it is important to bear in mind that the real economy in the EU is an economy based on bank lending, which is quite contrary to the situation in the United States.

### 5. Preserving the lending capacity of "small and simple banking institutions" requires further reducing administrative and bureaucratic burdens

The measures in the CRR II/CRD V package need to be assessed against their impact on bank lending in the European Union. That means that it is paramount to strengthen small and medium sized banks' lending capacities, which contribute a decisive amount of share to lending capacities in the European Union. If the question is how to introduce proportionality in the right way in the CRR/CRD IV package, one industry representative would never ask for any relief in equity or solvency ratios, with a core equity Tier 1 ratio of slightly more than 15% on average. 'Proportionality', to them, is more about the administrative and bureaucratic burden, which means lowering the requirements for reporting on disclosure, recovery plans, resolution, and the establishment of committees.

The current proposals do not strike the correct balance between stability, market confidence and efficient regulation. The next step would be to define which financial institutions would benefit from that relief; this speaker's institution supports the German proposal to create a 'small and simple' banking regulatory box. The German proposal was for a threshold of €3 billion, but this could be tied to a more relative ratio, based on a certain share of the GDP or risk weighted assets in a given economy.

### 6. An essential area for improvement in order to create an effective level playing field between fintechs and banks is the regulatory treatment of intangible assets

Regarding the prudential treatment of software investment, unlike non banking actors and their American competitors, European banks are required to deduct assets in software investment from their prudential capital. This treatment is no longer affordable, considering the need for both cybersecurity and commercial investments. In one speaker's view, fintech should be understood as financial services enabled by, or provided via, new technologies; this would mean that most banks now have to be considered as fintech providers.

Today, when a bank acquires a fintech entity, its main asset – the software – is automatically depreciated, whereas if the buyer is a non bank, the deductibility does not take effect. To this speaker, it would be unreasonable to assign a zero value to the search engine of Google, if a bank were to acquire it, and because of the way this is treated at present, banks may be less willing to finance fintechs. As such, legislators should abolish this deduction, because European banks need to compete on a level playing field.

### 7. Whether and when Pillar II guidance should lead to further harmonisation still requires clarification

In the area of idiosyncratic risk, Pillar II is extremely important. Pillar I was built to protect banks and the public from default in the short term, while Pillar II was introduced to ensure that banks are profitable in the long term; it is a bank specific supervisory tool, and it calls for supervisors to evaluate banks on a case by case basis. Doing so is demanding for supervisors, who have to assess different internal models and different banking business models; but one industry representative sated that the ECB have the capability to address this notably through the TRIM project, but one industry representative stated that Pillar II should not be standardised too much, and legislators should be strongly encouraged to avoid any confusion between Pillar II and Pillar I.

However, another industry representative added that their institution is concerned about the fact that the Pillar II guidance will be resting upon regulatory stress testing methods, and it has been seen in the EBA stress tests that banks that are more or less similar come out quite differently. If semi hard Pillar II requirements result from stress testing, stress testing should be made a comparable exercise.

An official stated that when the nature of risk changes, regulators or supervisors should adapt the nature of the tools. Another official added, regarding Pillar I/Pillar II, that the tools used should be focused and flexible. They are worried that, given the inflation of Pillar I requirements, flexibility is being lost from the system; if Pillar I is inflated too much, there is less scope for Pillar II, and there is less scope for macroprudential buffers. In some countries, it is relevant to look at counter cyclical buffers, and there has to be some scope for using these tools. Not everything should be covered by Pillar I, and maintaining flexibility is very important, to ensure that Europe's system works effectively with instruments that are focused on the risks Europe wants to address.

## Acceleration the resolution of NPL challenges

The NPL situation in Europe is well known: the average NPL ratio is 5.7% on aggregate, which represents a decrease. The increase of transactions in secondary markets, due mainly to large individual divestures by individual banks, is in another progress with respect to resolving NPLs. However, the main issue is the large variety across jurisdictions: the NPL ratio is consistently above 10% in a number of jurisdictions, especially as regards exposures to SMEs. This remains a structural challenge for the banks negatively impacted because large volumes of non- performing loans are contributing to their low profitability and making them less able to provide new financing to the real economy. In addition, the disparity of NPL ratios across Europe is proving an obstacle to completing the Banking Union because countries where asset quality is higher fear they will have to pay for the rash lending decisions made by the others.

A number of policy initiatives have been implemented in recent months: indeed a comprehensive action plan to deal with legacy asset quality issues was adopted by the Council of the European Union and is now being followed up by EU and national authorities. The ECB has published guidance to banks on NPLs and a draft addendum, currently subject to public consultation.

### 1. The size and scope of the NPL challenge in Europe

NPLs are not an issue for all banks, or all banks in any given country; additionally, no NPL is exactly the same as another and the stability of the banking sector has increased, even for banks with an NPL issue. It is clear that NPLs represent a legacy of the slowdown in the economy, which needs to be addressed.

As of the third quarter of 2016, the 130 largest banks in Europe had €1.3 trillion of non performing loans, in gross terms; in net terms, €0.6 trillion. The ratio has fallen to 5.4% from 8%, so significant progress has been achieved; NPLs in Italy, over the course of July, have experienced a very significant drop following a decision of a major Italian bank to sell NPLs. However, NPLs remain 7.4% of EU GDP, and are unevenly distributed. By comparison, in the US, NPL levels are 1.7%, and in Japan, they are 1.6%. Coverage ratios have increased significantly; Europe now stands at a figure of over 55.6%. Europe has reached levels of provisioning that suggest that more active management of these NPLs is possible, and therefore Europe can expect a further quick reduction.

Although progress is being made on the issue of NPLs in Europe, there is still a need to be cautious and avoid complacency. The first reason for this is that the sheer volume of NPLs remains high, which creates large problems for individual banks, and also means potential cross border effects that can affect the system as a whole. The banks with high NPLs are the least likely to be able to lend into the real economy. Secondly, the big inflection point since September 2016 has been largely the result of idiosyncratic action; this does not mean that action is being taken in all areas. There are still eight jurisdictions in the EU, half of which are outside the Eurozone, which have NPL levels of 10% or more.

In previous years, the non performing loan sale market was driven by transactions in Northern Europe, but more recently, there has been an increase in activity in Southern Europe as well. Non performing loan sales form part of a broader performing, semi performing and non performing loan sale market, which is estimated to have been worth about €100 billion per year over recent years. There have been about 10 NPL securitisations recently: three in Ireland, three public deals in Italy, three private deals in Italy, and one private deal in Greece. However, many NPL private sales also involve credit tranching, and securitisation technology is therefore essential for many secondary market solutions to NPLs.

While some of the public deal sizes have not been particularly large, the investor base is truly global in nature, with investors from Europe, Asia Pacific, and elsewhere. In many cases, investors are looking at non performing loans because they offer an opportunity to invest in the recovery and growth of the European economy, which could be related to macroeconomic factors, recovering loan performance, or collateral values. Many of the assets being sold are very seasoned in nature; for example, at least five to ten years since origination.

Junior investors typically want to have control through either their own servicing platform, or a specific servicer relationship, so that they have closer control of their investment. In this respect, regulatory servicing standards are important to maintain. Senior investors are also looking for asset backed bonds that look as similar as possible to bonds backed by performing assets. Additionally, the definition of NPLs can be quite broad for banks, both in terms of the collateral type and also in terms of the amount that the obligor is paying. The securitisation markets, which are used to analysing this type of cash flow, could provide a solution for the de leveraging of these assets as well.

### 2. Addressing NPLs requires determined actions from all stakeholders

The benefits that would be accrued from resolving the NPL problem are unquestionable, but a great deal of work is clearly needed on many fronts: supervisors should push banks to proactively tackle NPLs; legal systems should be changed to make resolving loans easier for debtors and creditors; market failures for NPLs should be addressed, and the on-going restructuring of the EU banking system needs to continue. Structural reforms of insolvency and debt recovery frameworks are an important field of action, as inefficient and poorly predictable insolvency and debt recovery frameworks weigh on NPL recovery value and set the wrong incentives for NPL resolution. National policies are the primary issue here, but action is also possible at the European level.

It is important to foster the development of secondary markets for distressed debt, which remain underdeveloped in Europe. This will involve initiatives to increase availability, quality and comparability of loan tapes, and further lifting impediments to the transfer, ownership and servicing of NPL across the EU. In the current challenging environment, a number of banks with high NPL ratios will need to restructure or exit the market.

Tackling the NPL issue has been one of the key priorities of the SSM since its beginning. It has developed some quite clear guidance on governance and operational arrangements, and is now starting to look at the concrete options and a follow up regarding banks. These requests have triggered a great deal of work internally within banks, which have looked at how to steer the internal project and process, incentive structure, and specific organisational changes. The SSM has seen a lot of best practice in banks, and these guidelines have already begun to be implemented. Some banks have improved their data quality to a significant extent; in some cases, however, the SSM has also had to ask banks to reconsider their initial plans.

The SSM will not report on specific banks, but as part of its commitment to accountability and transparency, it will report on the progress that the SSM has already started to make, together with the NCAs and the banks. Once the situation is more settled, the SSM will consider also providing more aggregated data. It has consistently said that it is not aiming to set top down, quantitative targets.

It is important to the SRB, as a resolution authority, that this topic should be addressed. In most cases, NPLs are not just the result of bad luck, but are a governance issue related to underwriting quality. Meanwhile, the EBA has a mandate to take forward the ECB's guidelines and roll them out to the EU 28; however, there is a need to make sure that these are relevant for the EU 28, and ensure that citizens and consumers are integrated into this process. The EBA is taking forward the guidelines on NPL management by banks to the EU 28; it also plays a role in producing guidelines on loan origination and affordability, 'future proofing the world' to try and make sure that there are better standards in place for loans going forward. However, not all of this work can be done by supervisors, particularly if the goal is a speedier reduction in NPL levels.

In the US, there exist clear write down rules after a year, and however painful that may be for banks, making this clear in advance resulted in a much faster clean up of the balance sheets in US banks than in European ones, and a much faster recovery. There are also much better functioning secondary markets in the US. The regulator stated that in principle, there is a reason to think about faster write downs, but the need to protect the integrity of the single market and the capital regime, and to avoid 'unpicking' parts of the overall process, ought to be considered.

An industry representative commented that from a private sector perspective, the ability to capture data in the right ways is going to be of crucial importance to the speedy resolution of assets: if any problems occur in the future, data sets need to be readily available. This is asset level data, rather than loan level data; this distinction is important, for instance, for someone who is buying or financing NPLs related to commercial real estate. The question about bid offer and convergence of rates is heavily related to that of certainty. Ultimately, this is about how to make the cost of capital tighter, and therefore how to narrow the bid offer and converge the rates more; the starting point for achieving this is data. This then goes to the issue of the legal infrastructure, and then ultimately financing, which is a by-product of it. A regulator noted that at present, the ECB is developing data templates for due diligence.

The issue of third party servicing also needed to be considered, as banks find it difficult to focus on the future and the past at the same time. Now that some third party servicers have been created, it is important to make sure that they stay around for the next crisis; this has not happened in China. Another market failure is 'timing consistency', meaning that there are still some thin NPL markets where there is a large bid ask spread, and banks are therefore reluctant to fill in data templates and move into the market. The AMC blueprint that the European Commission is working on will be very important for addressing this time inconsistency; however, it might be the case that so much progress has already been made with interest in NPLs that this impetus from a much broader sweep of investors already exists. If this is the case, there is a need to think about a 'platform for data', which is something that has already been flagged by the ECB and is also included in the Council conclusions.

Asset management companies (AMCs) may aid in correcting the market failure; it is very important to define what these, or other types of organisations, are doing. These did good work in Ireland and Spain, but for AMCs to be the servicer is a very difficult proposition. The legal framework has also shifted significantly since the crisis, so that solutions that are close to or actually represent a bail-out of banks are no longer on the cards. A regulator commented that AMCs are not always the solution, but in certain cases, they can be one solution. The ESM has been in favour of the idea of establishing AMCs at the national level, but an official explained that he was more sceptical about establishing them at the European level. When authorities or banks decide to establish an AMC, the market and private investors regard this as a clear signal that authorities and/or banks are really looking for a solution, and usually, this helps to improve confidence and increase investor appetite in buying NPLs, and sometimes also investing in banks. To set up an AMC takes a long time risking to postpone the solution. This is why it is crucial to speed up this process and have pre-agreed solutions to the AMC's source of funding, and the mechanism for the transfer price, which are among the most complex issues in order to avoid problems with state aid.

Much attention should be paid to corporate governance; this is almost always one of the main reasons why a bad bank is unsuccessful. In general, it would be better to have the private sector involved – at a capital level if possible, but at a management level if not – because these people have more knowledge and experience than other institutions. Additionally, AMCs work in a more efficient way when they specialise by geography and asset type. The ESM summarised by stating that AMCs are not the solution in themselves, but they are one of the solutions; the other actors – banks and national institutions – should not stop doing their utmost to resolve the issue of NPLs.

An industry representative concluded by stating that many very good things are happening, and the challenge now is to get these different pieces to work together and encourage data clean up, the legal infrastructure, third party services and transactions to occur, which all create momentum.

## Review of the operation of the ESAs

### 1. Strengthening ESMA is required to further integrate EU capital markets appropriately

Europe made an big step forward when the ESAs were established in 2011, especially in terms of the Single Rulebook. Europe is now very used to the three authorities (EBA, ESMA, EIOPA) and their technical standards, guidelines, Peer Reviews and Q&As, which are very important to the achievement of a single market and the reduction of barriers between and differences across Member States.

In 2011, ESMA started directly supervising credit-rating agencies and trade repositories.

However, ESMA's powers should be further strengthened to perform its functions, especially in respect of measures to develop the internal capital market. While a combination of national and EU supervision will continue to exist, Europe must rebalance the division of roles between the EU and national levels. For example, ESMA has suggested that CCPs, critical benchmarks and certain data providers under MiFID should be centrally supervised.

Moreover, it is currently difficult for ESMA and the other ESAs to decide on straightforward issues such as in what form data should be requested. ESMA does not have the power to set data reporting standards, which could facilitate consistent data sharing across the EU. ESMA should further increase its central role in developing EU-wide databases. A common EU financial data strategy amongst EU and National Authorities, paving the way to a more streamlined approach to the collection, transfer and usage of data in the EU is required.

It was also suggested that ESMA requires a legal instrument similar to the no-action letters available to other regulators. For example, following a trading requirement adopted at the EU level, in the case of quickly evaporating liquidity, it is important that ESMA should have an instrument which can rapidly terminate it. Additionally, ESMA should have the power to impose higher fines on supervised entities to ensure that its enforcement is credible.

The ESAs also need to prepare for Brexit. Their boards agreed that they could not allow competition on regulatory and supervisory standards to attract UK entities relocating to the EU27. They have therefore re-emphasised and published important general and sectorial principles on fostering consistency in authorisation, supervision and enforcement related to relocation.

The EU's largest financial market is leaving, and ESMA in particular must prepare. Here, ESMA has suggested increasing its powers over third country entities. If the current equivalence regime applies after Brexit, Europe would need to fully rely on UK regulators. London's substantial size as a financial centre makes this situation inappropriate and raises investor protection and financial stability concerns.

Regulation should also be applied and supervised consistently within the EU single market. In order to ensure supervisory convergence, the ESAs and notably ESMA requires generic instruments, such as powers to gather information about national supervisory practices, more specific tools and alternative governance arrangements. ESMA's limited possibility to intervene in authorisations is a weakness of the current system to respond to incentives for regulatory and supervisory arbitrage. It is necessary to create a mechanism to ensure that supervisory decisions across the EU are internally consistent.

Cross border business is important to current EU securities markets, not only for financial market infrastructures (FMIs) but also for the sale of consumer products. This poses a question about whether national regulators sufficiently take into account the risks to consumers in other parts of the EU.

### 2. Achieving a single banking market

The biggest difference between the EBA and ESMA is the EBA's focus on Banking Union. The Single Rulebook is also a significant achievement. In the first few years, the

Single Rulebook was focused on increasing the resilience of the system, but this should now shift to the objective of integration. Europe must now create a framework which facilitates market integration and allows banks to consider the single market their own domestic market.

The degree of harmonisation achieved in Europe is not sufficient for the Banking Union. The Banking Union has been a substantial change, but it has not been followed up by a sufficient amount of consistent legislation. As an example, the 'fit and proper' assessments have been implemented differently in national legislation, which means that the ECB uses completely different administrative processes in different Member States.

A harmonised implementation of the common rules is as important as their design. While European authorities have tried to achieve maximum harmonisation, EU institutions have left 'escape doors' which have been used extensively and which jeopardise the process of integration. Single reporting and macro prudential tools are examples of this. Capital buffers are indeed still used by national authorities notably to address macro prudential risks. Common rules should and do leave room for discretion from supervisory authorities; however the result has been divergent supervisory outcomes in a number of areas. Bankers have complained about the differences in the definition of a systemically important institution in different jurisdictions. This divergence leads to challenges in ensuring correct and proper implementation.

The EBA's main concern is the Banking Union rather than further centralisation or the acquisition of more powers. In the light of Brexit, the distinction between the Banking Union and the single market is gradually fading away. Ultimately, the goal is for firms to consider the single market their domestic market, within the safety provided by the Single Rulebook. However European banks do not feel that they are part of a large, integrated domestic market which could be their global base. There are still too many differences in implementing rules and practices. Liquidity remains national (cross-border groups are submitted to liquidity requirements in each of their subsidiaries located in the euro area). Symptomatic is the treatment of additional capital charges for systemically important banks related to cross-border euro area exposure, which are still considered as international exposures from a regulatory perspective and which hinders cross border consolidation

In such a context, the EBA and more generally the ESAs require tools to review and improve the Single Rulebook from the perspective of integration and the advancement of the single market. For instance, the concept of peer pressure is often used by the ESAs. However, this method does not work in practice: authorities prefer to extend flexibility to their neighbours in order to secure it for themselves. The mediation process has also been only partially successful. A preferable system would be for the EBA to act as a prosecutor and bring issues to an independent court.

### 3. EIOPA strongly believes in a holistic and integrated approach towards European prudential and business supervision

Substantial progress has also been made in insurance regulation. EIOPA has identified several supervisory inconsistencies and is trying to solve them with the tools it has. While EIOPA has provided supervisory opinions on Brexit with positive results, such soft tools have limits.

The ESAs are addressing effects, but it is more important to address causes. It is appropriate to be provocative and suggest that one cause is the variation between different European supervisory cultures. This divergence cannot simply be stopped by decree, however; to address this, Europe must build a common supervisory culture. Additionally, there are different underlying qualities and conditions for supervision in different European countries in respect of different amounts of human and financial resources, different levels of independence from the industry or domestic politics, and different levels of transparency.

EIOPA is focused on divergences in the implementation of Solvency II, highlighting authorisations in particular and cross border business in general. Only strong and European responses will provide consumers with the necessary safeguards. This means EIOPA's regulation should be strengthened with a mandate to act more decisively.

Europe does not need a revolution; it needs an evolution. However, Europe must be courageous. In this regard, a stronger mandate on supervisory convergence and a centralised approach to cross border business would be advantageous. Additionally, digital technology and 'insuretech' is also an issue which must be considered centrally. To improve the consistency of internal models and enhance supervisory convergence, EIOPA must be able to deliver independent and non-binding recommendations to national competent authorities and contribute to dispute settlement.

EIOPA has successfully used mandatory mediation. However, EIOPA is often the only participant protecting the interests of cross border consumers. National authorities are often more concerned with political accountability in their own countries. The EBA has also used mediation mechanisms. Ultimately, there are always conflicts between authorities. If compulsory mediation were introduced in all cases in which there is disagreement, this would assist in resolving disputes.

### 4. The views of a Member of the European Parliament

Europe has traditionally maintained control over its authorities. This democratic control is very important. While the Parliament is focused on what the ESAs will have to deliver, it also wants control over level 2 regulations.

The panellists highlighted the need to address cross border problems on a cross border basis. In this context, service authorisation is a crucial issue.

It is essential to increase cooperation between the ESAs and the accountability of the European authorities. Europe does not need to create a situation where there are three ESAs and no national authorities. Nevertheless, 'cross border' does mean 'international'. If the progress made so far is safeguarded, the three ESAs will have a bright future.

The question of cooperation with the European Parliament and oversight by it was very important when the ESAs were established. The issues raised in the Panel are all resolvable with good will. However, the ESAs do not have sufficient power to ensure that supervision in the single market is coherent and convergent. Granting increased powers to the ESAs is ultimately an issue of trust, although strong points have been made on transparency. The EU Parliament was waiting for the proposals of the Commission but should support the strengthening of the powers of the ESAs. In this regard, the official reminded the audience that the EU Parliament has sought the power for the ESAs to go to individual institutions directly, while noting that the European Council refused this in 2010.

# CHAPTER 3
# STRENGTHENING THE FINANCING OF THE EU ECONOMY

## Accelerating the CMU: which priorities following the mid-term review?

### 1. CMU priorities and challenges following the mid-term review

#### 1.1. CMU objectives and priorities

The Chair reminded the audience that the objective of the Capital Markets Union (CMU) is to give capital markets a bigger role in the European financial system, with the assumption that this will make it more stable and more competitive. EU capital markets have been developing quite well in the last few years particularly with a record issuance of corporate debt and a strong growth of assets managed by the fund industry. The European Commission (EC) has announced that 20 out of 33 measures on the CMU action plan have been delivered. The work that is underway on supervisory convergence and reducing the barriers between domestic markets is also essential for the CMU.

The speakers on the panel supported the CMU initiative and considered that the priorities in the CMU action plan reviewed in June 2017 are the right ones. Some of the speakers, however, considered that implementation remains a challenge and that the CMU would take time to make a real economic impact because of persisting fragmentation. One panellist pointed to some negative trends which must be overcome to develop EU capital markets: the increasing use of non transparent and illiquid debt instruments; the decline in liquidity and market making; the reduction in research notably for smaller companies caused by MiFID II; and the shift from high yield bonds into high yield loans. While the CMU is a very good plan, regulatory bodies and policymakers must work closely with the industry to implement it effectively.

The importance of SME financing was highlighted during the roundtable discussion, as well as issues raised by the rigidity and complexity of the current legislative process. Some other priorities and challenges associated with the CMU were noted: the need for a balance of ambition and achievability in the CMU action plan; the importance of implementing the CMU and Banking Union in parallel; the harmonised treatment of Non Performing Loans (NPLs); the facilitation of cross-border trades; the development of covered bonds and the need to increase the participation of retail investors, many of whom are risk averse.

#### 1.2. The importance of improving SME financing in the EU

Given the prevailing share of SMEs in many EU countries, developing SME capital markets is a key priority. Specifically, barriers to listing and unnecessary regulations on trading SME stocks should be removed. Additionally, it is necessary to increase transparency and facilitate information flows between SMEs and potential investors.

One speaker suggested that Europe must also reduce uneven development of local equity markets across Europe and merge capital markets at different levels of development. It is moreover preferable for the EU to build further legislative acts on the national frameworks that exist in more developed Member States and cover the grey areas where regulation is not fully developed in some jurisdictions, rather than developing new EU legislation.

Another speaker noted that SME activity is picking up and ECB surveys show that SME lending is generally increasing, but SMEs nevertheless feel that they are getting insufficient financing. This is mostly due to the tightening of bank underwriting standards after several years of high default rates. The resulting funding gap is predominantly caused by a significant shortage of SME equity funding, which must be increased. Institutional investors should be encouraged to invest in SMEs but insurance companies in particular have very limited equity portfolios, due to Solvency II and IFRS9 requirements, which need to be reviewed.

Increasing SME funding from banks requires three further changes: the proper regulation of credit unions, which can provide SMEs with local capital; the development of simple, transparent and standardised securitisation (STS) and of covered bonds, which will need to be encouraged as Targeted Longer-Term Refinancing Operations (TLTROs) of the ECB reduce; and reducing NPLs by an improvement of company insolvency rules and procedures. However, the speaker noted that some ideas such as automatic provisioning rules for unsecured lending will make it more difficult, reducing the financing options available for SMEs.

#### 1.3. Improving the EU legislative process

A panellist felt that the EU legislative process is burdensome and lengthy and therefore not adapted to the constantly evolving capital markets sector. For example, STS securitisation was first proposed in 2013, but the corresponding regulation will not come into force until the middle of 2019. In addition, there is an inability to adapt legislation quickly when needed. Changing Level 1 regulations, which are often very detailed, takes a long time because it requires a bill to be agreed by the Parliament and the Council and consequently amendments often come too late to address negative issues in the market. This relates to the 'philosophy' of regulation and whether it is principle or rule-based and also to the latitude that supervisors have to interpret and change requirements, which is greater in some jurisdictions than in the EU. Additionally the legal status of Q&A formats used by regulatory bodies to specify certain requirements needs to be clarified.

The way in which stakeholder consultation is conducted is another aspect to be considered. In the EU a great deal of consultation happens at Level 1,which takes a significant amount of time, but market stakeholders do not always have the possibility to provide feedback on more detailed rules and standards.

A further problem is that regulation is often developed in silos with no proper read-across different sectors, leading certain products to be impacted differently by regulations depending on their legal form e.g. securitisation or covered bonds or to inconsistencies between banking and insurance prudential regulations. This reduces the complementarity of regulation and the transfer of assets from one sector to another.

Another speaker commented that larger and more complex capital markets tend to require more extensive and detailed rulebooks. In Europe there is also an inbuilt complexity due to the fact that it is not a 'united state' that can only be reduced through further integration. Secondly, there is a lack of trust among supervisors and between financial institutions and supervisors that leads to over specification. One panellist considered that this lack of trust is partly due to inconsistencies in the implementation of EU regulations on a domestic basis leading to uncertainty for market participants regarding which rules apply at the cross-border level. These issues are being addressed notably by ESMA but will take time to solve and are difficult to tackle because national regulators and market participants often consider harmonisation efforts as additional red tape in the short term.

If Europe is seeking a more flexible and less complicated rule making system, one speaker felt that supervisors must be further empowered. Greater convergence between national supervisors and European authorities is also necessary. Of course, if regulations are close to the consumer, it is logical to maintain national supervision with increased convergence, but the further away the issue is from everyday consumer concerns, the more integrated the approach can be.

Strengthening supervision at the EU level was recommended in the context of the CMU mid-term review, a speaker pointed out, raising questions about the proper architecture of supervision for achieving the CMU and more specifically about the degree of regulatory centralisation that is needed, the division of labour between supervisors, and also the proper trade-off between regulation and supervisory action,and how detailed regulation should be.

### 2. Brexit implications for the deliverability of the CMU

The Chair noted that Brexit poses three key challenges for the CMU: (i) fragmentation risk to the EU's capital markets; (ii) a question concerning the type of structure for financial centres in the EU and whether relying on multiple centres is the right way forward; and (iii) the need to ensure an appropriate framework for third country regulation and supervision.

#### 2.1. Challenges raised by Brexit negotiations and impacts on the CMU

Several speakers emphasized the historical significance of Brexit and the current importance of its financial sector for the EU, given that the UK forms 40% of Europe's assets under management and 60% of its capital markets. Some however considered that economic and financial issues are not well addressed by the UK government in the on-going Brexit negotiations. It is difficult to know if there is a real strategy on the UK side and some in the UK are clearly favouring a hard Brexit regardless of the consequences. In this context it is extremely important for negotiators in Brussels to have a concrete plan B addressing how to finance the real economy and create jobs and growth across the EU27. The CMU is part of the solution, but will mainly have an impact only in the longer term.

Another speaker regretted that there is no real momentum in the Brexit negotiations at present and insufficient visibility regarding their possible outcome. However, the UK's wishful thinking about a continuation of existing trade relations cannot last forever because this negotiation is holding up the long delayed project of gradual EU integration. Moreover, the timing is very short, with less than a year to finish the process, which means that the most probable outcome is a 'very hard Brexit'. The speaker believed that Europe has to prepare reasonable unilateral measures that make sense for Europe, including the development of distributed financial centres. The Euro being the most advanced element of cooperation in Europe; it would make sense first to integrate capital markets at the Eurozone level. Due to the wide breadth of the CMU and the diversity of actions it covers, some shortcuts will be necessary. However, implementing it is possible, as was demonstrated by the banking union which was eventually achieved in two years' time following the crisis. Another key issue that remains to be tackled is the clearing of Euro denominated assets. If Brexit means Brexit, these activities will have to be relocated to the EU27 because the supervision of CCPs cannot be carved out from Brexit negotiations.

Another panellist emphasized that Brexit should be more clearly taken into account in the definition of CMU priorities. Three key aspects have to be considered in particular apart from the conditions for third country CCPs: first a general approach to equivalence regimes that may be adapted to the size and nature of the UK financial sector; next the supervisory regime that will apply to entities relocating from the UK to the EU and notably whether broker dealers should come under the central supervision of the SSM; and thirdly, the way that licences will be granted to firms moving to the EU, which needs to be consistent across the EU.

#### 2.2. The impact of Brexit on the structure of the EU financial sector

One speaker considered that moving from one centralised financial hub in London to several financial centres in the EU after Brexit would be difficult and take time, because financial centres tend to operate as hubs. Moreover there has been no support for building one central Eurozone financial centre.

Some other panellists claimed that moving to a model with distributed financial centres across the EU is quite feasible. There are already several important financial centres in Europe with different strengths and positionings. The US for example have a distributed set of economic centres that serve a common federal ambition. Although London has had a strong presence in financial markets for centuries, it was significantly reinforced by the Single Market, which was a key reason for concentrating liquidity in the UK and this will change in the coming years. Brexit is creating a situation where organisations are reassessing what needs to be located in London and this will trigger changes. The EU27 cannot accept the continuity with the present situation because it cannot be completely dependent on a third-country jurisdiction for the core of its financial interests and the management of its financial risks. This does not mean separating completely from the UK, but the EU needs to become more autonomous with regard to its key financial services

In order to build an autonomous capital market in continental Europe, Europe must strengthen regulatory convergence with a reinforcement of the ESAs and in particular ESMA. One issue however is that the EU will have to build a stronger capital market in a period of uncertainty about the nature of its future relations with the UK, a speaker pointed out.

#### 2.3. The need for more unified capital market supervision in the context of Brexit

A speaker stressed that improving the consistency of authorisations in a simple way is a key issue in the context of Brexit, noting the potential risks of divergence and regulatory competition. Another speaker pointed out that the ESAs have tools at their disposal to manage such issues such as mediation and guideline production. The ESAs could also challenge national approaches which are not in line with EU standards.

Regarding possible regulatory competition in the context of Brexit relocations, a third speaker stressed the importance of better, and probably more centralised, management of relationships with third country jurisdictions. The current system has been defined mainly to manage relations with the US, but the UK concentrates a higher level of financial services used in the EU. Supervisory authorities will need greater independence to manage these challenges, i.e. the ability to prioritise the general EU interest over national interests. Europe must move decisively where there are urgent needs, and converge gradually in areas where the problems are not so urgent.

## Can the asset management industry provide new forms of financing for the EU?

### 1. Potential contribution of asset management to the achievement of the CMU

#### 1.1. Current market trends

Europe has a significant asset management marketplace, built on the solid foundations of the main existing EU fund frameworks, i.e. UCITS and AIFMD. One speaker believed that no new regulatory frameworks are required although some fine-tuning of existing rules might still be needed.

UCITS has been very successful, with a growing trend in cross-border distribution exemplified in particular by the significant growth of fund registrations in Ireland and Luxembourg. 80% of UCITS and 40% of Alternative Investment Funds (AIFs) are cross border, demonstrating the success of EU passports and in a number of EU jurisdictions more than 50% of the funds offered are from other Member States. One more specific trend, which is due to continue, is the significant development of multi asset investment strategies, which may support longer term retirement objectives and income needs.

### 1.2. Developing asset management in the perspective of the CMU

The CMU aims to provide additional sources of financing to the EU economy and tackle the barriers that are currently hindering investment. Its success very much depends on the development of the asset management sector in Europe, one speaker believed. The retail investment market also needs to be developed since a large proportion of European retail assets (40% of household wealth) is currently still sitting in bank accounts, generating no or low returns.

It is however necessary to look beyond UCITS funds for providing new sources of finance for the EU economy, a speaker felt, because UCITS have strict investment rules which may hinder their ability to contribute significantly to diversifying sources of funding further.

Several panellists were positive about the potential of European Long Term Investment Funds (ELTIFs) in this regard. There has not been much market adoption so far and there are constraints to overcome, but ELTIFs could be a significant source of financing in the future. Sustainable finance in particular is essential to consider in the CMU perspective, one speaker emphasized. With €177 billion per annum required to meet the EU's climate and energy targets by 2030, sustainable finance and Environmental, Social and Governance (ESG) considerations are increasingly driving investment decisions. Private equity funds also need to be further developed in the EU to provide additional funding sources for SMEs.

Another important consideration is the advent of loan funds and private debt funds, which are growing quite significantly. These funds help to bridge funding gaps, produce a good return for investors with low default rates and are quite liquid with the structures being put together, a speaker pointed out. They should not, however, be viewed by regulators through a banking lens, since the relevant players are not credit institutions and the imposition of capital or prudential requirements would risk stymying the market. There is also a need to create a more consistent regime for these funds in Europe, a panellist suggested.

The importance of looking at the entire product framework from a CMU perspective, beyond funds was also emphasized. One of the objectives of the CMU is developing simple, transparent and standardised (STS) securitisations, which may contribute to creating additional sources of finance and may provide banks with new funding options and investors with new investment opportunities. Progress with STS has been very muted in Europe to date, because of the toxic reputation that securitisation carries in the wake of the financial crisis. Issuance volumes for the first half of 2017 were significantly lower than 10 years ago. However, there has been an increase in volumes from Q2 to Q3 of 2017, largely due to the agreement that was reached at the end of May around risk retention rules, which is encouraging.

## 2. Fragmentation and competitiveness issues facing the EU fund industry

### 2.1. Main fragmentation and competitiveness issues

Despite its success, the European asset management industry is facing significant challenges, particularly in terms of the persistent fragmentation of the EU fund markets and the small size of EU funds, which have a detrimental impact on costs and on investor returns. US funds are indeed seven times larger than EU ones on average. One speaker believed that there are too many funds in Europe and that fewer, but larger funds could provide investors with lower costs and greater efficiency, while preserving a sufficient breadth of choice. There is also an inherent complexity in the EU fund market, which is due to regulatory barriers but also to the diversity of investor needs and distribution models.

A number of speakers agreed that there is room for improvement in the EU fund environment and framework in order to reduce fragmentation. Efforts are needed in particular to improve cross-border fund distribution in the EU and the ease of access to appropriate products. The authorisation of products across borders has been simplified with the notification process related to the EU passport, but national marketing and administrative rules still vary significantly and may create barriers to cross-border distribution. These barriers are contrary to single market principles and need to be addressed, a speaker considered, because they generate additional costs and are particularly burdensome for smaller funds. Secondly, the proportion of captive fund distribution should be reduced, a speaker suggested, so that investors can access both in-house and third-party funds more easily, and direct access to invest funds should also be facilitated. Consistency issues in the exchange traded funds (ETF) sector were also mentioned notably with variations in issuance structures within the primary market in Europe, which are dampening the market. Post-trading rules regarding ETFs are also largely inconsistent across EU jurisdictions. Alongside this, consideration also needs to be given to the international perspective, one speaker suggested, in order to ensure that the rules that are being implemented (e.g. reporting requirements) allow European funds to remain competitive at the global level.

Other challenges facing the EU fund sector were also mentioned during the roundtable. Administrative burdens, notably related to the taxation system, are costly and difficult to handle for asset managers. Supervision also has significant implications for asset managers in terms of administrative constraints and costs. Consequently, there is a tendency for funds and fund management companies to merge, which should be encouraged with appropriate legal procedures. Finally, the importance of developing financial literacy was also highlighted by a speaker, particularly amongst retail customers, in order to improve their understanding of the products they are buying and of the risks they are taking. This is not only an issue for the public authorities; the financial industry also needs to support these efforts.

### 2.2. Possible solutions for improving the cross-border distribution of investment funds in the EU

Regulatory, supervisory and structural answers are being considered to address the main barriers to the cross-border distribution of funds within the EU.

Domestic marketing rules pose a particular challenge as there is currently no common definition or understanding amongst Member States of which activities may or may not be considered as 'marketing'. There is a definition in AIFMD but not in the UCITS directive. Marketing rules concern the evaluation of the appropriateness of the information and marketing material investors are provided with, particularly regarding the consistency between the marketing material and the legal documentation of the fund and whether the marketing material is balanced and unbiased in communicating risks as well as profitability, a speaker explained. But 'pre-marketing' for example, which involves testing the interest of a small group of potential investors for a product before it is marketed should not be considered as marketing. A speaker also considered that although marketing rules need to be further unified in the EU, the closer one gets to customer related issues, the more local the supervision and controls need to be. Another speaker suggested that a centralised point of information could be set up for asset managers, potentially within ESMA, to help them understand the marketing rules in each jurisdiction.

Digitalisation can also help to overcome distribution barriers, facilitate the dissemination of marketing material at the cross-border level and support administrative processes such as fund registration and reporting, which are not always aligned in Europe. Regulators therefore need to support initial digitalisation efforts and start defining the harmonised rules at the European and international level that would support a further evolution towards digitalisation. One important aspect is preserving legal certainty in this context. Distribution rules, such as anti-money laundering (AML) rules and those related to the Markets in Financial Instruments Directive (MiFID) also need to be applied online, which is quite feasible one speaker stated.

### 3. Financial stability and Brexit challenges

#### 3.1. Financial stability challenges

Financial stability challenges also need to be addressed in the asset management sector, one speaker emphasized. The FSB (Financial Stability Board) has made recommendations to address the liquidity and leverage risks associated with asset management activities, which are now being transformed into practical implementation measures by IOSCO.

Recently, search for yield has also increasingly been observed within the asset management and insurance industries, with firms investing in riskier products. Supervisors need to keep an eye on this, particularly in light of the greater volume of instruments due to be placed in the market by banks following MREL and TLAC requirements, which should not be positioned in investment fund assets without appropriate information on the related risks, a speaker stressed. There is also some political pressure in favour of foreign currency loans which may adversely affect banks and other financial service providers; such a situation has to be avoided relating to the asset management industry. A speaker however thought that the existing measures for tackling liquidity and leverage risks in EU fund frameworks and FSB recommendations should help to mitigate these risks related to search for yield.

#### 3.2. Brexit and third-country issues

Brexit also creates significant challenges for the EU asset management sector. One speaker was concerned by the rules issued by ESMA regarding the supervisory approach to relocations from the UK. These rule changes, which may appear to be primarily intended for hurting the UK in the speaker's view, may also have unintended consequences for the whole of the EU. The international success of UCITS is indeed built on the strengths of individual Member States where the ability to delegate has proven to be fundamental. European investors rely on fund managers for well-managed and well-researched products, which also need to be properly regulated and overseen by supervisors. Breaking up well-established financial centres to the benefit of new ones where sufficient expertise is not always present is not in the best interest of investors. This may lead to reduced professionalism, a disruption of business processes and increased uncertainty and costs for fund managers and investors.

Another speaker stressed that no-one in Europe has ever wanted to prohibit the delegation outside the EU of asset management activities. There is a strong recognition amongst EU authorities of the importance of delegation arrangements for the asset management sector and this will continue after Brexit. European regulators however have to think about the consequences of Brexit for the EU financial industry. A certain amount of rebalancing of the financial industry towards the continent can be expected, but there are no EU regulators advocating a complete relocation of staff and activities from the UK. Asset managers are currently assessing different organisational and location scenarios in order to determine the optimal set up for their activities post-Brexit, which will differ across players. The objective of the ESMA recommendations in this regard is to provide clear guidance on common rules so that entities know how they will be treated by EU supervisors and to foster consistency in the way these rules will be implemented.

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## Sustainable finance challenges

### 1. Sustainability policies are gaining pace

#### 1.1. Increasing interest in sustainability from investors and citizens is leading change

Investment funds can choose ethical practices such as not investing in companies which produce anti-personnel landmines and cluster ammunitions. An institution can actively use its influence on the companies whose shares it holds as asset manager. A responsible corporate governance taking account of long-term economic goals, is therefore a prerequisite for a sustainable Europe. In this respect notably relationship managers within banks will play a crucial role in the process of identifying and managing climate-related exposures without abandoning clients.

However, this will require training and a clear steer from policy makers. An important area of focus is on growing from the inside and the enabling environment, so public authorities must ensure that sustainable finance is an essential part of management. The European Commission seeks to encourage shareholders' long-term involvement and aid transparency. Investment in these topics is increasing, as sustainability is a higher priority for society and business. Any large organisation facing a new challenge usually starts with a strong impetus from top management and the CEO. After this launch, management sets priorities for each business against which it must measure its performance. Senior management must define objectives for businesses so that leaders are aware of how they will be measured when delivering them. In the future, the influx of ESG-related (Environmental, Social and Governance) products will grow along with institutional and private consumers' interest in sustainability and, fortunately, ESG assets can also be used as a management tool.

An initiative on sustainability is part of the CMU and is driven by the finance community. The interim report of the High Level Expert Group (HLEG launched to advise the Commission on the definition of a comprehensive EU strategy on sustainable finance) is interesting material, although firm conclusions cannot yet be drawn, as the report is still under discussion within the Commission.

#### 1.2. Policy frameworks regarding the transition toward sustainable economies support market-led initiatives

The importance of assessing and managing long-term climate and environmental risks should not be underestimated. Disclosing and decarbonising and other environmental risk management, low carbon indices, green bonds and real assets financing sustainable projects are all important. The private sector can create market initiatives but cannot compel participation, so a framework, not strict regulation, will assist the private sector and asset owners. One example is a joint initiative with the International Finance Corp (IFC – World Bank) which aims to create a large green bond fund to foster supply and demand for these bonds in emerging countries.

### 1.3. Public institutions are closely involved in sustainable investments

Sustainable finance is perhaps closer to the DNA of public institutions. Consequently, public institutions have to bring the private sector along. Around 40% of EFSI 2.0 concerns COP21-compliant projects. EIB has objectives of 20-25% of its lending programme to be dedicated to sustainable actions and tools required to achieve these objectives will take time to develop.

Additional work is required on mainstreaming in the EU budget to ensure that there is more activity on the deal risk area, using capacity to structure vehicles that can take out parts of the quantifiable risk. The EU has also to lead by example in order to increase the appetite of the private sector to join.

### 1.4. The three pillars of the EU policy on sustainability

The first pillar is delivering policies like the Paris Agreement, which fulfil the need for a political narrative on long-term sustainability and set clear investment signals for investors. The second is the sustainable finance policy framework for the 2030 agenda, where the EU can lead in negotiating clear and stringent policies. For 2030, there are specific targets to meet for renewables, energy efficiency governance and the carbon price set by the ETS (Emission Trading Scheme) market. This aims to increase the carbon price, bringing further investment in low-carbon technologies and renewable energy. A common goal is important, such as the foundations of the Sustainable Development Goals (SDGs) and Agenda 2030: living well within the planet's boundaries. Using the 2030 footprint to adjust back to be harmless by that point will lead innovation and inspire future deals. Similarly, national climate energy plans are important signals for the private sector on the decarbonisation trajectory and investment strategies.

The third pillar is creating an environment to enable proposals to be translated into real investment and deal flow, thus deepening co-operation between partners in development banks, international financial institutions, the EIB and the wider banking community.

In this respect the EU budget is also an important trigger in achieving decarbonisation. Financing targets is challenging but the money exists; the issue is ensuring a deal flow meeting available resources. In addition, climate policy learns new innovative ways how to invest, such as making public finance available to the private sector to guarantee certain risks of decarbonising investments. Two new public-private funds are being designed to increase investment by 2030.

## 2. Sustainability policies are also a key priority in emerging economies

This is now a key priority for certain organisations such as the World Bank, having moved from a special initiative to the mainstream. The primary goal is poverty alleviation and boosting shared prosperity, but emerging economies are also keenly aware of environmental consequences. One pillar is environmental sustainability, a much broader concept than climate change. The second is social inclusion and the third is fiscal sustainability, ensuring that countries do not store up problems for the future. A country partnership framework, reviewed periodically, identifies priorities and guides investments. Sustainable finance is part of all sector businesses, such as agriculture, rural development and urban development. Countries are developing smart cities that closely consider urban congestion, pollution and the cleaning of rivers, as water supply will be a serious issue in the future.

Organisations are working innovatively on the investment side, developing a number of instruments to help emerging countries cope with natural disasters, assisting after the event and building resilience in advance. Catastrophe bonds are designed to make resources available quickly for reconstruction, but also to mitigate events in advance.

Since investment needs in emerging markets are too large to be managed solely by multilateral development banks (MDBs), a challenge is to mobilise the private sector when lacking data or an understanding of how investments in these markets fare. Banks are profit-driven and must understand risks and returns before committing. A joint initiative by MDBs to create a consortium of data on investments in emerging markets and their outcomes is now attracting substantial interest, as access to it will help mobilise the private sector. Ways of making this data available more widely are being considered.

## 3. Developing sustainable finance

### 3.1. The EU could lead an international regulatory and standard setting effort

Some speakers expressed the opinion that there is actually a very mature environmental policy framework and consequently the potential need for further regulation to ensuring sufficient incentives for the financial (and corporate) sector to invest was rather limited He concluded by saying that the main challenge might now be to further boost the implementation.

However, other speakers alluded to the need for further adaptation to the regulatory framework since it may help the public and private sectors to get involved with sustainable finance. According to them, regulation should foresee some incentives for that business and how much capital banks will consume by investing in sustainable development. These are relevant questions for banks and investors before they can leverage these sectors. There is an opportunity for Europe to take the lead, however, this does not mean creating regulatory difficulties for investors; it is about solutions.

The HLEG report is important and its recommendations demonstrate progress. Regulation is needed and should be international. Standards in Europe are acceptable as signals, but global investors will not be in a position to arbitrate between EU policies and others. A key challenge is to go beyond the EU's proposals to an international set up. 100 trillion of investment over 15 years is needed to be consistent with a two-degree temperature rise and over 50% of that will be in Asia-Pacific and require European assistance.

### 3.2. Common definitions and further transparency

Confusion arises when jurisdictions use different labels. As financial and non-financial data increases in importance, data standardisation across banks worldwide is crucial to avoid market fragmentation. A worldwide classification of sustainable investments would be helpful.

Transparency and the sharing of results is essential for deal flow; a credible database of projects is required in conjunction with the private sector. Rating on sustainability is a good aim, but difficult in practice. The capacity to assess an environmental footprint and even to use ratings on sustainability in order to introduce a more forward looking view, will be important for companies and institutions.

### 3.3. Adopting common metrics on climate related risks is key

The industry manages what it measures, so it is affected by the policy community and regulatory authorities. The work of the Task Force on Climate-related Financial Disclosures (TCFD) is key, as it steers the industry by developing a set of metrics for investors to measure the extent to which a bank is strategically in line with a low-carbon growth path. Implementing the recommendations as comprehensively as possible is crucial.

### 3.4. Avoiding an excessive regulatory burden

The regulatory framework is in place for sustainability but implementation is an issue. Legislation has been adapted but not implemented. Regulation is a burden when it is not enforceable and international regulations suffer from the lack of an enforcement mechanism. Aligning globally without enforceability skews the playing field. Europe can lead in setting standards, although agreement at the international level may not be forthcoming. Flexible standards, with the eventual goal of legislation, seem more pragmatic.

Industry is supportive in implementing the transformation to a green economy; however, this should not increase the administrative burden. Achieving climate goals is associated with further costs due to workloads associated with more extensive reporting requirements so consistency is needed. Prudential regulation plays a role in applying subjective judgments and stress tests as regulators examine financial institutions' strategies. This allows for capital reward before data show sustainable investments to be more creditworthy than non-sustainable ones, when proper rewards can follow through the Pillar 1 framework.

#### 3.5. Prudential regulation and the improvement of risk-return ratios

Prudential regulation may change business; but performance is key and sustainability can support it. Including criteria related to environmental issues and corporate governance means that risks are better assessed and reduced in investment and financing decisions. Sustainable investments are good for the conscience and the long-term risk-return ratio, so there is not necessarily a trade-off between sustainability and performance. The transition to a low-carbon, sustainable economic model needs long-term finance, however, the current capital framework in the Basel 4 regime penalises such operations. Uncertainty over Basel 4 already discourages long-term exposures. Banks in the EU are more important for specialised lending project finance than in the US and the EU has a diversity of banking models and sizes so one-size-fits-all regulation is not ideal.

Large amounts of money will be needed and can only be supplied via public and private sector cooperation. That means risk sharing at the individual project level and market level, happening in the prudential framework, where risk mitigants and sharing must be recognised to allow the financial sector to do more.

#### 3.6. Essential outcomes from the High-Level Expert Group (HLEG)

A sustainable financial system cannot be installed instantly, but neither should it be necessary to begin again. A close focus allows legislators to assess where adjustment is needed. The first area under review is taxonomy, to understand sustainability and developments in other countries. The ultimate ambition is for a global solution, via the International Organization for Standardization (ISO). This usually takes time so the EU should establish a framework to bring to the ISO debate. All climate mitigation, social and governance issues will be considered and it is important to take disclosure, Article 173 and the Bloomberg taskforce into account.

A number of changes are required for a sustainable financial system, such as standards for sustainable bonds. The concept of fiduciary duty requires clarification. After the financial crisis, the focus of regulation was short-term stabilisation and high-premium liquidity. It will not be possible to solve climate issues in the same way, although many institutions would consider that easier. Moving towards a longer term, a broader notion of risk is important. Ratings agencies have a shorter time horizon and look at the duration of the asset. Their clients are traders, not long-term investors, but long term sustainability is a key issue for rating.

There is little appetite to redo financial regulation but adjustments may be needed. Banks feel strongly that, while the capital framework has rigour and has its achievements, there is more to be done on long-term project finance. After the financial crisis, the focus was on stabilising banks' securities management, but this has over-penalised the long-term lending business and must change to build a sustainable financial system. The insurance sector also has little appetite to change solvency tools. It is a strong and rigorous system which gives satisfaction. The question is over long-term investment and equity investment. A delicate area is the accounting and IFRS question, mark to market accounting and squaring it so that long-term investors can invest without having undue volatility on their balance sheet.

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## Green finance and FSB disclosure

### 1. TCFD: the essential contribution of transparency on climate-related risk and sustainable finance in order to reinforce the virtuous circle on energy transition

#### 1.1. COP21 had been a 'game changer'

Climate action continues to be the field of finance in which innovation is currently most profound. Following the Paris Agreement and subsequent work, Europe needs to continue with this momentum. Current initiatives that focus on transparency through standard setting and the assessment and disclosures of climate related risks show that, while much work remains to be done, Europe is setting the foundations for success. The underlying foundation for these initiatives to succeed is for governments to provide a clear and consistent regulatory framework, and progress has been made globally in this regard. However, multilateralism is also very important; the recent manifesto from China and the European Union is a good example of this.

Another speaker stated that COP21 had been a 'game changer' in terms of collating resources, and the level of engagement and discussion is very different from before. Their institution, along with others, has signed up to the Principles for Responsible Investment (PRI); it has made explicit its commitment to incorporate ESG issues into its analysis and its decision making process, and to support development in terms of understanding of this risk. As evidenced by the material that the United Nations published early in May regarding the PRI, there is recognition of some of the progress that is being made. This institution recognises the limits it has in terms of data, disclosure, its own analytics, and its understanding of the science behind the phenomenon of climate change, and welcomes and tries to support all efforts that aim to improve this.

#### 1.2. Scenario analysis is one of the challenges to address

The Bloomberg task force (Task Force on Climate-related Financial Disclosures - TCFD) has completed its work, and has received positive feedback; the goal now is to oversee implementation, respond to questions and deepen the analysis, in order to create something that is forward looking and the task force has suggested that large firms should provide scenario analysis. Legitimate concerns have been raised in this respect about scenario analysis since it is very difficult for organisations to decide which scenario to use: a multi national company based in France, for example, does not know whether it should use the French national commitment to the COP 21, the European one, or the global one; it does not know whether it should adjust to its own footprint, and in which countries, and it does not know which of the existing frameworks it should use. There are also commercial issues involved, as companies do not want to disclose their alternative strategies. The task force is now progressing this matter further.

In response to a question from an audience member, asking whether the FSB sponsoring the TCFD and United Nations Framework Convention on Climate Change (UNFCCC) doing COP21 would be a viable option for some of the global public sector bodies, an official replied that in various environment related areas, everybody has quite a sophisticated analysis of where they are today, and where they need to be in 2020, 2030, and beyond. There is therefore a 'compliance pathway' for Europe as a whole and for individual member states. However, to assist in identifying investment opportunities and challenges, it might help to begin translating that compliance pathway into investment need outlooks or roadmaps more regularly, like the International Energy Agency does. An expert added that the TCFD is progressing some way towards this goal by indicating four or five established scenarios. It has stopped short of doing much more, because many firms have their own scenarios already, and imposing a uniform scenario without perfect information risks creating a 'Soviet planner' situation.

### 1.3. The assessment the risk requires multiple efforts

Insurance and sustainability are connected in many ways; the TCFD recommendations will fill a gap in the insurance industry's assessment of long term risk. One speaker noted that their institution already has a good understanding of environmental, governance, and social impacts with a shorter term horizon, and this is captured in their processes, but the assessment of long term risk and quantification of the effect of this long term risk on this institution's asset base poses certain challenges. Long term risks can arise in different ways, such as though demographic change. Saving gaps can be created, which will have an impact on risk premiums and on savings and investment behaviour. However, the key issue is the climate related aspect, and the long term implications of this. Many asset managers are unaware of these topics, and this will need to be addressed going forward.

Another conceptual topic that has not yet been properly grasped is related to securities markets. There are three issues, the first of which is the time horizon; the general time horizon is very short, and analysts who come to see companies will ask most of their questions about the current year. The regulation often has a one year horizon, so there is a lot of focus on the current year. Secondly, the equity holding period has dropped enormously over the last few decades: it was eight years 30 years ago, and now it is eight months. The third issue is the role of market benchmarks, such as the DAX and the FTSE 100, which give an enormous premium to a very small set of companies. These companies may not be the ones that are the most important from the perspective of energy transition and environmental solutions.

An industry representative stated that the first thing that their institution did in relation to climate change was to identify the need for an overall framework, combining ratings from across all sectors, including financial institutions, governments, corporates, and public services. The second thing was that this institution reviewed its portfolio and made an assessment of the level of risk across around 86 sectors, aiming to identify and comment on levels of physical and transition risk. Their institution identified 14 high or very high credit risk exposures to carbon transition risk, and was then required to choose a scenario. This was something that the speaker's institution struggled with, but it decided to use the Paris Agreement country assessment for analysis. This institution then performed analysis on the sector level, and then moved on to assess the resilience of individual issuers.

### 1.4. One challenge is developing sustainable investment opportunities

Once policy foundations have been laid, financial structures need to be in place to take advantage of them. The European Investment Bank (EIB) has a role to play in this space by supporting EU policy goals in Europe and beyond, and providing instruments that mobilise the private sector for climate action, such as through green bonds, where the EIB has pledged to provide $100 billion for climate action projects in the five year period to 2020, which is expected to crowd in a multiple from the public and private sectors.

Given the need for more sophisticated risk assessment and management, it appears that a quite sophisticated set of capacities will need to be built, which may not have existed in the past. The overall global policy framework for enabling not only the low carbon economy, but also sector resource sufficiency, broadly exists; now, the issue is one of implementation and following through, with enforcement if necessary. If this is done, an official expressed their belief that a dynamic will come about that will create deal flow, which, in their view, is still more challenging than securing the necessary money. An industry representative added that one solution to the question of capacity is through the work of the EU High Level Expert Group, which provides capacity to companies and institutions that do not have the necessary tools, similar to accounting standards.

## 2. The EU High Level Expert Group: widening the spectrum of risks toward ESR, and lengthening of time horizons for all stakeholders

### 2.1. The high level group does not just deal with climate, but also sustainability in general

The HLEG has highlighted a number of early recommendations in the interim report that was released on 18 July, and is working on a number of issues, the first of which is a taxonomy. There is a need to be clear about what is sustainable and what is not sustainable. If this is not done, regulation, standards and labels cannot be changed. The high level group does not just deal with climate, but also sustainability in general: in the climate space, there is a Paris Agreement, a time horizon, scientific evidence, and other helpful factors, but the environment has significantly fewer metrics. Problems with water, land use, fisheries, and other areas need to be integrated into the work that takes place in this space. There is a need to look at the bigger picture, and the extent to which organisations are impacting not only $CO_2$, but are also impacting or dependent on other elements of natural capital, such as water or land.

### 2.2. Essential contributions of the HLEG: improving the investment chain, clarifying the fiduciary duty, improving ratings and benchmarks, proposing sustainable labels, enforcing in the EU disclosure standards…

Work is also taking place on the climate bond initiative and the green bond principles, and another topic is that of the investment chain. One of the challenges is how to move from profits to benefits, and to make those who pursue the 'triple bottom line' also attractive. Over the coming months, the HLEG will listen very carefully to what the various communities' needs are, and how to further build links between these communities, to get Europe into the state that it needs to be in by 2030 and 2050.

The high level group aims to achieve two goals: the widening of the spectrum of risks to include environmental, social and governance risks, which requires disclosures, changes in fiduciary duty, and possible changes in ratings and in benchmarks, and lengthening the time horizon, which is a more difficult goal. Regarding the first goal, the high level group will probably propose standards and labels for green bonds, and the EU is close to releasing an EU green bond standard.

The group is also considering calling for a change of fiduciary duty to clarify what must be included in this, which is difficult, because many texts deal with this topic. Work is ongoing regarding how this change could be implemented.

Regarding disclosures, the group is looking at Bloomberg proposals, Article 173 Law regarding energetic transition in France, and the Non Financial Reporting Directive, which the European Commission is already working on. The high level group is also asking itself what more could be done in the area of ratings, and the issue of market benchmarks has been discussed, which is a very complicated area.

#### 2.3. Developing the long-term perspective in investment

The third significant area concerns banks, insurance companies, asset managers and pension funds. The high level group is considering whether the regulation, which it does not want to change in all areas, is fit and proper from the perspective of long term investment. There may be some areas where an adjustment would be beneficial, and one of these appears to be the long term lending of banks notably regarding project financing, but the high level group would want more evidence regarding this. Additionally, regarding project financing, it appears that the discussion that is taking place in the Basel committee to increase this even further would be a very onerous charge from a project financing perspective. These two very specific aspects could be fruitful topics, because Europe needs its banks to return to long term lending, and needs the banks involved in the early process of infrastructure investment.

### 3. Further developing green bonds

It is 10 years since the EIB's first green bond issuance. This is now a market that has grown sizeable, and despite being a relatively small market, it is a very good success story from a diversification point of view and a size point of view. Green bonds offer both financial returns and positive social impacts, but there is a lack of supply from the corporate side.

#### 3.1. High integrity, diversification and further clarity on the risk related to adoption strategies should contribute to developing green bonds

From a product point of view, three points are quite important. First, diversification is expected, though the quality of that investment needs to remain of a high standard. There are issuances where there would be a question about the project and its positive (green) impact, if it still belongs to that asset class. The second point is about the level of integrity. Standard definitions and taxonomies are required: it is important to reach a common EU opinion on what is green. The final point is an important component of the long term risk debate, which green bonds can fulfil: integrating the risk related to adoption-strategies. Green bonds with sovereign, sub sovereign, or underlying supports, should make more explicit adoption-strategies, which would improve the access of projects to finance as it would comfort their resilience.

It is important to create an EU wide sustainable strategy that 'connects the dots' between the areas of energy, climate, transport, technology, and education. Secondly, to create market awareness, it is important to make it possible to materialise the externalities in Europe.

#### 3.2. Deal flow is more critical than money availability for the time being

The Chair summarised that multiple aspects need to be addressed, and the amount of work that needs to be done should not be underestimated. Total green bond issuance is about 1% of the market at the minute, and although there has been a lot of talk about the tremendous growth of the market since 2007, when starting from a very low base, it is easy to achieve significant percentage growth. In absolute amounts, green bond issuance remains well short of what is needed.

#### 3.3. Public and private sectors are challenged by the occurrence of natural disasters

Asked whether the issues of disaster risk reduction and prevention of natural catastrophes, and the specific public private partnerships that are required to address this question, have been considered by the European high level group, an expert replied that this is, in a sense, the reason insurance exists; the balance sheets have not been cut. The insurance sector always tries to engage in public private partnerships; everybody tries to work with cities, notably to help them build resilience among many purposes, and important initiatives exist, such as the Rockefeller Foundation and the C40 Cities Climate Leadership Group), as well as insurance industry initiatives. However, the dialogue is not yet as advanced as it could be: insurance companies often find that in cities, it is very difficult to find the right counterparty to hold discussions with. There are many European initiatives in this area, including the 2030 Investment Agenda, and this is therefore a significant priority.

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## EU infrastructure and SME financing prospects

A €500 billion target for the Juncker Plan was to be reached by 2020, and a special focus on SMEs is now being added.

### 1. EU infrastructure financing

#### 1.1. The progress made in favour of infrastructure investment in the EU: capital charges of Insurance undertakings have been positively adjusted

Throughout the drafting, adoption and implementation of the Solvency II Directive capital charges linked to infrastructure projects were punitive for insurance companies and prevented them from focusing sufficiently on the research and investment necessary in infrastructure projects.

This has been worked on from the entry into application of Solvency II, and the capital charges relating to insurers' investments have been lowered on infrastructure projects and infrastructure corporates. Early data from the EIOPA indicates that insurers' investments have already increased.

#### 1.2. New approaches for protecting investors contribute to long-term investment

Investor protection is essential since it supports the flow of liquidity toward the infrastructure of SME financing, either directly or through larger institutional investors, such as pension funds and insurance companies.

One positive effort with a significant contribution to matching assets and liabilities is the European Long-Term Investment Fund (ELTIF) and the ELTIF regulation. For the retail investor buying ELTIF, to achieve sufficient diversification, intermediaries need to know the other assets that the investors may hold, even in other intermediaries, and it is the responsibility of the investor to give all relevant information. There is a 10% limit for an investor accessing.

The European Venture Capital Fund (EuVECA) and the European Social Entrepreneurship Fund (EuSEF) should be rethought in order to allow them to further contribute to channelling EU savings toward the EU economy and improve investors' return.

#### 1.3. Growth-friendly taxation in also necessary

A friendly environment needs to be created on the investors' side, to allow them to diversify and be interested in investing in the long term, and that means growth-friendly taxation. It is possible to slightly diversify taxation incentives.

There has been a proposal authorising the EIB to create dedicated investment funds issuing securities dedicated to long-term investments on infrastructure projects and SMEs. Such combinations of bank or security financing with the financing brought by the EIB and national promotional domestic institutions is very important.

However, the only way to help this kind of investment vehicle is to give private savers a strong fiscal incentive during a certain limited period of time and for a limited amount.

#### 1.4. The deficit regarding the bankability of infrastructure projects reduces the EU project pipeline

Currently the main barrier is the size of the market and the potential of the projects on the table. Since capital charges have been revised, investors have been allowed to focus more on the determination of good targets to invest in. One important question is why there is not more investment in infrastructure from the private sector, given the positive macroeconomic conditions.

There has been a decrease in public investment in infrastructure in Europe, due to state policies of expense reduction. However, though there is a surplus of financing in infrastructure, there is still a deficit regarding the funding ability of infrastructure projects, which hinders EU member states from further supporting infrastructure procurement in each of their countries.

Consequently, there is a pipeline deficiency of quality infrastructure projects for the private sector to allocate their funds to. The pipeline issue is being tackled, but not quickly enough. There needs to be an increase in institutional capacity to plan, procure and deliver infrastructure projects.

An official added that a support to the pipeline for infrastructure projects should also come from the platforms established by the European Investment Bank (EIB) and the national public banks, which gather small or medium-sized infrastructure projects. These local platforms are better positioned to appreciate the externalities anticipated from these projects.

### 1.5. National Public Banks being junior to the private sector would further incentivise infrastructure investment

To address the issue of transforming savings into investment, the regulator has an agenda around focusing national promotional banks (NPBs) on securing savings. Public financial institutions have a role as enablers by leveraging public money to make the private sector come in and facilitate investment.

Although NPBIs are sometimes at the same investment level as the private sector, they should be junior, as their seniority means currently that they capture part of potential private sector revenues. Similarly, they should also be able to further develop a financial environment that is positive for SMEs and mid-caps.

### 1.6. Although the investment context has improved, it is still too early to assess the actual impacts of the European Investment Plan on growth and job creation

With regard to the EFSI and the Investment Plan for Europe, there still was a need to look at those projects that have had funds disbursed, as construction does not start until that point.

### 1.7. The level riskiness of infrastructure projects remains a concern for investors who need to better understand the effective added value of the EFSI in this respect

There is greater regulatory stability and cost-of-capital relief through capital-requirement changes, as well as the opportunity to put money into scaled-up investments. It would be therefore natural for insurance companies and pension funds to come in to help public authorities to foster the needed public investment.

However, risk appetite has remained pretty much the same. There is ample opportunity for de-risking to take place.

There is still an issue regarding whether additional, and therefore riskier, projects can be brought in in addition to what is already well done by the EFSI and the Juncker Plan. There should be a clearer definition of the type of projects the EFSI intends to favour, as there was a lack of understanding about what type of risk capital and products they are being provided with.

## 2. Improving SMEs financing conditions in the EU

### 2.1. EU Venture Capital should be boosted

SMEs are at the heart of the economy and represent some 60% of GDP. The Venture Capital (VC) market is one area where Europe traditionally suffers, so there is a question about how the VC market in Europe could be boosted.

### 2.2. SMEs need long term partners with no timetable to exit to have new money to grow their business, with no buyout agenda

Entrepreneurs need to be given what they want. One thing to examine is through which structures there is investment, and what offer is being made to entrepreneurs. Usually the BGF is not competing with VCs in the investments it makes.

Over the last six years the deal proposed by BGF has been a minority stake in the company with no timetable to exit. The BGF is an open-ended vehicle and will take a long-term perspective.

The Business Growth Fund (BGF) is a vehicle owned by the major banks in the UK, which invests in SMEs. It has invested £1.2-1.3 billion over the last six years, in over 200 companies across the UK, which employ 35,000-40,000 people.

### 2.3. The challenge is to reach a wider range of companies lying between smaller or larger ones whatever their location

There is a need to reach a bigger range of companies. The smaller end of the market is reasonably well supplied since there is a great deal of money for start-ups. There is a great deal of money concentrated in capitals around Europe and not in the provinces. Some of the BGF's most successful investments have been outside of London.

Over the long term in Europe the VC market is not as profitable as it should be. The challenge with a big intervention is that it is difficult for any institution to make it on its own despite the fact that the scale provided operational efficiency to make investments at a good cost/income ratio as well as the diversity to deal with the risk.

Therefore, there is a virtuous circle of collective action, but collective action is very difficult to carry out because nobody likes to give up sovereignty.

### 2.4. Capital markets cannot generally answer SME financing needs related to the current technological and globalisation challenge

When it comes to financing SMEs, there is a lack of channelling of savings. This is a period of digitalisation and globalisation, and the capital needs for financing growth are often beyond the expectations of the managers of small companies. This period is crucial. Europe faces important flows of investment from abroad.

A good part of the proposed solution lies in attracting individual investors to the stock exchange. However, most SMEs do not want to give information to the market as it may generate bad intentions from competitors or larger companies. Financial markets cannot be expected to answer the whole question. It is clear that the banks have a very important role in this field and probably more so than in infrastructure.

Some measures have been taken in terms of securitisation to help banks to further finance SMEs. However, companies need equity. European companies investing in technology probably require specific tools for a limited period, in order to address unusual and specific risk. The Commission is working on scaling up initiatives under the Juncker Plan, and will come with the possibility of injecting preferred debt rather than equity. In addition to the Juncker Plan, private investors could be further enabled through the issuance of preferred bonds for long-term development.

### 2.5. The existing ability of banks to invest in SMEs has to be preserved and insurance companies should be further involved

The only way to have collective action is to provide incentives. The public actors bring in securities, try to explain and try to bring some vision of the environment.

There were insurers in the BGF when it was set up in Canada, because there is a different regime for them there. To this end time should be spent looking at Solvency II and the ELTIF's progress.

One insurer explained they wanted to invest more in SMEs, and had the liquidity to do so. They needed the help of very good and specialised asset managers, but would be glad to invest in corporate bonds, in euro private placements (PP) and in loans. They were ready, if they were helped to make the right selection and if the regulatory framework was not to too painful in terms of capital charges.

They also want to work with banks on securitisations. There have been several problems there and it is still heavy to manage, because the criteria remain of a high standard.

**2.6. The regulatory environment is being reviewed in a manner that should contribute to further improving and incentivising SME financing**

In the context of the Capital Markets Union (CMU), there has been a strong focus on helping SMEs to raise equity on capital markets. The prospectus rules have been revised in order to facilitate this. In terms of facilitating SME access to markets and raising capital, there have been consideration of proportionality and simplification of the rules.

Another important measure is the proposal for a Pan-European Personal Pension Product (PEPP).

Lessons had also to be learned on the regulation of financial institutions. DG FISMA has been actively listening to what it received in the course of the call for evidence. It is looking into the simplification and proportionality of regulatory measures.

The Solvency II implementing measures are also being reviewed on the basis of the contributions received in the course of the call for evidence. The calibration of capital charges regarding private equity and privately placed debt in Solvency II is also being looked at.

The statute for EuVECA and EuSEF has been reviewed in order to have expanded investment possibilities for funds. The range of eligible managers has been broadened. The registration processes have been simplified.

**2.7. Fiscal incentives can contribute to creating a virtuous SME financing circle. However, an appropriate balance has to be struck between the incentive provided for entrepreneurs and those provided for investors**

The EU Commission encourages member states to grant fiscal incentives to measures which could be extremely important for channelling funding to SMEs.

Over the last six months in Italy, individual investors were incentivised to invest in SMEs. There is a strong incentive to invest in the second layer of the market, with big fiscal advantages if these securities are kept for at least five years. This has been so successful that it is quicker than the incentives for entrepreneurs to enter the financial market.

**2.8. Learning from current experiments should suggest that certain appropriate conditions for the emergence of capital markets for smaller enterprises are essential**

Italy has small but interesting numbers in the mini-bond market involving non-listed SMEs. It is a market that may encourage the companies to go to the equity market. There need to be attempts at convincing SMEs to open capital and be more transparent. Entrepreneurs need to be taught that transparency is important and positive. Providing investors with quality information is very important.

However, rethinking the Market Abuse Regulation should contribute to adapting the information required from smaller caps in particular regarding the trading of fixed income products.

**2.9. Crowdfunding requires investors to be aware of the risk they take**

There has to be caution about crowdfunding as an area of supply. It tends to be quite specific in what it funds and it is concerning whether investors are clear about the risks that they are taking and the money that they are risking. There should be a good crowdfunding market, but that means that it must be sensibly regulated.

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## Attracting retail investors to EU capital markets and PRIIPs / MiFID II pending issues

### 1. The importance of increasing retail involvement in European capital markets

Reducing bank financing and developing capital market based finance is a key objective in Europe, for which one of the main drivers is an increase in the participation of retail investors.

Retail investors are indeed very important for the stock market in particular, because they help to stabilise it and reduce major swings. Unfortunately, retail participation in European capital markets is too limited and tends to decrease. Only 3% of European households hold government debt, although it is a relatively safe asset and households only hold 2% of total financial assets in continental Europe. Much greater retail participation would be needed to support the economy, either directly or indirectly through institutional vehicles. However this can only happen if capital markets as a whole grow in Europe and if bank and capital market financing are rebalanced, a speaker believed, which requires the whole structure of financing to change and a stronger capital market ecosystem to be built. This would allow the cost of product distribution and of investor protection regulation, which is excessive for such a small retail market, to decrease. This is an objective of the CMU, but the present action plan is mostly about improving the market infrastructure in Europe and facilitating institutional investment, a speaker regretted. Retail investors should not be forgotten, as equity investment can be a very important part of filling the €700 billion gap in the funding of pensions in particular.

However, there are different markets in Europe and some of them have quite a high level of retail participation. The Swedish market for example has developed well over the years, thanks to a large number of IPOs, a strong interest of retail investors in innovative businesses and active shareholder associations. The Swedish Government has also contributed by allowing everyone to invest part of their pension savings in funds and by providing an attractive investment savings account framework. Other parts of Europe have different traditions, with more money being saved in banks and more dependence on pay-as-you-go pension schemes.

### 2. Reasons for the lack of retail investment and issues to address

**2.1. Culture, financial literacy and trust issues**

There are significant levels of savings in many European countries, so it is not a lack of money that is causing insufficient investment in capital markets and equity. A first reason is a strong risk aversion of European retail investors. Investors have to accept more risks and that their investments are not deposits, while the authorities need to be present to ensure that markets function fairly and that there are no market failures.

There is also a lack of financial knowledge and investment culture, as well as insufficient trust and confidence in the market and its products. Regulators have to play a role in strengthening these aspects, in addition to protecting investors.

There is insufficient equity culture in particular among retail investors, who mostly prefer savings products offering guarantees. In France, savings are mostly in life insurance contracts with guaranteed interest rates. There is currently a small move towards more investment in fund units in these contracts, mainly due to the low interest rate environment, but this is not yet a strong trend. In parallel, there is the tax exempt Plan d'Epargne en Action (PEA), which is a very efficient tool for the management of capital, yet customers prefer packaged products. The main reasons behind this situation, a speaker believed, are the lower media coverage of macro-economic issues in France than in the Anglo-Saxon world and the dominance of pay-as-you go pension schemes that do not offer any exposure to capital markets. For active investors in securities markets another issue is the access to research, which is often more difficult to obtain for EU stocks than for US ones at present.

### 2.2. Distribution structure, tax and legislative issues

Another issue to be considered regarding the lack of retail investment in the capital markets in Europe is the current distribution structure, which relies mainly on intermediaries. The banks or advisers that most people go to for their investments tend to be biased towards the packaged products or funds they manufacture or distribute instead of advising people to take a longer term horizon and invest more in equity. Equity investment is however essential for younger investors in particular. MiFID II should initiate a change in the intermediary system towards encouraging more equity investment in portfolios and a longer term investment perspective, even if this results in advisers earning less in fees. Regulators should also make sure that retail investors have access to a sufficient choice of appropriate investment products.

Present tax arrangements, which are quite complicated in Europe also hinder investment, particularly across borders, and create distortions between different types of investments. When people do not understand how tax works, they prefer not to invest, a speaker considered, whereas strong and simple measures such as the tax relief at source that is provided in the US can be a strong incentive. Discussions about the CMU need to face that challenge at least in a longer term perspective, because differing domestic taxes are hindering European capital market integration.

Transaction costs are a further obstacle to more retail investment in Europe. Cross-border order execution costs remain particularly high, notably because of post trading arrangements. It is usually less costly to trade US shares in Europe than shares from another EU state, which is a problem because investors are becoming increasingly sensitive to costs.

## 3. On-going improvements and related challenges

### 3.1. MiFID II and PRIIPs

Actions are underway at the EU level to improve securities distribution and information rules. The implementation of common MiFID II and PRIIPs rules[1] across the EU should improve trust by allowing investors to operate in an increasingly safe environment. These rules should be implemented consistently across the EU in order to provide a level playing field across products and sectors and ensure legal certainty.

Some speakers were hopeful that MiFID II would also help to reduce distribution costs and charges and were favourable to improving transparency on advice costs. Others were concerned that MiFID II might lead to higher trading costs. MiFID II should help to improve product governance; it also provides supervisors with a last resort power of product intervention, a speaker emphasized, which may contribute to enhancing investor confidence. A challenge however is to achieve a consistent implementation of these rules across the EU, which is one of the key areas on which ESMA is focusing at present in preparation for the January 3rd implementation.

Some speakers were also supportive of PRIIPs, which aims at facilitating comparisons between packaged investment products across sectors and presenting costs in an accessible way, as this could also help to increase investor confidence in the securities market and strengthen the level playing field between products.

The intention of regulators is that all main investment products should be subject to PRIIPs requirements, although it could be difficult to fit some of them into the framework. The main challenge however is making sure that investors understand all the information that is available and to make sure that it is suitable and relevant, given the wide variety of products available.

ESMA is also analysing, together with the other ESAs and following a request made during the mid term review of the CMU, the return investors are receiving at the end of their investments, after deducting fees, taxes and other costs, in order to assess the appropriateness of existing investment products. Comparable data on fees and costs are not easy to find at the moment, but PRIIPs should facilitate access to this information.

### 3.2. Passive management and proportionality measures

Work is underway on specific investment products and notably closet indexing. More clarity is needed to help customers distinguish between passive trackers and actively managed investment products in particular and compare the related costs. A speaker however mentioned that studies have shown that the cost of managing products is not a major component of total costs and that distribution costs are quite high in the EU compared to other regions. This latter issue is due to be addressed by the EU authorities in the context of the CMU, with legislative proposals expected by the beginning of 2018 to lift some of the barriers to fund cross-border distribution in particular.

The supply side also needs to be looked at when assessing how to further develop retail securities markets, a speaker stated. SMEs and mid caps should be encouraged to issue more bonds and equities, as this would facilitate their funding and also increase the supply of investable securities. Some proportionality measures have been adopted to facilitate the issuance of securities by SMEs, notably in the prospectus regulation. It is however important that investors are not lured into excessively risky investments, another speaker felt. If securities regulations are simplified for the sake of proportionality, robust supervision of capital markets should be maintained to avoid any failures. Moreover, some securities such as corporate bonds will remain difficult to access for retail investors due to the cost of issuance and the illiquidity of the market, a speaker pointed out.

## 4. Additional solutions for developing retail investment in the context of the CMU

### 4.1. Specific actions for developing retail investment in capital markets

Some additional solutions that may contribute to increasing retail investment in the context of the CMU were discussed. Some felt that generally more was being done for institutional investors, who have nearly taken over securities markets in Europe, leaving very little space for retail investment to grow. Further efforts should be made to build a more consistent rulebook at the retail level in particular, in order to develop cross-border investment.

Improving investor education and particularly equity culture is also essential. Although PRIIPs and MiFID II will improve significantly standards of transparency and compliance, these initiatives will not have much impact on investor education, which is more of a cultural issue, a speaker felt. Some efforts are being made by the public authorities in this regard, but there is still a long way to go, particularly in Southern Europe.

Taxation of securities investments also needs to be improved and simplified, particularly on a cross-border basis. One important issue picked up in the CMU is the difference in tax treatment in most jurisdictions between equity and debt in favour of the latter. An appropriate tax treatment is also needed for the PEPP[2] to work effectively and encourage young people to save for their retirement.

### 4.2. Leveraging technology and robo-advice solutions

Improving investment advice is essential and technology could be further utilised to achieve this goal. MiFID is a big step forward in ensuring that any advice provided is in the best interest of investors, but only a limited number of customers are ready to pay for it. Robo advice provides lighter or cheaper alternatives to traditional advice. Only 1% of the financial sector is really using robo-advice at the moment and the turnover going through these platforms is still very limited, but this technology is growing fast. More customers would be willing to use automated systems if there was more transparency on the service delivered, a speaker believed. In many cases, such systems will be combined with a 'real person', who might take the final conversation forward. It is however necessary to ensure that any advice, whether electronic or in person, is properly regulated and aims at protecting investments and also that regulation is technologically neutral.

Robo advice is a good way for the retail investor to be better acquainted with equity, a speaker believed, but this requires equity to play a significant role in the portfolio mix of these services, which is not always the case. Moreover robo-advice can foster progress in terms of legal certainty, investor information and protection in a shorter timeframe than other solutions such as financial education programmes, provided that investors are encouraged to stay in a chosen equity for a relatively long time and not to overreact to market evolutions. However, new retail clients find it difficult to trust such solutions and often want to have a physical meeting before committing to the service, a speaker stressed.

Combining multi asset funds and lifecycle strategies for retirement with robo-advice will be an important development, another speaker thought. Another aspect to consider is the independence of this advice and whether robo-advisers are offering genuine advice or a sales pitch. The US and UK have gone further than the EU27 in distinguishing this, but different traditions exist in continental Europe, where the adviser is usually part salesperson. Surveys have nevertheless shown that, as long as the status of the adviser is made clear, in general investors will trust them. For robo advisers this must be clarified online, because customers can be tricked as easily by robo-advice as by a human adviser.

1. MiFID : Markets in Financial Instruments Directive ; PRIIPs : Packaged Retail and Insurance-based Investment Products Regulation; KID: key information document
2. PEPP: Pan-European Pension Product

## Impact of bank prudential rules (FRTB, NSFR) on EU capital markets

### 1. Since Basel I the implementation of international banking standards has been uneven across the globe

Basel I is one of the most fully implemented international agreements. Basel II was agreed, but not implemented in the US. Regarding Basel III, the 2010 agreement has been implemented across the world, with parts requiring revisiting currently focused on. The public authorities will worry if Basel IV is not agreed soon.

### 2. Basel IV: various specific technical standards among which FRTB and NSFR, are still under review

Between the two Basels seven specific technical standards are agreed but not implemented, of which only the approach on Interest Rate Risk in the Banking Book (IRRBB) has good prospects of implementation around the world as scheduled. The current focus is on NSFR and FRTB.

The European Commission has issued a draft modifying the Basel Agreement in certain aspects whilst a report by the United States Secretary of the Treasury indicates an intention to postpone implementation until review and recalibration of the agreement is complete. That shocks some, but many countries want to see Basel revisit certain aspects of the agreement in the Net Stable Funding Ratio (NSFR) and Fundamental Review of the Trading Book (FRTB).

### 3. The Basel Committee closely monitors timeliness, consistency and the outcomes of international standards implementation on a regular basis

The question of the level playing field is an area of interest. There is an understandable focus on the US Treasury report. The Fed and other supervisory authorities have full control on writing regulations, but will not necessarily ignore the Treasury report's recommendations. However, there is much more reason to believe that the US will not adopt the rules.

Finally, officials considered that the Commission did the right thing by getting ahead of the curve.

### 4. The EU considers that the impact of these additional technical standards should fall under the commitment of the G20 not to significantly increase the regulatory capital of banks

The problem is that the impact on market risk capital of the FRTB by the Basel Committee was intended to be around 20% but is actually around 60 80%, which must be reduced. In addition, although there is disagreement among the countries represented on the Basel Committee, the Secretariat considers the FRTB outside the G20 Commitment to not significantly increase the capital requirement. The EU considers that the impact of these additional technical standards should fall under the commitment of the G20 not to significantly increase the regulatory capital requirements of banks.

### 5. FRTB results from continuous industry interaction and is still being adjusted

An official stated that the FRTB was a multi year process with enormous industry interaction, but its momentum and political support has waned. The impact of this standard is known since at the request of the industry the Basel Committee conducted several quantitative impact studies. In addition, stakeholders are encouraged to think in terms of the absolute amount rather than the percentage increase, when they discuss the increase in market risk capital.

The Basel Committee is looking at making an operational test as well as an assessment of the response function of the standard regarding its impact on financial markets and players. A few things in the standardised approach are being looked at on recalibration, but that is a narrow range of modifications.

### 6. The industry still criticises the design of the NSFR

The issues raised by NSFR are about derivatives as well as securities factors copied from the LCR, which effectively asks securities finance businesses to survive the LCR but for one year. It was never an intended outcome of any Basel document. It is the asymmetry in repo which the Commission has gone some way to reduce, but on Level 1 HQLA it is additional funding that the bank does not need.A recent Basel III implementation report indicates that the NSFR for large banks is gradually increasing and the shortfall rapidly declining.

However, nobody has looked at the figures for the post Brexit situation where many capital markets subsidiaries move from London to the continent. There are also questions about what the NSFR looks like for those and what trading book rules look like on a standalone basis since they are currently assessed at a consolidated level, which is not the way that banks will manage capital.

There are two other key topics for Europe: whether NSFR should be applied to all banks and the question of waivers. Many countries have high resistance to considering waivers to current domestic ring fencing of the liquidity and capital within the banking union as proposed by the EU Commission. The waivers currently in place must be extended, but in the same jurisdiction those must be extended to others to allow for a mobility of liquidity in the banking union.

### 7. Defining appropriately an impact assessment methodology is essential

On trading activities Basel is gradually increasing the heat whilst offering assurance that everything is fine, but for banks providing the financial markets with liquidity it is rather warm. Only two regulatory changes currently impact the markets, but seven more are incoming. Some warn that implementing all of the new regulations alongside the current nervousness around the calibration is too risky.

Before implementing the FRTB, NSFR and SA CCR, serious consideration must be given to the impact studies. Some are concerned by the EBA impact studies. Compliance on a consolidated basis does not matter with the ring fencing of different pools of capital around the globe, but such an impact is not understood. The impact on individual subsidiaries in groups, ring fenced in Europe, must be considered. Ultimately there is a large pool of capital being fragmented and potentially unable to support the activities that stakeholders want it to. In addition, that is actually not a trade off between financial stability and instability. All stress tests run by the official sector show banks exiting the most severe stresses with more capital than they went into the last crisis with. Crises absolutely have costs, but preventing them is not cost free.

Going forward effort must go into assessing both positive and negative impacts of the reforms. Some advocate conducting the review from the perspectives of A to G: Aggregate, Behavioural, Cross sectoral, Dynamic, Ecosystem, Feedback and General equity volume. The industry and regulators must cooperate to find proper assessments of effects and side effects.

Some find the entire impact discussion unfortunate. Various reports and subsequent responses are published when what is really needed is dialogue and to find convergence in views.

There is continued pressure on banks and shareholders to improve returns, and consideration must be given to reduced return businesses, and how to make them more profitable. Studies with the official sector will make it simple to identify the low returning activities.

Two major unintended consequences must be discussed. First is for end users; if capital charges increase, then derivatives instrument prices will increase, potentially making the cost of hedging foreign users prohibitive and leading actuaries to reduce their hedging policy. That may leave some risk insufficiently or not at all hedged, which is clearly not the objective from a financial stability perspective. Second is for the industry itself; certain market segments or asset classes will become uneconomical for banks, leading some players to reduce activity and withdraw, likely exiting the less liquid markets first, further reducing market liquidity and depth, which is also not good from a financial stability perspective.

There is no magic in market making. Liquidity in the market is closely linked to the presence of sufficiently active market makers. For market makers to be efficient they need sufficient inventory to satisfy demand when needed, and carry matchbook without excessive burden. The single regulation may hit both inventory holding and matchbook treatment, leading some market makers to withdraw from some markets. The case is similar for NSFR. The asymmetry remaining between repo and reverse repo somewhat leads to the same consequences, again impacting the ability to hedge.

### 8. A complex and changing context in fixed income markets prevents concluding the work on the regulations in order to improve financial stability at a reasonable cost

Industry members are pleased to hear acknowledgement of an issue with the figures and impact assessments. Upcoming regulation requiring significant additional buffers is a clear issue. The figures rely on optimistic assumptions and EU capital market activities will be hit harder by the rules than other markets, both of which must be considered and tackled.

Liquidity levels are at the heart of the balance between financial stability and economic activity. A key question is whether the reforms seen so far unduly restrict the activities of market makers. The good news is that many stakeholders are considering the issue. The bad news is that even recent work is inconclusive as to whether action is needed and, if so, what.

One driver behind the current uncertainty is the range of drivers in play including the monetary policy and low interest environment, changes in the functioning of fixed income markets, reduced risk tolerance by dealers and market makers in the post crisis environment, and the impacts of regulatory reform. The second driver is about assessing the level of liquidity. The core question must be considered across at least two dimensions: the current and normal market levels of liquidity in normal market conditions, and the resilience of that liquidity in times of stress.

### 9. The EU Commission and the Presidency are keen to address the points that need attention in the proposed legislation on liquidity and market risk in the coming months

The NSFR was proposed in November. It has a clear rationale: to avoid extreme mismatch in liquidity. There will be one cost if there is international consensus and a far greater cost if not. Although it is good to negotiate together, it is better to act after negotiation. Friends of the Basel Committee could usefully reflect on post negotiation. Movement begins when negotiation translates into practice. Clarification of the FRTB is due for the end of the year, although which year is not specified.

### 10. The decision of certain large countries to postpone the implementation of these standards suggest the EU should consider whether the level playing field and regulatory certainty can be achieved globally without losing the momentum toward fixing remaining stability issues

NSFR and FRTB must be implemented. NSFR has a proposed rule in the US, but there is currently no US proposal for FRTB. A concern is that a proposal from the US on FRTB may not be received, and the proposal from the European Commission may differ from Basel's output at the end of the current or next year. If the US Treasury recommends that the US delay implementation of FRTB then a similar exercise must be performed in Europe with an alignment in the implementation agenda.

The level playing field must be considered. The US will not apply the framework as it is. Basel has reopened all of the issues and work is ongoing. It is therefore unclear why the Commission should keep its proposal on the table. Europe must do the same as other jurisdictions and postpone.

The industry is not asking that the package be dropped and work directed elsewhere, but that the specific points of concern regarding calibration or the structure of the European market be taken into consideration. Time should be taken to ensure a proper framework rather than rushing to implement potentially improper rules perhaps with unintended consequences. The industry is more than happy to contribute to the work to find the right balance for the rules to be applied.

However, commentators advise that if the current momentum is lost, then it may be lost for the long term. The agreed package of reforms must be put in place and then revised where necessary. The NSFR and FRTB address two key problems that led to the crisis: the mismatch in maturity transformation and the abuse of the trading book. They must be fixed, and that will become difficult if the current momentum is missed.

The momentum must not be lost, but that has an enormous impact on an organisation's planning and business model going forward. A day to day challenge for industry participants is stakeholder management. Not knowing the impact makes it difficult to make clear decisions. Meanwhile, preparing for implementation requires work, so huge investment has already gone on. The sooner there is clarity and harmonisation on what must be done, the greater the benefit. It will impact business models for the next 10 15 years.

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## Review of Solvency II

**1. An essential objective specific to the incoming revisions of the Solvency II framework is to ensure its coherence with insurance accounting standards**

There was a broad consensus that Solvency II is basically a meaningful system and that its relevance had been shown in the first period of application. As a result of the Long Term Guarantee package that treads a careful balance between objective of prudence and growth. Therefore, care is needed when deciding about changes to the system.

Notwithstanding this, since the International Financial Reporting Standards (IFRS) 17 will be the new accounting framework for insurers from 2021, it will be important to ensure some level of consistency between the solvency framework and the accounting framework. It is important that the solvency and financial reporting frameworks are respecting the insurance business model and the way the companies are managed. Currently, there are too many different frameworks and this complexity is reflected in market valuations.

The European Commission has sent a call to EIOPA for technical advice and intends to remove any unintended inconsistencies in the standard formula. The Commission also understands the need for proportionality and in this context a simplified application of some of the requirements. This, however, does not mean pushing forward inconsistent measures since policyholder protection is the core objective of Solvency II.

**2. An appropriate sequencing of the revision of Solvency II enables factoring in relevant experience and can increase its consistency**

One speaker noted that care is also needed with the sequencing of the Solvency II revisions. All the issues seem to be linked to each other, and an impact assessment of the whole picture is strongly recommended. Appropriate sequencing allows to consider consistency with IFRS 17 accountancy rules.

Consistency between IFRS 17 and Solvency II is important as it will reduce complexity. Revising the Solvency Capital Requirement (SCR) is an opportunity to eliminate inconsistencies or inaccuracies in the regulatory framework and also ensure that Solvency 2 does not apply unjustified constraints on the financing of the economy.

One speaker highlighted that it also makes sense to have a different sequence with the revision of the Long-Term Guarantees (LTG) package in order to see how it works over a number of years. Changing the more fundamental aspects of the SCR requires taking into account all the aspects that could have a material effect on the overall result.

**3. Various improvements are needed**

The industry speakers highlighted that legislators and regulators can be proud of Solvency II as it is the most sophisticated and comprehensive solvency regime in the world.

In order to improve the Solvency II regime so as to maintain a stable insurance system and to protect policyholders, three objectives must be achieved: i - an adequate calibration of some risk modules, such as assistance and catastrophe risk; ii - a reduction in unjustified complexity; iii - and an adequate assessment of the risk profile of the different assets, in particular through a relevant level of granularity duly taking into account the pivotal role of insurers as long term investors

There also needs to be a clear, common understanding of the LACDT (the Loss Absorbing Capacity of Deferred Taxes), specially with respect to the cost of capital as well as regarding the Ultimate Forward Rate (UFR) used to discount the liabilities of insurance companies. There is also an ongoing debate regarding the optimal way to address in the solvency framework the exposures of insurance companies to regional governments and local authorities.

In addition, digital assets need to be recognised for own funds as they are in other industries like banking. Some insurance companies invest significant sums in digital assets, thereby investing in the economy and creating jobs.

EIOPA has produced its advice on Solvency II and the SCR review, which will be delivered to the European Commission. The new system needs to be implemented in a convergent way.

**4. Long-term guarantee review will be critical to adequately reflect the business model and its inherent risks while mitigating unwarranted solvency volatility and enabling long-term investments**

The LTG review aims at ensuring that the volatility of very long-term business is properly dealt with while reflecting the long-term character of the business and its underlying risks. In this context, it is important to be able to offer long-term products also in the future and to invest in a wide range of long-term assets to cover them. It is neither in the interests of policyholders nor the economy to invest in risk free assets only.

One speaker expressed three wishes in terms of the review: the avoidance of excessive prudence so that insurers are allowed to be long-term investors; the avoidance of an overly conservative framework for new features like negative interest rates that would lock parameters in extreme market conditions; and the preservation of the internal models as a tool for maintaining a good understanding of their risk profile.

If Solvency II is to be an early-warning indicator for supervisors, the market consistent valuation of assets and liabilities should in principle not be abandoned. However, the effectiveness of the LTG measures should be reinforced and improved in order to soften credit spread and equity movements that do not reflect actual risks underlying the business model or permanent trends. The volatility embedded in Solvency II needs to be managed. The European Commission's decision to launch a study on the impact of Solvency 2 on the investment mix of insurers is welcomed.

**5. Consistency with the Capital Market Union and Sustainable Finance EU priorities are further goals for consideration**

The sequencing of the review should be articulated with the political priorities and objectives of the action plan on the Capital Markets Union (CMU) in mind. It is important to ensure that insurers are better able to finance the economy. Private equity is extremely important in helping insurers to contribute to financing small and medium-sized enterprises (SMEs). The agenda is already significant but something more ambitious is required to fully address this. More generally, the long term commitments of insurers need to be better understood and addressed from a prudential standpoint.

Ultimately, the solvency of the insurance undertaking is the first pillar of sustainable finance. However, not everything can be achieved simply by reducing the prudential requirements. The system has to be well-calibrated. One speaker believed that climate issues would not be solved via a solvency regime. Though long-term investments need to be discussed, the question of whether or not those investments are green is irrelevant. Rebates should not be given on specific investments for political reasons.

Another speaker stated however that Solvency II could be a useful tool in moving forward in a prudentially sound manner on the Paris Agreement and the work on sustainable finance and sustainable development.

Catastrophe risk is another issue. It is not only about how long-term investment can be financed more through EU capital markets but also about how financial markets take on new risks related to the sustainability of the planet. The Commission substantiated its call for advice on this to EIOPA prior to the recent weather events in the Caribbean. Unfortunately, such events will occur more frequently and be more intense.

### 6. Cross border supervisory co-ordination at the international and EU levels and the development of national guarantee funds.

Not everything can be achieved with a refinement of the current regulations or with a future revision of the Directive. Indeed, a lot can be done via applying the current system, which is why EIOPA is now focusing on supervisory convergence at the EU level.

EIOPA is aiming at ensuring consistent implementation of the current rules in order to avoid forum-shopping.

Besides, the upcoming European Supervisory Authorities (ESA) review would be a good opportunity to adapt some of EIOPA's powers in the context of ensuring the proper implementation of Solvency II. Governance also needs to be reflected upon because EIOPA has a pivotal role both in terms of supervision and regulation.

In order to properly implement Solvency II, it would also be beneficial to go beyond the common prudential regime in Europe, so that a minimum level of consumer protection is ensured across the board through for instance the creation of a resolution regime and/or the setting-up or the development of national guarantee funds. One speaker hoped that the Commission will better incentivise what is done at the national level to enhance policyholder protection, in particular as far as risk calibration is concerned.

Also, developing a truly European pension market would be far easier if there is a national guarantee fund or if the local supervisory authority is able to take pre emptive measures to avoid distress.

On a European level, insurance groups are acting on a cross-border basis and it is very important to achieve greater convergence in supervision for which the ESA review could be leveraged.

Following this, it will be important to look into the functioning of the international colleges of supervisors, including the work done by the International Association of Insurance Supervisors (IAIS) with the view of protecting policyholders as well as to maintain the European industry's competitive position.

Solvency II is a good micro system but it includes a number of macro elements that help mitigate externalities that certain risk exposures might have on the system. EIOPA and the IAIS are checking whether the micro framework should be expanded to include elements that could mitigate not only the probability of failure of a single company but also the externalities that it could have on the system. There is currently no harmonised method of measuring those exposures.

### 7. Low interest rates and increasing volatility are the global context impacting insurance companies

Currently, interest rates are low while equity markets are fairly stable and volatility is very low. Some market participants believe that volatility will increase in the future. In this context, achieving stability of solvency ratios will be extremely important so that insurers can play their historic role of supporting financial stability, particularly if volatility in the equity and credit market increases.

### 8. Whether there is a 'soft' or a 'hard' Brexit will impact policyholders

Brexit affects not only Solvency II but also consumer protection issues in terms of the validity of contracts. Many issues surrounding Brexit are particularly important to policyholders, such as how cross-border policies and premiums that were entered into before Brexit will be handled. These will depend on whether there is a 'soft' or a 'hard' Brexit and on what agreements, if any, are put in place. The ability to closely monitor the equivalence of a foreign regime is critical in the context of Brexit. EIOPA has issued an opinion on Brexit notably in this respect.

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## Developing Baltic and CEE capital markets

### 1. Challenges and opportunities regarding the development of capital markets in the Baltic / CEE region

#### 1.1. Baltic and Central Eastern European (CEE) economies are strongly bank focused

The Baltic / CEE region is heavily dependent on traditional bank lending and many enterprises in the region are still hesitant about using riskier funding sources, such as equity. This makes the financial systems of these countries vulnerable and limits the channels available to finance the real economy, and especially SMEs. The development of capital markets is therefore of critical importance to the region in helping to create additional sources of funding and diversify risk. This situation is not specific to the Baltic / CEE region as the whole European financial system is largely bank-dominated, compared to the US in particular.

There is broad consensus among authorities in the region in favour of the Capital Markets Union (CMU) objective of diversifying and expanding sources of finance in the EU. Banks and capital markets should not be opposed to each other, however, as they have the common purpose of financing the economy. Banks have more ability to evaluate smaller risks whereas capital markets are generally better positioned for evaluating and financing bigger risks.

#### 1.2. Baltic / CEE capital markets are relatively under-developed

Common features of the Baltic and CEE capital markets include their relatively small size, both in terms of market capitalisation and average daily turnover, as well as certain deficiencies or specificities in the structures of the economies in the region which create significant challenges.

One structural deficiency is the high proportion of SMEs on the Baltic and CEE exchanges. For example, only slightly more than 1% of the companies trading on the Bulgarian stock exchange can be classified as large according to the definition in MiFID. A lack of institutional investors is another characteristic of the region. The amount of net assets managed by pension funds and mutual funds is low, making it difficult to achieve economies of scale if relying only on domestic development. The limited number of companies whose size is above the threshold to go public is another obstacle to the development of capital markets in the region. Many of these cannot be listed, according to MiFID II criteria. Bigger companies tend to be foreign-owned and financed through central treasuries, limiting the possibilities of local expansion.

Another reason for the under-development of Baltic / CEE capital markets is the relatively short time since the establishment of capital markets in the region. This is reflected in the low percentages of market capitalisation versus population or GDP compared to the rest of the EU: for example the CEE region represents around 20% of Europe's population and 8% of its GDP but only 3% of its capital markets.

#### 1.3. Development potential for capital markets in the Baltic / CEE region

However, the current deficiencies of the Baltic / CEE region capital markets can also be considered as possible development opportunities. Policymakers and regulators in the region should in particular take full advantage of the current CMU initiative, which aims at unlocking more long-term capital and delivering additional funding for companies, as an opportunity to make capital markets within the region more attractive, some panellists suggested.

Consensus around the need for boosting local capital market ecosystems has never been stronger, an industry speaker emphasized. In the Baltic countries, there is strong engagement from governments, regulators and market participants towards this objective. There is also a promising concerted action at the international level with the establishment of a working group on CMU within the Vienna initiative, which brings together practitioners from relevant countries with experienced institutions such as the IMF, the EBRD or the EIB. The structural reform support programme (SRSP) launched by the European Commission that provides support to national authorities in different areas including the development of capital markets also provides grounds for optimism.

Making all strategic or publicly-owned companies in CEE public is an untapped opportunity for the region, one industry speaker believed. In addition, a number of assets in government disposal that are not strategic, e.g. minority or majority shares of privatised or listed companies, could boost the supply side of the capital market. Extending the scope of capital markets into new areas such as infrastructures could also be a new niche and a further opportunity for domestic capital markets. Missing infrastructure links in the region requires a great deal of financing. Private-public partnerships (PPPs) have been set up that may be financed by assets held in particular by pension funds.

There is moreover a strong growth of listing and investment opportunities in some countries such as Estonia, shown by an increase in the number of prospectuses being registered this year. Investors are also seeking investment opportunities, which demonstrates that there is money available in the market. These are usually small companies, but this indicates potential. Another less positive aspect is the development of aggressive sales practices in this context, which may pose investor protection issues.

## 2. Priorities for developing capital markets in the Baltic / CEE region

### 2.1. Leveraging best practices

One way forward for developing markets in the region could be the transfer of domestic best practices from other EU Member States.

When analysing European capital markets that work well, such as Sweden, three main characteristics can be identified, one speaker suggested. The first is the presence of an adequate investor base with a well-diversified capital pool that has an appetite for investing in smaller, high-potential companies. The Baltic region lacks such an investor base at present, but structural measures such as the development of a regional or national public-private fund or even of a European-level fund of funds could be a solution. A second successful characteristic of the Swedish ecosystem is a high level of equity culture and the strong engagement of retail investors. Incentives and ease of access have been key drivers of the retail market in Sweden, with a strong role played by investment savings accounts facilitating the investment in securities notably tax-wise. Thirdly the Swedish market also benefits from the existence of a strong market ecosystem i.e. a community of advisors, brokers, analysts and credit rating agencies that supports the access of SMEs to capital markets. Unfortunately, these services are often not affordable for SMEs in the Baltic region, so measures to support financially equity research and the partial coverage of one-off IPO costs could be considered.

Another opportunity to consider is the development of alternative funding solutions based on fintech applications such as crowdfunding or crowdinvestment, the Chair suggested. Innovative fintech solutions would benefit from more harmonisation at the European level, although the appropriate regulatory tools for these are still to be defined.

### 2.2. Widening the investor base and the trade-off between local and cross-border development

One panellist considered that an appropriate balance needs to be found between local development and EU integration. Given the limited development of capital markets in the Baltic / CEE region, stronger growth at the national or regional level is needed first. However, placing too much emphasis on national or regional markets may lead to the development of competing regulatory blocs within the EU.

Some other speakers believed that smaller countries have more to win than to lose through developing access to pan-European securities markets. In one panellist's view, there is no real trade-off between local and EU-level development. If there is too much focus on local development, domestic barriers to cross-border investment will remain or new ones may be created. Smaller companies struggle to find sufficient investors locally, given the general limited development of capital markets in Europe. In this context, expanding the investor base is essential notably by attracting non-domestic investors from across the EU. In the Baltic / CEE region, most companies are small but they may attract asset managers looking for investment opportunities across Europe. This however requires limiting the differences and specificities created by national regulations and discretions, which may dissuade international investors by increasing complexity and limiting their economies of scale. Addressing the portability of pensions is another factor likely to expand the institutional investor base.

The unbundling of research mandated by MiFID II is a further reason for broadening the investor base, as it is the only way to maintain research and analysis on the enterprises of small countries, which otherwise will be too costly.

TARGET2-Securities (T2S) and the CSD Regulation (CSDR) are good examples of initiatives combining pan-European and local dimensions, one speaker suggested, as they facilitate the interconnectedness of markets and the harmonisation of disparate requirements and processes. Facilitating accessibility to small markets in terms of order execution and processing is indeed also critical for attracting big asset managers or intermediaries.

One other option that was suggested for developing capital markets in the region is to expand the scope of indexes such as MSCI in order to include stocks from smaller Baltic / CEE capital markets, which means considering them as mid-sized markets in Europe, rather than 'frontier markets' outside the spectrum of the indexes.

### 2.3. Taking into account the specificities of smaller markets in the Baltic / CEE region with appropriate proportionality

Several panellists were in favour of a proportionate implementation of European regulation in order to take into account the small size of issuers and intermediaries and the recent development of capital markets in the region. A one-size-fits-all implementation of the CMU would 'kill the patient' an industry representative believed. Applying EU capital market regulations such as MiFID II, MiFIR, MAR, EMIR, CSDR… in a uniform way would indeed lead to costly over-regulation, some panellists believed, with the risk of stifling existing markets.

Regulations should be applied progressively depending on the size or level of development of markets and market participants. The proportionality measures of the reviewed Prospectus Directive were welcomed and further areas where simplification for SMEs and smaller players would be needed were suggested such as financial reporting, credit information, requirements for depository banks and the licensing of advisors.

CHAPTER 4

# FINTECH AND DIGITALISATION

## Are EU digital and fintech initiatives up to the challenges?

### 1. Opportunities and challenges associated with technological developments in the financial sector

#### 1.1. Main opportunities offered by technology in the financial sector

Fintech has the potential to improve customer service and to further empower customers. One speaker emphasized that technology, such as big data can help to reduce the reliance of customers on advisors and achieve a better balance of responsibilities in financial decisions. Distributed ledger technology (DLT) with its decentralised approach can also support the provision of financial services at a lower cost and in a more efficient way.

Another speaker considered that new competition, for example created by artificial intelligence (AI), is the main driver that will encourage technology to improve financial services and lower their cost. Financial services that support many everyday life actions (shopping, buying a house...) will increasingly be provided through mobile devices and the internet. Consumers in Europe will progressively get used to interacting more and more with technology and algorithms when obtaining financial services, as experience e.g. in the Nordic countries has shown.

A third speaker explained that technology can help to improve many financial processes. Financial Market Infrastructures (FMIs) in particular are trying to use, whenever possible, different new technologies such as cloud services, machine intelligence, blockchain, digital currencies and quantum computing. It is difficult to know which of these technologies will dominate in three years' time. At present cloud services are the fastest developing technology, as they can significantly help to improve quality and efficiency and reduce costs. Machine intelligence can also support very usefully surveillance systems by prioritising the alerts and issues that the staff needs to focus on. These systems can be taught how to prioritise events and are able to handle very large amounts of information, making it possible to use them also potentially for monitoring trading in electronic systems. Blockchain can also help to improve the efficiency and reliability of many back office and administrative processes, such as the electronic voting system used in the context of annual general meetings (AGM).

#### 1.2. Strategic challenges related to new technologies

New technologies create strategic risk for traditional financial services institutions and banks, which are forced to search for new ways to compete. One speaker noted that the Basel Committee has highlighted five possible scenarios for the impact of technology on banks in a recent report. The most likely scenario, the report concluded, is that many banks will fail to adjust and risk losing contact with their customers, which would undermine their business model and also present a substantial risk to financial stability.

Another speaker agreed that genuinely disruptive activity is happening in the banking market. It is misleading to think of this as standard technological change. The confluence of multiple individually disruptive technologies and data enablers – e.g. big data, the cloud, and smart infrastructures, among others – with on-going changes to consumer behaviour and business models is fundamentally transforming the industry.

This revolution opens new opportunities for banks, however, if they are able to put the customer at the centre of their technological developments and to produce the best possible customer experience in addition to their cost-cutting efforts. Customers have never been so powerful because they can now compare the services and costs of providers and purchase all financial services with their mobile phone. In order for banks to retain their position, they need to define a vision of their business model in 10 or 20 years' time and of the competitive advantages that are needed to outdo fintechs and other non-banking providers. Operationally, banks are hampered by old IT systems which put them at a competitive disadvantage compared to the smart technologies used by fintechs. But the most significant challenge for banks is to change the mindset of their employees by encouraging them to work in more flexible and flatter structures, and in a more agile way. Banks which are not able to develop and implement this future vision will progressively lose contact with their clients and fail over the longer term.

#### 1.3. Potential risks associated with new technologies in the financial sector

Fintech potentially creates risks in respect of data protection, cybersecurity and consumer protection in particular that need to be carefully monitored.

Ensuring that new technologies, such as cloud services, do not create security issues or cyber-risks is a major challenge notably for FMIs, for which preserving financial stability and market integrity is essential. Consumer protection is another concern with many new services based on technology that are not subject to any consumer protection regulations at present. According to an EBA (European Banking Authority) study this is the case for 40% of fintech firms. Additionally, it is necessary to apply AML (anti-money laundering) rules rigorously all across financial transactions, which is not the case today.

The dependency on a small number of providers for each type of technology is another issue for financial institutions. One speaker however considered that this dependency risk is inherent to innovation, which will always be driven by a limited number of first movers. Potential risks can be mitigated by using different providers in parallel or putting back-up plans in place. For cloud services for example the approach chosen by one FMI represented on the panel is to work with the three biggest providers in the market in order to avoid relying on one provider. This is more costly but keeps options open and provides useful benchmarks.

A further issue is that technology is evolving faster than legal frameworks can adapt, creating an uncertain legal environment. This legal uncertainty and instability related to rapid technological change is an additional challenge which is particularly acute in cross border environments where it is often unclear which set of laws or judicial authority may apply. Additionally, technology can push some risk towards non regulated areas or providers. If traditional intermediation functions are destabilised by these changes, this may also have macro-prudential consequences.

### 2. Policy approach regarding fintech and digitalisation and the role of the public authorities

#### 2.1. A pro-active, cross-sectorial and European policy approach

One speaker believed that governments, regulators and supervisors must be active players in fintech development or even 'lead the whole process' and that a European approach is necessary. First, there is a need to clarify what additional value fintech developments may provide in terms of competition, costs, capital allocation and economic growth. Additionally, EU and domestic authorities must cooperate with the industry to increase their competences and address future challenges collectively. The 'evolutionary' approach that is traditionally used by financial regulators and supervisors to mitigate risks in the financial sector is not adapted in this case because it can only address past challenges. Fintech requires a 'revolutionary' approach in regulation and supervision to anticipate and address issues that might happen in the future with regard to fintech, which has not yet unlocked its full potential.

In addition, the regulatory challenge that fintech is posing is too complex to be addressed in the traditional way, segmented by sector or type of customer. There are many innovations in different sectors and the boundaries between technologies and sectors are increasingly disappearing.

### 2.2. Technology-neutrality and need for a holistic approach to regulation and supervision

Firstly a technology-neutral approach to regulation is needed on a 'same activities, same risks, same rules' basis, that also does not determine the type of technology that should be used, one speaker stated. Considering that recent technological developments are 'totally new' and different from existing activities performed by traditional financial institutions is misleading because in many respects fintech is reshaping existing financial intermediation and financial market infrastructure activities, looking for ways to improve their efficiency and reliability. In addition, just as the financial sector is constantly working within and around the rules, the same will probably happen with fintech. The success of some fintech concepts, such as crowdfunding, is probably due more to regulatory arbitrage than to genuine innovation, one speaker felt. Another speaker however stressed that this new competition might provide opportunities to review present regulations and evaluate whether all requirements are still relevant and up-to-date, including for existing players. Regulations also need to be updated in order to take into account new technologies such as the cloud for example, which is not considered by present legislation, but may improve safety by effective encryption. In addition some issues or standards might be left to the market to sort out.

A sufficiently holistic regulatory and supervisory approach is also necessary because new fintech players are often 'cherry-picking' parts of existing activities and therefore regulatory approaches focusing on individual technologies would lead to excessively detailed approaches that would miss broader risks. Taking a step back and using the traditional financial intermediation activities as a basis for policy seems preferable, one speaker suggested. Although the environment and the way of delivering activities is different with new technologies there is still a need to identify the risks in the system and who is carrying them. With fintech, an increasing amount of activity is being handled in lightly regulated areas, but still traditional risks do not disappear because peer-to-peer platforms for example may be funded by banks or may securitise loans.

### 2.3. A collaborative approach between the financial industry and the public authorities

Care must be taken, one speaker emphasized, that regulatory and supervisory constraints do not hinder the use of new technologies or the externalisation of services to new service providers. Although related risks should be identified and managed, innovation should be allowed to develop. For example the use of private clouds is not permitted by some supervisors to stock client data, one speaker regretted, which is quite a limitation for banks. Authorities and firms must identify and manage the risks of innovation together. A general improvement of the knowledge and competences regarding technology is also needed among regulators and supervisors, who require more staff with data science and IT skills in particular.

In some areas, the speed of innovation and the lack of market standards mean that public authorities and private sector firms must collaborate to understand the implications of technologies. Supervisory sandboxes, which are environments where new technologies can safely be tested with real customers, are a very useful tool to help the authorities and the industry manage risks together and jointly develop fintech applications, several speakers emphasized.

Sandboxes can help newcomers in the sector who do not have experienced compliance departments, to better handle regulation and learn how to interact with regulatory and supervisory authorities. Sandboxes can also help supervisors to decide if a concept is really new and if it works after closely monitoring its implementation. One speaker considered that they are actually more useful for supervisors than for the industry. Sandboxes should be made as large as possible, another speaker suggested, ideally covering several countries and incorporating both traditional players and start ups, because some technologies will only work if there is sufficient scale. At present however they are only national.

Another helpful tool is the use of 'innovation hubs', which can cover a range of needs from the provision of information to advising on new technologies based on an assessment of their degree of innovation and usefulness.

The alignment of incentives is also very important. Often, problems in the financial sector are caused by bad incentive structures. That is not easy to put into regulation, but assessing the incentive structure of any business is essential for evaluating risks.

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# Leveraging fintech in the context of the CMU

## 1. Opportunities and challenges of fintech applications in the capital markets

### 1.1. Current level and speed of adoption of fintech solutions in the financial sector

To a certain extent, every financial institution has already started to use new technologies such as distributed ledger technology (DLT), artificial intelligence (AI) and robo-advice. There has been an increase in collaboration between fintech companies and traditional financial institutions, with the latter seeking innovations that they are not necessarily able to develop or implement by themselves and fintechs looking for client access. Wider scale projects involving fintech are starting to emerge such as the project of the Australian stock exchange to use blockchain technology for its cash equity market and several consortia are assessing and testing the use of cryptocurrency on the blockchain.

The speed and scale of fintech adoption is particularly significant in China where big fintech companies such as Tencent and major digital insurance companies such as Zhong An have imposed themselves on the market, which is not the case yet in Western countries. Tencent's app, which counts over 950 million users offers various services including financial services (payments, loans…) together with social media and a search engine. All the data produced is combined and used for the services provided by the app, allowing the achievement of very low fraud rates and also low NPL levels for loans, results which are superior to those usually obtained with bank data. One speaker commented that such offers may however be difficult to develop in Europe with the current European data protection regulation.

### 1.2. Improvements to existing processes supported by fintech

Fintech applications can be used to improve current processes that are not resilient or efficient enough. For example, blockchain can support the governance of a bank's risk clearing operations by providing additional data backups. It can also eliminate the need for certain manual processes that are labour intensive and carry significant operational risk notably related to transfers of information (e.g. corporate actions).

Fintech may also catalyse further change with regard to financial market infrastructures (FMIs). FMIs have been digitised for many years but are assessing the use of fintech for new services and asset classes that are not yet digitised (e.g. gold) and / or costly to serve (e.g. SMEs). Change will however happen mainly in secondary areas in the short term, one panellist believed, as fintech technology is not yet robust enough to be used for core FMI services. Start-ups are building new platforms that use blockchain technology to run the whole cycle of trading down to clearing and settlement, but new technology alone is not enough to create a new market infrastructure of sufficient scale to replace major existing FMIs or to fundamentally change the way existing providers operate, one speaker considered.

### 1.3. Contribution of fintech to the achievement of CMU objectives

There is potential for fintech to be a key driver of the development of EU capital markets going forward and fintech is one of the main new priorities in the Capital Markets Union (CMU) action plan that has been updated following the mid-term review.

One speaker suggested that any assessment of the contribution of fintech to the CMU first requires an understanding of which parts of the CMU framework are most decisive in building a European capital market. Three points are significant in this regard: building a stronger market ecosystem for SMEs in Europe; increasing engagement from retail investors in capital markets; increasing the depth of markets across the EU and developing their cross border nature. There is scope for fintech to improve all three of these aspects of the investment chain in the short and longer term.

Fintech may first have a significant impact on SME funding, allowing them to raise more capital in a cheaper way and from different investor pools, thus lowering their funding costs and risks. Change is already occurring with, for example, crowd-funding and investment platforms facilitating SME financing. These platforms may play quite a significant role in the future, although it is difficult to predict to what extent, a speaker considered. The use of DLT, which can have an impact where data or processes need to be shared safely between multiple participants, is also being explored for e.g. the issuance, payment and settlement of SME security trades and also for customer authentication.

On the investment side, services like robo-advice can reduce the cost of advising customers and can help to match investors and investment opportunities. Fintech can also provide tools and information to help people better understand the implications of investing in financial markets and taking risks. There is also scope for fintech to facilitate cross-border investment and product distribution without having to build a physical local presence, although the regulatory implications of this still need to be clarified.

It should be recognised that fintech will also have indirect effects, which may be important for the achievement of the CMU in the longer term. Examples include: cost reduction, which will facilitate the adoption of more diversified financial products by retail investors; and making investments of limited amounts in SMEs easier to handle for individuals and SME issuers, since blockchain and smart contracts can facilitate certain operations such as the handling of dividends.

Technology can also facilitate the development of new funding mechanisms and investment spaces. Initial Coin Offerings (ICOs), for example, allow investors to invest in the protocols and the usage of a technology rather than in the equity of the company that is providing the technology. The trading that will happen in the secondary market will also be in the tokens of the protocol. This marks a fundamental change whereby investors are more concerned with the quality of technology and the protocols rather than with the quality of the company's management and organisation. These new financing mechanisms will have an impact throughout the whole trading and processing chain. For example, an investment company wanting to create a fund investing in ICOs will need a custodian for such assets, which will raise questions regarding how these assets can be serviced and, in turn, will lead to the development of new custody services.

One speaker finally noted that fintechs themselves could help to achieve the objectives of the CMU by becoming over time a new category of medium-sized companies, more capital market-oriented than traditional SMEs and therefore less hesitant to go public, which would allow them to be more competitive on a global scale.

### 1.4. Challenges associated with the development of fintech

There are some challenges to the development of fintech applications in the market, the most significant of which is the regulatory environment. One speaker claimed that starting a fintech is '80% to do with the regulations and only 20% to do with the technology'. A fintech company has to obey existing market rules in order to attract investors to a platform and, if it cannot work within those rules, it either has to innovate in the ways it runs its business or move to other business or jurisdictional areas with more compatible regulations. Therefore, regulation is more decisive to a certain extent than technology for defining in which environment a business may operate.

Another challenge is related to access to capital. At present, capital markets need to be quite local and regional because of the regulations, whereas private capital is heavily provided by angel investors outside Europe who usually have an international perspective.

KYC (know-your-customer) and AML (anti-money laundering) rules provide further challenges. Automating KYC will cost significant amounts of money and there are only few service providers at present. KYC and AML requirements however also have significant impacts on traditional banks with rules that often differ across jurisdictions, involve significant liabilities and require in some cases a high level of intrusiveness.

Another challenge is the current knowledge gap in the financial industry and the investment community regarding technological developments. One speaker believed that most investors do not understand much of what is being discussed in this area and that this is also the case in traditional financial institutions where perhaps only 20% of the staff are technologically minded.

Finally, utilising blockchain and other new technologies e.g. for processing corporate actions, requires common approaches and standards which do not always exist at present, regarding how the information is structured. Without such commonality, there can be no European or global approach.

## 2. Prospects of an EU fintech framework

### 2.1. A technology neutral approach to regulation

The speakers on the panel were generally in favour of technological neutrality – i.e. that there should be the same rules for the same functions and same risks – because it allows the market to decide which practices or technologies are the best and puts all players on an equal footing. It is difficult for regulators to decide which technologies to favour since the pace of innovation is so fast and they are not the best placed to know what will succeed in the end. Another aspect is that technology often allows the same actions to be performed in a more efficient way.

One speaker considered that the 'same business, same rules' principle is also necessary to maintain financial stability and market integrity, notably when considering activities performed by FMIs such as securities transaction clearing and settlement. A specific regulatory framework for fintech is not desirable, because different operators conducting the same activities need to comply with the existing regulatory framework.

Another speaker however believed that consideration should also be given to the scale on which services are provided when defining rules, in order to allow in the first place the development of services and concepts that are scalable.

### 2.2. Balancing financial stability, consumer protection and innovation

One speaker stated that a technologically neutral approach should not preclude regulators from carefully observing what is happening in the market and monitoring potential operational and financial stability risks associated with fintech. There are indeed significant risks in widely adopting fintech at a time when capital market regulation is still being rolled out and market structure is evolving.

Another speaker emphasized that fintech is no longer an option but a necessity, and regulation will be required to prevent risk, ensure stability and establish consumer confidence. At the same time, over regulation must be avoided so as not to stifle innovation. Any fintech framework should therefore strike the right balance between financial stability, consumer protection and innovation in order to fully harness the benefits of technology. The same type of approach could be used for innovative funding mechanisms such as ICOs.

Regulation reflects the present organisation of the market and needs to be updated transversally for each activity, taking into account technological innovation but in a technologically-neutral way. One speaker suggested that existing post-trading regulation for example, which is mainly designed for traditional FMIs, could be reviewed to make sure that it does not unnecessarily constrain new fintech developments.

Another speaker suggested that although there is potentially a scope for some kind of European fintech framework to support its development, this should not necessarily involve creating new legislation or changing regulation. Different approaches could be considered such as supervisory sandboxes. There is also the question of what regulators should regulate regarding fintech, a speaker stressed, whether it is the general principles or the specifics of the solutions themselves.

### 2.3. An EU approach to sandboxes

Several speakers believed that sandboxes, which are supervised environments where new technologies can safely be tested and experiments can be conducted, are an appropriate solution for supporting the development of fintech.

Such sandboxes, however, are currently found at the national level, whereas financial regulation is mostly European and many fintech projects have an international ambition in order to leverage potential scale and network effects. Suggestions were made that an EU approach should be favoured regarding supervisory sandboxes, building on supervisory cooperation, in order to carry out tests on a European level.

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## Digitalisation in retail banking and payments

### 1. A recent public consultation on fintech will enable the EU Commission to adopt a strategy by the end of 2017, while new paradigms in digital innovation are causing the regulatory scope to widen

The EC recently had a public consultation on fintech and how to regulate different parts of the digital services and financial industry. The goal is to adopt a fintech strategy by the end of the year, including initiatives in blockchain. The public consultation revealed support for principles such as neutrality, proportionality and "same service, same rules".

The planned fintech observatory and forum will be a place to bring together stakeholders interested in various use cases and maybe agree to test them. The Commission has also convened the European members of the ISO technical committee 307 on blockchain, and policymakers are looking further at what needs to be done in the standards and interoperability landscape. Positive responses were also received for the fintech innovation lab, in which regulators could discuss service level agreements, and an initiative on regulatory sandboxes, which will be explored further at the Start-up Nations Summit in Tallinn, on 21 22 November 2017.

The adoption of packages on cybersecurity and the free flow of data will make sure that the industry has the tools to prevent cyberattacks and address information sharing. These must move rapidly through the Council and Parliament to enable financial service providers to utilise cloud services and data storage anywhere in the Union. Any framework should not prevent anyone from investing in innovation, but must also contain principles on risk and supervision. This is one of the key elements of the regulator's agenda.

In the past, supervisors have been more focused on traditional prudential considerations, such as safety of funds. This remains an issue, but IT systems and data are commanding their attention much more. They are incentivising a range of new services, the challenges from which cannot be disregarded.

### 2. The new operating system is based on an unprecedented exchange of data which ends up at a digital identity that regulators need to protect while also stimulating competition in the sector

A fundamental change is driven by PSD2 since banks are required to give access to third party service providers and payment initiators, which is truly a paradigm shift.

In addition, banks have historically been in a position to put together complete identities of their clients, but this may be changing now, as they open up to other providers. It is important that information is handled securely and does not get lost on the way. There is also a tricky question around the APIs (Application Programming Interfaces) between the incumbent banks and new service providers. The key is that customers need to give informed consent if somebody else wants to access their private data.

There are big opportunities here, but also big risks. Protection of digital identity, when managing payments in this new operating system, is extremely important. In this collection of systems, intelligent architectures and infrastructures talk to each other, with diminishing human intervention. At their very heart is the ability to exchange data on a scale never seen before. A vast proportion of those data are about the individual human on the planet. The payments industry is leading society's experimentation in this new world.

There were several references to payments eventually merging into the transaction and becoming an even more invisible signal, though what still most matters to everybody is the identity of the party at each end of the transaction. Data are being shared on such a scale that parties could assemble a digital identity of each of us that is more comprehensive than our physical identity. In that context, the EU General Data Protection Regulation (GDPR) is a world leader in protecting us through that process.

In this context, for example between 80% and 90% of French people are concerned about the protection of their personal data and feel insufficiently informed about how they are used. Most consider their data safer with a bank. Crédit Agricole adopted a charter on client data at the beginning of this year, the basic idea being that they will not sell data without clients' consent. Tensions around being forced to reveal confidential information and control it after doing so could be solved by regulators and governments working together. The perception of the industry is that digitalisation and innovation are concerned with efficiency and customer experience, whereas security is related to data. According to some research, 70% of customers are more willing to store their data with a bank than with any other payment initiation provider, but that target is moving today.

Several speakers mentioned that people are more willing to trust banks but, in reality, regulators and governments force them to give away customers' most confidential data and that is where the danger sneaks in. In the years ahead, some non-banks may become great examples of doing things right, but things may also go wrong. There will be screw ups, crimes and fraudsters, as the integrity of the non-bank model is tested. There is also a political price tag attached to being bold and promoting innovation. It was for the regulatory community to find the right conclusions to safeguard digital identity. This will be a process of trial and error, because the trust associated with institutions that people have known for hundreds of years is not there anymore.

However, the private sector is moving fast, because the competition is delivering better service, and a concerted effort by government and regulators will be required to keep pace. There is a proof of concept for digital cash out there, yet some are pretending this is not happening. Fintechs are generating competitive pressure that is causing supervisors and regulators to change their mind-sets.

To address these trends one regulator does not fine new entrants to the market if they misbehave in their first year and waives their profit taxes. There are many ways in which the regulator can hold the hand of new entrants; one is to give advice. Everything has become very complex, and new entrants sometimes lack experience. An additional sandbox approach is to drop the barrier to entry. Banking is not a complicated business; you may have access to technology, proper funding and a structure, but infrastructure is difficult for new firms. Maybe some authority could provide them with a platform.

Yet, a regulator saw a danger in the sandbox approach, although challenges had to be addressed differently by different authorities. Some questioned whether a regulator has a mandate to promote competition. However, even the most orthodox supervisor must accept the need to approach start-ups and fintechs in a different fashion. The regulator already applied principles of proportionality, and young companies could speed thing up by doing more online, thus promoting more competition. Some commented that anyone entering a regulated industry, has to be supervised, but perhaps it should be left to the market to decide whether to level the playing field. Some saw a revolution underway here; to protect the consumer it is vital that government, regulator and private sector develop a modus operandi.

The Commission's perspective on regulatory sandboxes and innovation hubs was that member states should utilise their subsidiarity but consumers must be protected to the same degree, for either ring fenced or small entrants. In this context the Commission is seeking to find a way for the regulator to support innovation without endangering financial stability or consumer protection. If everyone could be included in a sandbox built from a pan European perspective, all would learn from each other.

In parallel, the Commission works with the ESAs on harmonisation and collaboration between countries, and is looking at moving some services to blockchain, and will perhaps utilise innovation procurement for that.

### 3. Fintechs, banks and EU institutions are partnering to revolutionise payment systems and build customers' confidence upon quality, reliability and unbelievable pricing

Technology is enabling things that could not even be thought of in the past. Today, in order to be relevant, you need something other than trust; you must also appeal to the customer. Building on the cornerstone of security, any proposals that also contain customer experience will determine who wins in the future. This is something that, in the years leading up the financial crisis, banks did not see as relevant. Finally, the real challenge now is not technological, but behavioural. Customers request a 24/7 service that is simple and fast, so organisations have to further adapt and invest to speed up their processes, although banks have been at the forefront of innovation for many years; they developed online banking, self service branches and money transfers.

Digitalisation should never result in an exclusive approach. Studies have shown that most customers prefer a dedicated relationship with a personal adviser, and 80% of clients still subscribe to financial products in a branch. It should be left to the customer to decide how to deal with their money, and banks to provide complete interoperability between different channels. Banks could even be considered large fintechs, investing in technology and changing the services that customers receive.

This ends up with examples of the regulators, supervisors and private banks working closely together. One of them could be seen in Estonia, on products around e identity and solutions for API and money laundering. Trust was needed to get such cooperation going.

Zelle, a Peer to Peer (P2P) company set up in partnership between different banks, recently outperformed PayPal's Venmo by number and volume of transactions during the same period. This is a P2P solution proposed by the banking industry, even when it would be more natural to use banks. TransferWise also relies on the banking network to ship money around the world, and many newer retail banks choose TransferWise to do their international transfers.

So much is happening in the financial industry with services becoming increasingly digital and customers expecting more convenience, faster payments and easier access to everything.

Acknowledging the importance of the relationship between banks and other stakeholders, the EPC (75 members who are Payment Service Providers (PSP - mostly banks) or associations of PSP) is rolling out a SEPA Instant Credit Transfer (SCT Inst) payment scheme providing the necessary conditions and rules for an integrated instant payment service.

This is also being pushed by the ECB through the Market Infrastructure Board, which is developing the TARGET Instant Payment Settlement (TIPS), a much awaited integrated service to provide settlements instantly, from one end of Europe to the other. The Central Bank became involved because, initially, innovative solutions tend to focus on national markets but must have the potential to extend their reach to pan European level or to be interoperable with other solutions. By providing TIPS, the ECB and the Eurosystem will make sure that the demand for instant payments can be met at Pan-European level and further facilitate integration in the euro area.

Competition is very important, but so too is safety. Whenever you have instant finality for a payment, access to further information regarding both the payer and the payee is much less relevant or no longer needed. These developments will change payment habits.

In the future, there is likely to be more of a single market in financial services. TransferWise has challenged the status quo in overseas money transfers, but their biggest problem at the beginning was one of trust. First, customers felt like they were joining a revolutionary movement, but the founders relentlessly focused on making the product better than any other service provider, with an initial price 10 times better than their competitors'. They improved their speed, measuring transmissions in seconds from receipt to disbursal. Soon, customers were telling their friends about the service. The product has grown exponentially through word of mouth, and was now saving customers £45 million a month. Any bank could have started TransferWise in the last 100 years, but none did.

## AML, KYC, data and competition challenges for digital banking

### 1. The impact of digitalisation

Digitalisation is an area of great opportunity, impacting both classical retail banking and the payment industry. It provides an omni channel approach for consumers who want all their needs fulfilled in one place. Digital banking is in addition intrinsically related to big data which equates, for the customer, to convenience and, for the banks, to new competition.

Digitalisation touches upon all aspects of the industry. Some firms, for example, are developing instant lending whereby a customer can receive funds within 20 seconds of a loan application. Others are executing the payment process in ways that are enticing to B2C clients. By acquiring data on a person's living expenses, a bank could provide a package that includes not just a mortgage but other household essentials such as energy and insurance. The question, however, is whether customers would be happy for their data to be used this way and, in any event, whether it would be permitted under the General Data Protection Regulation (GDPR).

### 2. The emerging opportunities of fintech require banks to consider unprecedented levels of investment

Banks are investing in digital banking in order to have access to the diverse opportunities associated with it. They invest directly and also through the many fintech initiatives not so much in pursuit of a direct return on investment but for the opportunity to use the technology. At no point in history has so much money been invested in the industry, all of which will ultimately benefit notably all the payment business which is now more diversified than ever.

There is the question of whether banks are the best platform for digital banking when compared to, for example, the telecom sector. One speaker acknowledged that players outside the banking sector can sometimes develop better solutions that are quick to market. But another speaker remarked that, unlike telecom service providers, banks still enjoy the trust of their customers. Moreover, the cost of regulation can preclude fintechs from obtaining a banking licence and entering the banking space.

### 3. The competitive challenges from information technology; the real question is identifying exactly what it is that banks are preparing themselves against

Banks will soon face competition from information technology companies as payments and transactions cease to be distinct processes as seen, for example, with Apple Pay. Transactions produce a vast amount of data, and anybody with experience and knowledge in the area of big data will be able to eat away at the banks' share of the market. Some banks are preparing themselves for this competition by using, for example, real-time banking platforms. The real question, however, is identifying exactly what it is that banks are preparing themselves against, exemplified by the fact that some people who bank on WeChat in China might not know exactly which institution they are banking with.

### 4. The main challenge for financial institutions is probably to have a clear understanding of what law and regulations require them to do in a highly innovative context

One speaker stressed that it is difficult to make any predictions with regard to the regulations because much of what is done at the European level is determined at the international level by standard-setters such as the Financial Action Task Force (FATF). Since Europe has a relatively new legal and regulatory AML/CFT framework, which is relatively robust and technologically neutral, and therefore able to accommodate financial innovation, it is unlikely that there will be significantly more or significantly less legislation or regulation unless international standards change. But tweaks to this framework are possible where this is necessary to respond to emerging compliance challenges that cannot be solved through guidance alone.

There will, however, be more regulatory guidance for anti money laundering (AML) and counter-terrorist financing (CTF) in this field which will: explain the rules so that everyone has a shared understanding of what to do; clarify regulatory and supervisory expectations; and aid compliance by setting out specific things that firms can do to comply, without being prescriptive.

### 5. Adapting anti-money laundering and counter-terrorist financing regulation also to non-bank financial service providers

One speaker stressed that greater focus is required on non-bank service providers in the context of AML/CTF rather than on banks alone. Bitcoin payments, in particular, are not currently scrutinised under AML/CTF rules.

Another speaker stressed that a great deal of thought is currently being given, both at the national level and at the European level, to the implications of fintech on the regulatory system.

### 6. The facilitation of fair access to customer data is an essential regulatory challenge

It is difficult to define 'digital banking' as there are so many variables that one would need to be careful not to inadvertently exclude some service providers or some types of services.

The second Payment Services Directive (PSD2) regulates access to bank accounts and the wealth of client data associated with them. Regulators have therefore acknowledged the situation and the banks will have to adapt. Ultimately, the legislative process needs to move faster in order to keep pace with market development.

### 7. An appropriate exchange of information between banks and with supervisors is essential to address cyber risks

The exchange of information between banks is important in combating money laundering and dealing with cybercrime but banks frequently find themselves struggling to comply with the regulations on banking secrecy, data protection and confidentiality. Regulatory guidance and legal certainty is therefore required. One speaker stated that, instead of abolishing the existing rules, it is desirable to find the right balance and to adopt an approach that makes common sense. It is accepted that privacy is a fundamental right but, when faced with money laundering, terrorist financing, fraud and cybercrime, a balance needs to be struck. Law enforcement agencies recognise the need for proactive information sharing but it is also important that financial institutions have good customer due diligence measures in place in order to help detect criminals.

### 8. Further harmonisation and an efficient definition of the practicalities of regulations is required to achieving an effective level playing field and the fighting of criminality

Clarity on AML/CTF rules is welcomed, and harmonisation is important in removing the burdens that can otherwise accompany compliance in terms of costs and customer experience, but the real issue is the effectiveness of any practical measures, highlighted by the fact that only a tiny fraction of suspicious reports filed with financial intelligent units (FIUs) in Europe are tried in court.

Banks can be extremely useful in locating criminals and missing people by, for example, tracking their ATM usage, and law enforcement authorities accordingly need to provide those banks with relevant information to allow them to carry out such tracking and monitoring in an effective and thorough way.

A side effect of these activities, however, is that people who do not want to be caught as a result of a bank's know-your-customer (KYC) measures will move to other areas and to other banks that are less stringent. This raises the question of whether the resources are being applied to the right means and the right ends.

In addition, one speaker stressed that the different people within banks who work on AML, CTF and fraud issues do not necessarily talk to each other. Banks therefore also need to look inwardly in bringing all of this information together in an actionable way. Banks should also use utilities and industry platforms to help pool and share information. In that regard, technology already exists that can address the privacy concerns mentioned earlier in terms of encrypting, hashing and masking data.

### 9. Further improving regulation, including in the area of e-IDs and legal entity identifiers, should improve correspondent banking efficiency

One speaker stated that a working group at the G20 level is looking into improving correspondent banking, with guidance expected that will give players a more precise understanding of what is required of them.

Players can also expect supervisors and regulators to help them comply with the rules more efficiently and economically.

Certain jurisdictions have an officially recognised method of creating a digital identity, which is encouraged within the industry. Publication of a legal entity identifier (LEI) is now a requirement under the second Markets in Financial Instruments Directive (MiFID II). It is important to note, however, that a digital identity is only one aspect of customer due diligence.

### 10. There are still many regulatory, competitive and practical domestic obstacles to Pan-European financial services without boundaries

While Pan-European financial services are desirable for consumers, they are less so for banks because of pricing and transaction differences across Europe. One speaker highlighted practical impediments such as requiring a national social security number to open a bank account in a particular country while another speaker stressed that the real impediment was the unwillingness of service providers to enter into pan European financial services as opposed to the presence of national laws.

Currently, there is a right to open a basic payment account anywhere in Europe, and one speaker believed that this will soon expand to other financial services but that AML obligations would still apply since opening bank accounts in different countries without good reason could legitimately give rise to a suspicion of money laundering or terrorist financing.

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## Fintech in the insurance industry

### 1. Insurance, digitalisation and Fintechs

Today, digitalisation is mainly a revolution in day-to-day use. Smartphone usage is creating high expectations for technology and insurers need to adopt new ways of working to keep up with their customers. They need to adapt to the real risks out there and provide a frictionless and relevant service, making for a friendlier customer experience. Insurance companies are also prepared for bigger transformations that would cover new risk pools, such as driverless cars and cyber-risk insurance. They could adopt more predictive and therefore preventative measures to offer customers insights that would reduce them risks through the proliferation of data from sensors and telematics. This could be a way to include people who have previously been excluded from coverage.

One example of digital disruption from the UK, is cognitive computing using neural networks to reduce the time it takes to pay a personal injury claim, allowing claims adjusters more time to focus on the human side of interactions. Artificial Intelligence (AI) applications are in their infancy since It is not yet known whether reviewing or approving algorithms or data sets that might change very often, are effective.

However, some institutions are considering using AI to mitigate the risk of failed transactions or bias in their data. One benefit is a more granular segmentation of risk and an increased opportunity for more objective underwriting that will reduce the overall cost. This should lower premia, which would benefit customers, and allow for more products personalised to consumers' specific behaviour. There is a clear tendency to move away from existing risk coverage to more predictive care in health and also household insurance. Big data analytics and AI also offer better quality advice in some situations.

Digitalisation is happening to every industry and creating a big impact. It is based on taking what is there already and improving the IT infrastructure and processes. Differentiation tries to see what the consumer is really looking for, then feeds that back to development.

Disruption is normally associated with Fintech start-ups. Also incumbents do Fintech. But are Fintechs becoming insurers or will they keep focusing on the technology? One insurance company is investing in disruption and partnering with Fintechs to try to solve industry problems.

There are a number of novel and real benefits from Insurtech, as well as challenges and risks for stakeholders, many of which are specific to the insurance and pension sectors. Fintechs and Insurtech are challenging traditional insurance business models, while the electronic distribution of products is changing the insurance paradigm. The differentiating effect of new technologies on setting the premia and the risk could be to the benefit, but maybe also to the detriment, of the consumer.

One essential part of the value chain still in question, particularly for life and long term products, is intermediation, but technology might only play a small part in this. Producing a policy without any human interaction cannot be an answer. There is room for different channels within life insurance, supported by technology, but without technology always satisfying the consumers' plans.

## 2. Customers, products and data

All these technologies driven changes require a new kind of risk management but, until recently, no one has been prepared to take on new risks. It is possible to set individualised premia based on a number of data and, for instance, have a more targeted offering for health products. If you live a better lifestyle, you get a better premium, but what happens when someone has genetic characteristics and the insurer is unwilling to offer them a premium or sets the price so high it is unaffordable? There are some negative aspects in the balance between exclusion and inclusion. A more positive case could be seen when certain houses located in flood areas are offered insurance, if the granularity of the data allows it.

Supervisors are critical of focusing on data that the consumer cannot control. Big data methodologies increase the possibility of price discrimination, so one must be careful about any inferences drawn. Price optimisation also links to this point, as consumers shopping around will be aware of what the right price is and less likely to pay more than those who do not. This raises questions about the overarching obligation to treat customers fairly where pricing is not risk based. Personalised products seem sensible to many, but entail less of a possibility to perform comparisons. You cannot compare between auto insurers, for example, unless you have undergone telematics testing with all of them. Are consumers therefore, able to make informed choices? A further specific challenge lay in insurers' ability to use data to calculate premia. Fintechs could assist some customers to obtain better conditions and premia, though others may simply be excluded from obtaining insurance altogether. Some viewed this as putting a major strain on the social insurance model principle of solidarity; others perceived insurers as private businesses operating in a free market, not subscribers to any social system. If there is a risk of discriminating against some customers, it is the lawmaker's job to dictate how premia should be applied.

As part of the Insurance Distribution Directive (IDD), EIOPA has provided the Commission with advice around an Insurance Product Information Document (IPID). This short document allows comparability of non-life products also readable via smart phones. There are also issues around how consumers' data are being used for underwriting and pricing, causing issues of portability and ownership. The General Data Protection Regulation (GDPR) is coming into force next year, and EIOPA will be monitoring its impact on consumer protection.

## 3. Regulation, supervision and sandboxes

Using data also raises issues of safety and protection. Cyberattacks on insurers can have very big consequences, so they should be building up their defences. A further area of development is blockchain, which can bring benefits to issues such as fraud, money laundering and regulatory arbitrage. Transparency in this area is key.

There will be regulatory challenges embedded in this progress, the first in deciding when intervention is needed or whether it is appropriate. The Commission could look into the existing regulatory framework and consider modifications to Solvency II or SCR.

A further risk is around the balance of new entrants against incumbents, or the same risks/same rule dilemma. Newcomers are key to stimulate Fintech solutions, but innovations are also possible within incumbents. Any regulatory response should carefully balance those different interests, as the Regulators should not rush into over regulating and causing a stifling effect, but must be thoughtful about applying fair and sustainable oversight. Will innovation be treated differently in different places? Is more regulation really the best way of stimulating Fintechs? Stakeholders adopting an enabling attitude could go a long way to address these issues.

Some perceived that newcomers and incumbents to the sector, are merging ever closer together and cooperating; it is therefore artificial to distinguish between the two. Maybe there is no dilemma and it is a common wish for the industry to become more digitalised, with no need to isolate Fintechs or insurtech anymore. Some are convinced of the need to treat everybody equally, without the protection of sandboxes, all meeting the same rules and regulations. The supervisors and policymakers should therefore adopt an activity and not entity based approach. Another challenge in creating a sandbox is ensuring the rules are clear on how long a new company stays inside and who pays if the company fails. Newcomers may not be fully capitalised to the extent that an incumbent would be.

With that said, insurance and pension regulations already take digital developments into account. Solvency II is technology neutral. It allows some proportionality and, through the SCR review, seeks to simplify the framework. The full IDD has extended the rules on distribution to encompass comparison websites and to regulate the online sale of insurance. However, it follows a regulatory pattern that may be outdated, where customer information is provided on paper, although it is possible to opt in to receive electronic copies. The regulator will need to take a decision on Fintechs' access to the markets, the rules by which they abide and their relationships with clients.

The Pan European Pension Product (PEPP) has a default option that makes online distribution possible without one to-one advice beforehand. The draft regulation currently keeps the customer online for the lifetime of the contract, though it will be possible to obtain paper documents for free.

EIOPA takes a key role in enabling the benefits from financial innovation while ensuring a high level of consumer protection and financial stability. All legislation and supervisory approaches are to be technology neutral, and proportionality should reign. It is looking to coordinate the European institutions and bodies with relevant international actors. EIOPA must be at the forefront of a functioning digital app market and must never represent an unwarranted impediment to financial innovation. It will help facilitate a level playing field for both start-ups and incumbents and so is welcoming of sandboxes, as long as consumer safeguards are in place. There is continuous dialogue with all stakeholders, such as through a series of roundtables on insurtech topics, including underwriting, price setting and claims management using big data. A thematic review is planned for 2018 on fair treatment of customers, ethical boundaries and privacy issues around big data.

Another immediate strand of work is on cyber risk, including sandboxes, innovation hubs and emerging private/public partnerships. The goal is to benchmark best practices. EIOPA envisages examining the supervision of algorithms, how they are coded and whether this is a transparent process.

Retch is a further area EIOPA will be examining, along with blockchain, innovation hubs and possible European sandboxes. Supervisors' worst fear is the development of insurance that is not called insurance, with no regulation and big risks for consumers. Insurance needs supervision to ensure consumes can claim what they are owed.

## 4. Insuring against cyber risk

The size of the cyber insurance market is not known, nor are insurers fully aware of such a risks yet. Some companies have begun to model coverage, while others do not believe it is possible to insure fully against cyber risk today. The industry is well advised to make progress cautiously in what appears to be a large potential market, as it did for directors' and officers' liability insurance. New insurance products depended on types of guarantee, and these are not yet defined here.

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## Addressing increasing cybersecurity risks

### 1. Main characteristics and challenges of cyber-risk

Properly addressing cyber risk in the financial sector is very important because the financial system is an increasing target for cybercriminals.

2016 was 'a watershed moment' for the financial industry regarding cyber-risk. Several cyber attacks with increasing sophistication occurred at different levels of banks' infrastructure, necessitating an extension in the scope of cyber-resilience measures from network security to local infrastructure security.

The nature of risks to the financial sector has dramatically and rapidly changed. Previously, physical risks were the main focus, now cyber-risks are a key concern for most market participants. Moreover, some of the protections instituted in the last 25 years against physical risks (e.g. data replication) may actually propagate cyber risk and complicate cybersecurity, showing that a continuous evolution of defences is needed. The nature of cyber attacks has also changed over the last decade moving from theft to destruction, which requires different defences. The rapid rate of change in cyber-attacks and the increasing technological sophistication of perpetrators also means that tomorrow's attacks will not be the same as yesterday's.

The systemic dimension of cyber-risk was also stressed. Cyber-risk resembles traditional bank risk in the sense that if a bank is attacked this may trigger a loss of confidence in the bank and a liquidity event. However, cyber attacks often target multiple actors, which could provoke a broader liquidity run on several banks, creating systemic risk. In addition, some State-backed attackers have considerable power and these attacks may target a broad range of players in the industry beyond the financial sector including infrastructures, utilities or telecommunication companies, further increasing the potential systemicity of these risks.

### 2. Policy measures and public sector initiatives at the EU and international levels

#### 2.1. European public sector initiatives

The European Commission (EC) recently adopted a package on cybersecurity that extends across all sectors. This package reinforces ENISA (European Union Agency for Network and Information Security) which will become the EU agency in charge of supporting and coordinating Member States' work on cybersecurity. In addition a report on the implementation of the Directive on network and information systems (NIS) has been published. An EU wide cybersecurity certification of products and services will be established to ensure high security standards and raise user confidence, and 'cyber-hygiene' will be promoted. Finally, the EU will create a network of excellence centres and a research and competence centre to support innovation and encourage more cybersecurity solutions to be developed in the Union.

The EC will also adopt a fintech strategy by the end of the year that will include policies and actions related to cybersecurity. Respondents to the consultation led in preparation for this text notably considered that similar activities should be subject to the same cybersecurity requirements, asked for guidance on how to enhance information-sharing and supported regulatory and supervisory convergence on stress-testing.

Following the publication of the global CPMI IOSCO guidance on cyber resilience for financial market infrastructures (FMIs) the ECB is ensuring that there is appropriate governance to manage cyber risks, that FMIs identify their key assets that require protection and that they have the necessary protections in place in terms of information security and operational risk. In addition to governance, identification and protection, the ECB is focusing on ensuring that FMIs in the Eurosystem have the right detection and recovery capabilities, in line with the requirements to recover systems within 2 hours (2 h RTO). Moreover, in the Eurosystem, the ECB aims to create stronger cyber risk awareness and ensure appropriate information exchange between the different players and stakeholders in the market. The ECB is notably considering the establishment of a 'Eurosystem board' where authorities and critical FMIs and service providers could come together and exchange information and is also encouraging the financial industry to work with other parties in the wider economy that are all concerned by cyber-risk.

#### 2.2. The US approach to cybersecurity

Cybersecurity is also a major priority for US financial regulators. The CFTC has a constantly evolving approach to cybersecurity. While the CFTC has developed cybersecurity guidance for firms, focusing mainly on infrastructures in the OTC derivatives market, it has resisted introducing granular measures. Instead, the US regulator encourages the development of best practices and standards in the industry and applies a principle based approach to cybersecurity in its supervisory programmes. This approach is not the result of a 'master plan', however. Rather, it is a recognition that challenges in cybersecurity are constantly changing e.g. with a shift from individual hacking to State-sponsored cyber-attacks, which is why it is not an easy issue for financial regulators. While firms must be encouraged to be resilient against cyber attacks, having a rigid formula for cybersecurity would create systemic vulnerability. This is why continuing discussions between domestic, international regulators and market participants is very important.

#### 2.3. Possible areas of improvement regarding cybersecurity policy initiatives

Several panellists called for a further harmonisation of cybersecurity approaches at the European and international levels, notably regarding testing scenarios, threat intelligence and event reporting requirements. At present there are multiple regulatory frameworks dealing with cyber-resilience and no standardised solutions. Part of the reason for this is that safety is a subjective notion, potentially leading to different answers. Regulations tend to overlap to a large extent, but not totally, requiring a detailed regulatory mapping to be conducted by industry participants The complexity of doing this becomes exponential when firms must fulfil domestic and international obligations, which is costly and time consuming.

However there is no agreement at present at the international level on the need for a more consistent approach to cybersecurity or for the performance of cross jurisdiction or multilateral testing exercises. In addition, there are different levels of preparedness and awareness across jurisdictions, which make international agreements on cybersecurity challenging.

Some speakers also called for more collaboration between the public and private sectors and across industry sectors and entities. The identification of best practices and the development of global standards (e.g. in the areas of testing, information-sharing and liaising with the authorities) could help in this perspective. For example there are the Bank of England's CBEST testing standards and the FS ISAC (Financial Services – Information Sharing and Analysis Center) initiative in the US to facilitate information sharing in the financial sector.

Cross sectorial collaboration and information sharing on evolving cyber-risks, stress-testing and vulnerability testing are indeed important even if they take time to implement. The financial industry also needs a clear map of the sector in order to understand the interdependencies between institutions. These approaches seem preferable to additional regulation and attempting to build a 'fortress' through a set of strict rules, because market participants must have the capacity to react quickly and take the necessary countermeasures in a relatively flexible way.

## 3. Private sector initiatives and best practices

A first challenge is developing sufficient awareness in the industry throughout financial firms. Cybersecurity is rising to the top of the agenda for banks in particular, with increasing awareness about it at board level. To some extent, however, cybersecurity has not yet been properly recognised so far because there has not been a sufficiently serious cyber crisis. Employees must become sensitive to cyber risk as much as they are to credit or interest rate risks, which means developing appropriate training and reporting around cyber-risk.

Companies which are the most successful at tackling cyber-risk are indeed those which consider it at the heart of their business risk. In some businesses it is natural to think of IT risk as a business risk, but in many traditional financial institutions it is still considered as a technical risk and there is no common language between the cybersecurity control room and the managers of operational risk and business resiliency.

A second priority is developing information-sharing at industry-level. The establishment by major banks of a centre in the US (FSARC) to share intelligence on cyber-risk and act as a central point of control for government agencies is a very positive example, a speaker believed. Other industry-driven actions such as the strategy that Swift is developing to protect its community of banks and financial institutions against cyber-risk were also mentioned. This strategy is based on the use of a mandatory security control framework and an attestation policy, the monitoring of counterparty relationships and the facilitation of information sharing between institutions. Additionally, stress testing enables the industry to determine the responsibilities of individual companies in the fight against systemic risk.

The classification of cyber-events and the establishment of scenarios are also useful tools. This involves the creation of a series of loss events that can be used to define the counter-measures that are needed and evaluate the related investments required, as well as the elaboration of a risk methodology to help extrapolate 'the threat axis of the future' and determine what its future assets at risk will be. Here, regulation must incentivise a proper definition of cyber risk at the business level and encourage the establishment of resilience plans by firms. Cyber events are inevitable, and it is important to articulate what an acceptable scale of cyber-event would be.

## 4. Implications of technological innovation regarding cyber-resilience

### 4.1. Technology exposes to new risks but may also support resilience actions

While new fintech technologies might expose the financial sector to increased or new risks, several panellists considered that these technologies would also provide new tools to fight cyber-risks and could improve resilience in certain areas. One example is distributed ledger technology (DLT), which can provide improved reporting functions by writing data once and replicating it many times across a system. There is also hope that the new IT-savvy millennial generation, who have the technical backgrounds allowing them to grasp the magnitude and rate of change of cyber risk, will better take these risks into account in the design of new digital solutions.

### 4.2. The need to preserve existing risk management practices and the basics of cybersecurity

Some speakers, however, emphasized the need to preserve existing risk management practices. While it is important to adopt new and innovative security approaches, it is also vital to maintain basic security practices such as patch management.

The WannaCry cyber attack for example affected 300,000 servers because these did not have the latest Windows patches installed. Certification also plays an important role in increasing trust and security in new products and services. This forms part of ENISA's renewed mandate, which will enable the European authorities to identify trustworthy applications across different sectors.

Finally, security should be designed into new processes from the beginning, otherwise there will be vulnerabilities. And lessons should be learned from previous attacks in order to design cyber-risk measures. For example in the case of Bitcoin, attackers no longer target the protocols or the transport of Bitcoin but endpoints i.e. where users stock their wallets. This should be taken into account when designing cyber-security measures concerning cryptocurrencies in particular.

CHAPTER 5

# IMPROVING FINANCIAL STABILITY

## Enhancing supervisory arrangements for CCPs operating in the EU

### 1. Outline of the EMIR review proposal for amending the supervisory regime of CCPs

On 13 June 2017, the European Commission (EC) adopted a proposal for strengthening the supervision of EU and third-country CCPs operating in the EU in the context of the EMIR review. This proposal aims to further ensure the safety of these CCPs, which are increasingly concentrating risks following the implementation of the G20 commitments, to enhance their supervision on a cross-border basis and also to address the implications for the EU of third-country CCPs handling significant volumes of cleared products denominated in EU currencies.

The proposal hinges on two main pillars: first, a strengthening of the European dimension of CCP supervision, improving its consistency and involving the relevant central banks of issue (CBIs) in the supervisory process; and secondly, the introduction of a two-tier system to deal with third-country CCPs.

Tier 1 CCPs, those that are not systemically important for the EU will continue to operate under the current recognition framework, albeit with improved supervision through more effective cooperation arrangements between ESMA and third-country authorities. Tier 2 CCPs, which are those that are systemically important for the EU will be subject to EMIR and possibly to additional central bank requirements. In addition, there is the possibility that some Tier 2 CCPs may be of 'substantial systemic significance' for the EU financial system. If this is the case, ESMA and the relevant CBIs shall recommend to the EC that such CCPs can access the Single Market only if they are established in the EU. For those CCPs, the EC may adopt an implementing act and declare that they cannot be recognised unless they relocate to the EU. A member of the panel considered that this 'progressive and proportionate construction' balances access to the Single Market and financial stability in the EU.

### 2. Proposals regarding the supervision of EU CCPs

#### 2.1. Progress already made with the implementation of EMIR and global CCP standards

Significant progress has already been made in the supervision of CCPs in Europe, several speakers stated. EMIR has delivered important aspects of the G20 reform agenda and helped to enhance financial stability in the EU. Underpinning this progress is the important role of CCP colleges in strengthening their supervision and enhancing information- and data-sharing, as well as decision-making. ESMA has tried to address areas of differences through its guidance material and the provision of greater clarity to national supervisors on how to move to a more common approach. It has also evaluated issues related to margin and collateral requirements and pointed out some best practices through yearly peer reviews.

Progress has also been made at the global level in defining measures to mitigate the risks that are increasingly concentrating in CCPs. The G20 global initiative regarding OTC derivatives central clearing created pressure for the establishment of the CPMI-IOSCO PFMI principles for financial market infrastructure (FMI) and further guidance on FMI recovery and resolution. For the first time in the regulation of market infrastructure, there is a coherent and consistent global approach that is continuously being refined. Reliance on international standards is essential when contemplating the inherently transnational nature of the larger CCPs, whether within the EU or globally, several speakers emphasised.

#### 2.2. Improvements expected and conditions of success of the EMIR review proposal

Several speakers on the panel were supportive of the EMIR review proposals regarding the supervision of EU CCPs. Generally having a European approach to the supervision of the market infrastructure, from trading to settlement, is essential and this is particularly true for CCPs for which supervision is insufficiently consistent at present, a speaker considered. The proposal to strengthen the role for ESMA (through a CCP Executive Session within ESMA) for EU CCPs was therefore welcomed. This arrangement should address some of the limitations of the current system, where ESMA only has a very limited toolbox at its disposal to ensure the consistency of CCP supervision. Improving CCP supervision in the EU is also a prerequisite for addressing the issue of third-country CCPs.

The need to clarify decision-making processes as well as the roles, responsibilities and interactions of the institutions involved in EU CCP supervision, notably in a context of crisis, was however stressed by several panellists.

The evolution of supervision in the EU is underpinned by several points, one speaker considered: the need to keep the link to international standards, to be risk-based, to involve significant coordination, to be reciprocal, to involve all authorities that have a requisite interest, and to deliver clear accountability, responsibility and decision-making.

The proposed approach is somewhat 'tricky' to implement, a panellist believed, because almost all supervisors and public authorities in the EU are potentially interested in supervising CCPs. The supervisory process should be designed so that it remains manageable despite the number of stakeholders involved and without any risk of decisions being blocked.

Several speakers moreover emphasized that in stressed market conditions a clear definition of roles and responsibilities and of decision-making processes and also clear lines of communication are essential.

In one speaker's view, one problem with the EC proposal is that it does not clarify who within the supervisory committee is making the decisions and that is especially important in a recovery and resolution situation. There also needs to be a more explicit articulation between the EMIR review approach and the one in the CCP recovery and resolution framework, which recommends having a local resolution authority in charge. Moreover the articulation between the different institutions that will be involved in CCP supervision in ordinary times also needs to be further specified, notably the interaction between the supervisor and the CBI.

#### 2.3. The role of central banks of issue (CBIs)

The speakers generally agreed with the proposal to enhance the role of the CBI in CCP supervision, but the need to clarify their responsibilities in this context and their articulation with the supervisors of the CCP was emphasized.

A greater role for the CBI is relevant in order to ensure stability in markets where CCPs are clearing products which are essential for the operation of monetary policy (e.g. repos), and to monitor markets cleared by CCPs that can generate significant calls of liquidity and where there are strong interdependencies between FMIs, some speakers stated. This is reflected in the EC proposal, but the possible role of CBIs with regard to liquidity purposes and the possibility for CBIs to provide a liquidity backstop and to be a lender of last resort and what that implies, should also be considered some suggested. That would allow the CBI to be more legitimate and more significant in the decision-making process regarding CCPs.

One speaker considered that strengthening the role of the CBI would also help to make supervisory decisions regarding systemically relevant CCPs more enforceable, because they have a systemic risk management role and a general view on market risks, and many of them also supervise clearing members who are banks. In that respect the speaker was favourable to the involvement of macro-prudential authorities in CCP supervision, such as the ECB.

It is not clear however how any disagreements between the supervisors and the CBI may be resolved, which is particularly important in a crisis situation, another speaker suggested. One panellist also stressed that inconsistent or conflicting requirements between EMIR and the CBI should be avoided.

One speaker however stated that a clear distinction needs to be made between oversight in the interest of monetary policy and a prudential approach; otherwise, this may lead to a democratic deficit, given that accountability for monetary policy is clearly defined in the Treaty. There needs to be an increased degree of accountability vis-à-vis the agencies in order to avoid the need for tensions to be resolved through a treaty change, which may lead to a loss of independence in monetary policy for the central bank.

## 3. Proposals regarding the supervision of third-country CCPs

### 3.1. Content and feasibility of dual supervision for systemically important third-country CCPs

Speakers agreed that shortcomings of the current recognition regime in EMIR need to be addressed. The existing process leaves only a very formal recognition power to ESMA and no real ability to monitor how the third-country CCP is developing after recognition. The EC proposal for continuing the current regime for Tier 1 CCPs and enhancing it for Tier 2 CCPs with dual supervision and an involvement of the CBI concerned is a rational way of improving the present situation and ensuring that risks are appropriately managed, some speakers stressed. It is indeed essential to make that cooperation at the international level work in order to deliver the G20's intent for OTC derivative markets while avoiding market fragmentation, protectionism and regulatory arbitrage.

Some panellists however disagreed on the precise content of 'dual supervision' and what it should imply.

One speaker was in favour of 'deep supervisory cooperation' based on deference and reciprocal cooperation. Another panellist emphasized that the dual supervision proposed by the EC is a different approach and involves the home and host supervisors and also the CBI working together, whereas with cooperation based on deference it is the home supervisor that decides. The latter speaker noted that the EC proposal is also similar to the way the supervision of third-country CCPs is handled in the US. In addition, the speaker felt that 'cooperation' and 'deference' are contradictory and are difficult to combine. The first speaker however saw no contradiction between the two, considering that deference is a very important tool to make sure that supervision is performed effectively and in a coordinated and efficient way. After the registration of the CCP, one rule is applied rather than the other; that is deference and that is supervisory cooperation working effectively. Deference is actually in the EC proposal, the first speaker stated, adding that the EC's proposal is not totally consistent with the US approach.

Another speaker agreed that extra-territorial supervision of third-country CCPs could be envisaged, but believed that the main issue is whether the college of regulators approach can be made to work both within the EU and externally, where a unified approach would be needed vis a vis the third country supervisor, and this particularly in times of crisis.

### 3.2. Possible location requirement

The panel was divided on the possibility of imposing location requirements for some third-country CCPs operating in the EU deemed to be 'significantly systemic'.

Some speakers opposed this measure, stressing its possible negative impacts on the market. In the short term, it may prevent European members from accessing certain CCPs with little notice, and deliver market instability and disruption. In the longer term, it will lead to less diversified and more fragmented markets, increased economic costs and less liquidity. They also questioned the rationale for this requirement arguing that there is no risk-based reason for it, as long as the ECB or the CBI concerned can fulfil its mandate and that effective supervisory cooperation is in place.

Some other speakers were favourable to having that possibility in the toolbox, at least as a last resort action. In one speaker's view, location matters, particularly in times of crisis and for markets where a large proportion of the clearing of EU-currency-denominated instruments is performed outside the Union, with no real substitutes in the EU. Another speaker explained that during a crisis, if one or two major clearing members have problems and liquidity dries up, location will be a measure of last resort, because from a central bank perspective, where currency tools are held is important. A third speaker considered that imposing location may be necessary if it appears that dual supervision does not work in a recovery and resolution context, given that there is no global supervisor or resolution authority.

### 3.3. Potential impacts of the requirements proposed regarding third-country CCPs

Several studies on the possible cost impacts of the proposed measures regarding CCP supervision have been conducted and differ hugely. One speaker explained that these differences can be explained by the assumptions made. The evaluations should take into account that markets adapt when new structures are established and that, over time, there should be a comparable level of efficiency. Another speaker stressed that if a location policy is enforced through EMIR, only the EU27 banks will be affected. The question is therefore whether non-EU27 banks will move into the EU27 market or whether there will be a persistent pull out of the EU27 into the international market.

The impacts of the EC recommendations on clearing members, end-investors and counterparties need to considered, another panellist suggested, and a distinction made between EU and non-EU banks. If only EU banks are constrained to go back to Europe for euro-denominated clearing, the initial goal will not have been achieved because the EU authorities will not have the global picture regarding euro-denominated clearing. Consideration needs to be given to the right incentives for non-EU clearing members to move to continental Europe, as well as to potential extraterritorial measures.

One panellist considered that there are many technical ways in which to address possible cost impacts related to the EC proposals. Some post-trade operations can increase the compression implemented on positions. Interlinking and cross-margining might also be contemplated.

# Are market-based finance risks under control?

## 1. Initiatives underway to tackle vulnerabilities from asset management activities

There has been a significant growth of market-based finance over the past few years, notably of the asset management sector. Assets under management rose globally from $ 54 trillion to 77 trillion approximately between 2005 and 2015, which constitutes 40% of the assets in the global financial system.

This evolution is positive for the financing of the economy but may also create new vulnerabilities that are being assessed at the global level by the FSB, IOSCO and the IMF.

### 1.1. Scope of activities and definition of market-based finance

There has been a welcome shift in the FSB's terminology away from 'shadow banking' to 'resilient market based finance'. This latter term better describes the reality, some speakers considered, which is that financing can be conducted through banks and also alternative means such as market based finance. Initially the discussion was influenced by political considerations and a banking perspective. But that approach was not appropriate, considering all non-banking activities as equally risky, which is not the case for asset management in particular. The debate is now moving in the right direction, several panellists felt, thanks to the work of the FSB and IOSCO. One change that is welcome is the move away from an entity-focused approach to risks towards an activity-focused one. One speaker moreover emphasized that size is not a factor of additional risk in the asset management sector and that on the contrary larger managers tend to have stronger risk management procedures.

However, definitions could be improved. Different definitions of shadow banking are used at different times by different authorities, and there is no clear definition of market based finance. Additionally, the continuum of activities in market based finance must be clarified. This lack of clarity hinders the identification and monitoring of vulnerabilities and may lead to endangering activities which are fundamental to the real economy.

Asset management is only a small part of market based finance though, one speaker stressed. There is a strong focus of regulators on this sector because of its size and growth, but also because it is easier to assess due to pre existing regulations and widely available data. However, other market areas merit further investigation.

### 1.2. Significant safeguards are already provided by existing EU investment fund regulations

Investment funds are already highly regulated in the EU with the UCITS and AIFMD directives, which are considered as world-class regulations, several speakers stressed, and have contributed to making UCITS in particular a global brand. These directives notably address liquidity and leverage risks and are completed by some IOSCO global standards which have also been implemented in Europe. The EU passporting system of these directives has also contributed to making the internal market a reality. The home country of UCITS funds in the EU is now largely irrelevant thanks to this system. As a result the asset management sector is one of the most integrated ones in Europe. However, further efforts are needed to ensure a more common European approach in the implementation of AIFMD, notably regarding leverage rules, which is an issue that should be covered by the forthcoming AIFMD review.

Progress has also been made in the area of Money Market Funds (MMFs) in the EU. Most European MMFs were already structured as UCITS and a specific MMF regulation (MMFR) has now been completed that will be implemented before 2019. The speakers on the panel were satisfied with the compromise that has been reached regarding MMFR, which should allow vulnerabilities to be tackled while preserving the viability of the product and satisfying client needs. One speaker however felt that the adopted text, which significantly differs from the initial proposal, is more the fruit of a compromise between a few Member States with strong positions on the MMF market, than of a very specific assessment of MMF risks. Concerns with some requirements of the regulation were also expressed, for example regarding the restrictions that are imposed on the instruments counting towards liquidity requirements (e.g. the limit of the amount of high quality government securities for LVNAV and CNAV products), which may not maximise good quality liquidity.

### 1.3. Progress made with the assessment of vulnerabilities at the global level

The FSB's policy recommendations for addressing vulnerabilities from asset management activities were published in January 2017 and there is wide support for them showing that there is now a good understanding of the specificities of the sector among regulators. These cover four main types of vulnerabilities: (i) liquidity mismatches between fund investments and redemption terms; (ii) leverage within funds; (iii) operational risk and challenges for asset managers in stressed conditions; and (iv) securities lending activities. Following the publication of this report, it was decided that IOSCO would 'operationalise' these recommendations particularly concerning liquidity mismatch and leverage requirements – i.e. transforming the FSB high level recommendations into practical measures. It is essential in this context to ensure a constructive dialogue between regulators and regulated entities and to define an appropriate approach for implementing these rules and supervising them.

One speaker emphasized that when considering liquidity risks, the liability side needs to be taken into account, as well as the asset side related to the liquidity of underlyings. In addition, while leverage is an important issue, it is important to realise that 90% of EU funds have little or no leverage: UCITS are limited in their total exposure to derivative markets and AIFs cannot have a global leveraged exposure exceeding 300%. The other risks identified by the FSB are less important, the speaker felt. Regarding operational risk, the FSB focuses on the portability of assets during crises, which is not much of an issue for EU funds, given that assets are safeguarded by a depository. As for securities lending, a speaker specified that securities lending is not a 'principal business' for asset managers, who act as intermediaries in these transactions. The main issue is therefore having sufficient collateral to cover default risks, which is in line with current market practices and FSB recommendations.

## 2. Measures proposed to address vulnerabilities stemming from liquidity mismatches in funds

In July 2017, IOSCO published two consultation papers on liquidity mismatches, one with recommendations for implementing FSB guidelines and the other with proposed best practices. Liquidity management is a complex topic, one speaker felt, because there is a need to constantly reassess practices, design practical liquidity management tools and explain how and when these might be activated. Some of the difficulties related to the definition of liquidity management measures include liquidity disclosure to investors (how and when it should be provided) and the drivers behind decisions on daily redemption terms (how to ensure continuous alignment between asset portfolios and redemption terms). These issues will need to be defined by the public authorities in connection with the industry.

Regarding redemption terms and their connection with the liquidity of underlying assets, one speaker believed that from an economic perspective, it makes sense to develop schemes whereby clients pay more if they want to withdraw money quickly in periods of stress, than if they accept to stay in the fund. However, it is not always easy to promote such rules commercially or to ensure that they are applied fairly.

A further issue is the current variation across jurisdictions in the way redemption terms in relation to the underlying assets are implemented, despite consensus on high-level principles, which may impede liquidity management and create data gaps. At the EU level this issue could be solved by an improvement of supervisory convergence and a strengthening of the powers of ESMA. Some recommendations could also be made by IOSCO at the international level requiring regional and national authorities to minimise inconsistencies in the implementation of rules, one speaker suggested.

Concerning the dealing frequency of fund units, a speaker considered that it should be consistent with the frequency of valuation adjustments. In a continuous market, the frequency of valuation adjustments can be daily, but for intrinsically illiquid assets such as real estate, valuation cannot be done so regularly. Dealing frequency is also impacted by notice and settlement periods.

As for entrance and exit fees, these could be justified for example in countries where there is a financial transaction tax, a speaker believed, even if they are unpopular. The issue is to find the right balance when applying them between flexibility and fairness, because too much discretion may be perceived as unfair by some stakeholders. Another speaker suggested that many issues related to redemption fees and terms can be solved with swing pricing.

### 3. Potential vulnerabilities associated with exchange traded funds (ETFs) and index funds

While the FSB has not highlighted any specific risks associated with passive investments, their growth is a matter of concern for some stakeholders. The main issues relate to potential impacts of the development of passive management on price discovery and the risk of producing price swings and sentiment driven movements without a corresponding movement in fundamentals.

The primary reason for the rapid growth of index funds and ETFs over the last few years is their low cost, which leaves more money for returns, one speaker stated. Statistics show a shift in the market, with many managers moving from active to passive management, and a shift away from the use of swaps and futures into ETFs and index funds. As for the potential impact of indexing activity on price discovery, the financial sector will always have this ability, the speaker believed, because indexing represents less than 5% of trading in the overall market and no more than 20% even in the jurisdictions where indexing is the strongest. The bulk of the market is therefore represented by a diversified range of market participants who support on-going price discovery and there is still ample room for ETFs to grow without negatively impacting price discovery. Additionally, Indexing should not be viewed as an asset class but as a vehicle. The distinction between active and passive management is also not always easy to make because some ETFs have a very focused approach (e.g. on segments such as digital music or robotics…). This distinction should however be clarified for investors, another speaker emphasized.

Some issues may nevertheless need to be further assessed regarding passive management, such as the possible stability implications of some operational specificities of the ETF market (e.g. the creation / redemption mechanism, the role of authorized participants (APs) and of market-makers) and the existence of some niche products that may pose risks (e.g. leveraged ETFs or inverse ETFs). The liquidity and leverage characteristics of ETFs also need to be clarified. ETFs are mostly structured as UCITS in the EU and therefore most of them have no leverage. Liquidity however needs to be approached differently from ordinary mutual funds. ETFs have two levels of liquidity: the liquidity of the shares in the secondary market, which potentially brings additional liquidity to the market, and the liquidity of the underlying assets of the ETF which needs to be compatible with a daily pricing, which is not the case for all assets (e.g. commercial property). Building an appropriate liquidity management programme is essential in this perspective. A further issue, another speaker suggested concerns procyclicality risks and the fact that ETFs may potentially amplify market trends, which may be an issue in less liquid asset classes when problems appear in the market.

### 4. Addressing remaining and emerging vulnerabilities in the market-based finance sector

#### 4.1. Remaining vulnerabilities and issues to be considered

The speakers on the panel highlighted some additional external vulnerabilities that may affect the asset management sector: cyber-risk that may impact the core infrastructure of the securities market; CCP resilience for which proposals made by the EU Commission are a step forward; LIBOR for which an appropriate transition plan is needed; and the severe underfunding of pensions. A further vulnerability is that fund regulations consider all sovereign debts to be of equal creditworthiness which is unfortunately not the case. Brexit is another political issue that has implications also in the asset management sector. If significant changes are made to delegation rules outside the EU, entities may be forced to move their portfolio management locations out from the UK, which could negatively impact the integrity of these funds, one speaker warned.

#### 4.2. Further actions to be considered for mitigating remaining and emerging vulnerabilities

The biggest risk mitigation issue facing the financial sector in Europe is data gaps, one speaker considered. At most, there is reliable aggregate and consistent data at the EU level for less than 10% of market based finance activities. Better data would allow an accurate monitoring of market trends, a proper identification of risk and an improvement of liquidity risk management. Tackling data gaps is however difficult because market-based finance is very fragmented, requiring a granular approach. Data collection must be done at an EU level and involve ESMA, another speaker suggested.

The use of macroprudential tools was also discussed. Some speakers were not favourable to the use of such policies for non-banks, particularly if they are focused on some parts of market-based finance, as they may re-aggregate risk and have pro-cyclical effects. In any case more data is needed to further assess their possible use for market-based finance.

Finally, there is a difficulty for rule makers and supervisors to follow continuously what is happening in financial markets and avoid loopholes, given the constant evolutions in the market. This is more a supervisory issue, but regulators should be able to adjust legislation if needed at level 2 without having to start a new legislative process at level 1.

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## Resolution of banking groups

The necessary tools to deal with bank failures and avoid disrupting the financial system are in place at the European level but, although the framework works operationally, experiences from recent cases provide important insights for some possible future improvements.

### 1. The EU Bank Recovery and Resolution Directive (BRRD) is working

#### 1.1. Framework

The EU framework comprises the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR). At its core is the bail-in, which requires banks' shareholders and creditors to bear the costs when a bank fails. This protects taxpayers and exerts market discipline. Banks must be aware that they might actually fail, and so behave responsibly and manage their risks effectively; likewise investors must be aware that they might lose their money and so should invest cautiously.

This session reflected on the recent resolution cases from this year (June and July 2017). The ECB, the Single Resolution Board (SRB), the European Commission and the relevant national authorities proved that they can cooperate closely to deal with failing banks and handle the whole process smoothly. It is clear that the EU crisis management framework has been tested in Italy and Spain and is able to have an impact on real issues. According to an official, the EU supervisor resolved Monte dei Paschi di Siena (MPS) because it was generous, Banco Popular because it was lucky and the two Venetian banks because it was prudent.

MPS was a precautionary recapitalisation requiring a range of technical requirements and preconditions. Banco Popular was lucky because there had been a professional, solvent buyer to hand in Santander, able to act in the middle of the night. The two Venetian banks were liquidated, although many onlookers had commented that this was a misuse of public money. However both Venetian banks had been reporting losses since they came under direct ECB supervision in 2014. After being declared failing or likely to fail, the Single Resolution Board (SRB) concluded that resolving them was not in the public interest as they did not provide critical functions that would endanger financial stability. Therefore the banks were subject to normal Italian insolvency proceedings, in the form of the sales of their assets and liabilities.

### 1.2. Market discipline

The BRRD clarifies that all debt is bail-in able and instil market discipline for all sizes of banks. The write down follows the ordinary allocation of losses in insolvency. After shares and other similar instruments, it first imposes losses evenly on holders of subordinated debt and then on senior debtholders.

TLAC was now being included in the BRRD legislation. It has to be clear that the subordinated debt and the other debt instruments of the institution are also bail in able, otherwise the BRRD will be undermined.

## 2. Recent cases have challenged the current resolution framework

### 2.1. Italy

The panel was asked what had been learned from recent resolution cases, what they had in common and their differences. The BRRD is very comprehensive: resolution tools and national insolvency procedures stand together, but it is not easy to balance these different dimensions and draw common conclusions.

The Italians have seen three major resolution events in the recent past. The four bridge banks, the precautionary recapitalisation of MPS and the state's support for the two Venetian banks were all completely different cases.

In the first case, all the resolution tools were used and it would not have been possible to manage the situation without them. In all cases, some burden sharing was applied. There was compensation for mis-selling and for retail subordinated bondholders. Even if the bail in mechanism was not applied with the four bridge banks, there was a strong impact on bondholders in the Italian market and market operations from a reputational point of view.

Based on these quite different experiences there were some who argued that the one-size-fits-all approach of the BRRD explains its difficult implementation in Italy; some preconditions may be needed, because starting points within the banking sector across jurisdictions can be quite different, and a transitional phase would help. When the BRRD was implemented in Italy, the country was undergoing its worst recession since the Second World War and a 10% drop in GDP. In these conditions, there was and still is no market for banking assets. The four bridge banks and the Venetian banks received €1 for their capital, and the regulator had to convince counterparties to merge the entities. There were legacy problems with the retail bondholders, and their share dropped from 16% at the end of 2011 to 6% today.

It will take time to improve the situation. The main lesson to be learned is that every case is different. These were all small domestic banks, so what will happen in a complex cross border situation has not yet been tested. Banks might be working to a 24 hour cycle, without the possibility of an overnight period when customers are not trading.

### 2.2. State aid

Is the state aid framework aligned with the BRRD? State aid is embedded in the EU Treaty and interacts with sectorial legislation. The BRRD is primary legislation that has come into effect since and the banking communication should be interpreted in light of these rules. Despite some good results over the last two years, this framework is still in a transition phase. Public intervention for limited restructuring and liquidation, remains available but under stricter conditions than in the past. Examples have shown that collaboration between institutions works, but certain pieces of important information could be improved to allow a more accurate definition of the permissible aid budget and more frequent asset quality reviews (AQRs) as part of stress tests. On the question of burden sharing, there is indeed a misalignment between banking communications and the BRRD with regard to senior bondholders. That needs to be taken into consideration in future revisions. Nonetheless banking communications are unlikely to be reviewed before the November package is finalised alongside a comprehensive review of the BRRD.

In the interaction between BRRD and state aid rules, the basic premise of no big bail outs remains. Precautionary recapitalisation is a temporary buffer, not a permanent solution. (e.g. Monte Paschi) and has to be paid back in full in all cases. If a bank has to exit, it has either to go in resolution if the SRB considers there to be public interest. Otherwise the bank has to exit the market via national insolvency. Resolution is an alternative to insolvency. Any public confusion about this needs to be dissipated.

There is always the possibility of providing liquidation aid for distressed banks to exit the market, as was done for the two Venetian banks.

In some Italian cases there was compensation for mis selling outside the resolution framework; this is possible under EU rules. Some may suggest that this provides the wrong incentives for choosing one solution ahead of another, but it must be remembered that the recent cases are legacy cases. In the future, national supervisors might, for example, need to supervise more closely the issuance of those instruments and how they can be better channelled away from the hands of households

The case of Popular reveals that early intervention powers may not be sufficient to take adequate action. Lack of liquidity is definitely not an adequate reason to declare a bank failing or likely to fail. Some reflection needs however to be devoted to this issue.

It is all about having the right incentive structures in place. No one predicted these resolutions and they were all different. It is therefore needed to allow a degree of flexibility in the rules. The state aid rules have shown they can to cater for various pragmatical solutions to handle non-surviving banks when no other options have been available to safeguard financial stability.

### 3. Future improvements to the framework

#### 3.1. Liquidity, moratorium tools and the harmonisation of insolvency law

When should a bank be declared failing or likely to fail? Noncompliance with liquidity ratios is not sufficient to determine the supervisor's early intervention. The institutional framework is very complicated and offers room for operational improvements and a more detailed review. The precautionary recapitalisation instrument has to be applied cautiously, so that it remains the exception. From the supervisor's point of view, the definition of solvency in this context is key. The current definition is unacceptable because it lacks a forward looking component. Defining the likely losses can also be done in different ways, but has to be carried out prudently. Many of the rules in place today are subject to varying interpretations. One learning experience might be to agree on more concrete definitions and thus promote greater legal certainty and credibility in general.

The moratorium tool also ought to be discussed. One view is that, if you have too long a moratorium, you increase the risk of mortality. Another official considered it quite a helpful tool. The Commission should explore introducing it to EU countries and thus buying time to allow for a more structured approach to resolution. Similar tools are already in use in the US.

Recent cases have shown that, in times of crisis, data quality and their prompt availability are decisive factors in determining the success of any resolution measures.

NPL portfolios also remain high on the agenda. The SSM recently issued guidelines on how to treat NPLs for new businesses, and the supervisor will show how to tackle vintage portfolios by the end of March 2018. Needless to say, there are no easy answers.

Early intervention measures to resolve liquidity problems remain one of the toughest problems of all. The supervisor monitors this as much as possible, but it was exactly the reason why the sixth largest bank in the Spanish market had to be resolved overnight. If you leave a liquidity challenge unresolved, next morning you have a bank run. When orchestrating emergency liquidity support, the devil lies in the detail: it is about ensuring collateral is available to allow either central banks or governments to do their job.

The harmonisation of insolvency law is another essential complement to the BRRD. While the directive does not exclude senior bonds from bail-in, insolvency proceedings are driven by state aid rules and only require loss absorption by the owners and subordinated creditors. As a minimum, state aid in the banking sector needs to be adjusted to prevent inconsistent outcomes between resolution and insolvency procedures. Recent cases also emphasise the need for loss absorbing buffers, or MREL, of sufficient quantity and quality.

#### 3.2. Cooperation and political interests

Nordea's decision to move its headquarters tied into the discussions on harmonised rules. Nordea is a G-SIB, facing fierce international competition. By relocating to the Banking Union, Nordea will be able to compete in a level playing field and in in a stable and predictable environment with high-quality supervision.

The reforms made since the crisis reduced the risk of failure and made the likelihood of an ordinary resolution, even of a large and complex bank, much greater than before, not just because of higher levels of capital and the ability to bail in, but also as a focus on operational issues, such as continuity and contracting arrangements. What is critical is how well the interaction between supervisors works across multiple jurisdictions, during high pressure politically charged situations. The signals on whether this will work are mixed. One of the big issues will be expectations placed on internal as opposed to external TLAC, which will partly demonstrate how much the supervisors believe these processes will work in a crisis. Observers will also see whether the requirements linked to the EU intermediate parent undertaking (IPU) proposal may stifle the synergies of cross-border banking.

A further industry speaker remarked that, given all the work that has been done, he and his peers were now more relaxed this summer than nine years ago, on the day Lehman collapsed. It is obviously key to have sufficient resolution funding and, for this bank, that means 28.6% on a risk weighted basis and 10% on a leverage ratio basis.

Trust and cooperation are also key. We need to take care that the single point of entry (SPE) model does not become a fantasy. Proposals like prepositioning internal TLAC in the range of 90% of the TLAC requirement that would be applicable on a stand-alone basis, solo requirements and the IPU, if not implemented in a reasonable fashion, will create a situation in which SPE does not work. The implications for cross border capital flows and growth in Europe would be substantial. There are good reasons for many of these proposals on an indivdual basis, but they need to be adequately calibrated and implemented in a reasonable way, in sufficient time and as consistently as possible. Supervisory and political coordination and trust will be critical.

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## Systemic risks and resolution in the insurance sector

### 1. The next systemic crisis may not necessarily be financial

The G20 have defined systemic risk as the risk of disruptions to financial services that is caused by an impairment of all or parts of the financial system, with the potential of serious negative consequences for the real economy. Systemic risk is often regarded as a banking issue, but it also exists on the insurance side, and relates to the risk of interconnection within the financial system; it is a global issue, but there need to be local answers to it.

This context leaded the International Association of Insurance Supervisors (IAIS) who also worked on a methodology to designate Global Systemically Important Insurers (G-SIIs), and there have also been some domestic designations in the US. However, the environment has changed since then. In particular massive public debt has been a consequence of previous crisis, which has changed the lives of many people with significant political and monetary consequences. Major imbalances are also witnessed in the world. The level of debt, which in developed countries is still very high, is increasing very quickly in the emerging world. Finally, the nature of risks has also evolved: the consequences of lax monetary policies, and the emergence of cyber risks and climate-related risks are now far more prevalent.

### 2. In an ever-changing market, a solid supervisory and reporting framework to notably assess macro-prudential implications is key

State regulators believe that traditional core insurance activities do not cause a systemic threat to the financial system. Given their nature, insurance products and underlying business models can even help to mitigate systemic risk in times of stress. Nevertheless, state regulators need to remain vigilant in light of ever changing market conditions and evolving insurer practices, and need to update their supervisory toolbox as needed. As the world is now almost a decade past the financial crisis, this is an appropriate time to evaluate the effectiveness of some of the supervisory mechanisms put in place after the crisis, and take a fresh look at new approaches.

One official highlighted in this respect that in the US the NAIC's launched a macro-prudential initiative, which involves a review of all of the state insurance regulators' toolboxes. The initiative is assessing what existing data, metrics and analysis are available to support macro-prudential monitoring, and what enhancements or additions might be necessary to serve this purpose. There are four main areas that the NAIC are going to be focusing on with this new initiative: liquidity, recovery resolution, capital stress testing, and identifying exposure concentrations. One of the areas that the NAIC is going to be looking at is that of resolution and recovery plans, as a potential part of an overall set of analytics.

However, while many of the supervisory tools for micro-prudential surveillance also serve a macro purpose, one outcome of the initiative of the IAIS for defining an Activity Based Approach (ABA) for assessing systemic risk, could be to highlight any additional tools that could be needed to better measure, assess and finally address systemic risk.

### 3. An activity based approach is useful for identifying and addressing systemic risk

The objective of an ABA should be the identification of activities or common exposures of insurers that are highly correlated with financial markets which, in the event of market stress, could not only create capital and liquidity challenges to the firm with implications for policy holders, but also potentially transmit or exacerbate shock to the financial system. This is distinct from an entity based approach, which currently attempts to identify firms where the firm's distress or disorderly failure would potentially cause significant disruption to the global financial system.

A methodology for insurance is being developed, with both the ABA approach and the old entity based approach. It is not clear whether both will run alongside each other or whether one will replace the other. The question of comparing the systemic risk between banks and insurance is also being worked on.

Considerable progress is being made in relation to the activities based approach. The IAIS's systemic risk assessment task force's consultation paper is expected in November 2017. In one speaker's view, evidence from the asset management industry shows that, in the context of systemic risk, an activity based approach is the most credible means of identifying and addressing systemic risk, and should replace the bank centric, entity based approach in the insurance sector.

### 4. The profession considers that the G-SII assessment methodology remains significantly flawed and ineffective, and that the various regulatory approaches trying to address macro-prudential or systemic issues should be further coordinated

An industry representative stated, on the issue of the G-SII assessment methodology, that while their institution recognises that the 2016 methodology is an improvement on the 2013 methodology, it remains significantly flawed and ineffective as a mitigant of systemic risk, for three reasons. Firstly, it relies on the formulaic approach that measures insurance entities across five rigid metrics: size, global activity, interconnectedness, asset liquidation, and substitutability. Secondly, it provides an incomplete view of insurers engaged in potentially systemically relevant activities, and fails to adequately capture potential systemic risk in the system as a whole. Thirdly, it does not adequately link the criteria for identifying systemically relevant institutions to the sources of systemic risk, or the risk transmission channels of asset liquidation and counterparty exposures.

Only looking at systemic risk through an activity based lens allows the role of regulatory capital to be put in its proper context. But additional capital is not considered as the answer; one of the virtues of an ABA in this respect, is that it allows for the identification and use of more appropriate and economically efficient regulatory measures. In this context, the speaker's institution was surprised by the release of the consultation on revisions to International Core Principle (ICP) 24 for public comments by 1 October 2017. While this institution agrees with the first five paragraphs of ICP 24, ICPs 24.6 and 24.7 would require national supervisors to have systemic risk identification and management systems in place without any understanding of how these would relate to an activity based approach. Therefore, this consultation should be deferred, the speaker proposed.

### 5. Avoiding a systemic crisis does not necessarily come down to increased capital and piling-up regulatory layers

The work of the 'Crisis Management Groups' set up to allow supervisors to steer the world's most important insurance groups through a crisis, have clarified that international regulation and supervision does not necessarily come down to increased capital: qualitative assessment and fruitful dialogue with supervisors are much more helpful. Own Risk and Solvency Assessments (ORSA) now exist in nearly all legislation, which is a very effective tool for companies and supervisors. Sharing this between the college of supervisors on a European basis, or even on an international basis, is very important. Those present should aim to make sure that the ORSAs that companies provide are rigorous, well-thought out and identify all the risks that the regulator feels should be identified, and then there should be a conversation with the regulator about these areas of concern.

Regarding systemic plans and how supervisors address the risk of systemicity, one has to avoid 'piling up' layers of regulations that will not be a good idea, and which will harm the sector. Yet, supervisors are not 'starting from scratch': systemic risk management plans (SRMP), liquidity risk management plans, recovery plans, and other measures already exist. The work that needs to be done now is to look at residual risk, and capture what has not yet been addressed. However, the present low valuation of the insurance sector is quite low is partly due to the fact that the sector is perceived as very complex, and if layers of regulations are added, this perception will become more widespread.

Another industry representative noted that the low interest rate environment has fuelled concerns about collective failure in the life insurance sector, but pointed out that these concerns are not restricted to the life insurance sector. As a result, as they develop new regulation, regulators are particularly careful to not unnecessarily destroy value. This is understandable, but this approach may actually create more systemic risk. The industry representative believes that liability discount curve adjustments could pose systemic risk, and this must be better understood. Also, a departure from risk-based capital charges for certain asset classes could have unintended consequences.

### 6. Defining an effective resolution framework which effectively contributes to preventing and addressing potential crisis raises many challenges

At the present time, companies are told that supervisors have developed a resolution plan, but this is not shared with the management of the company; one speaker believes that this could be changed. Resolution is a very difficult issue, because it raises the question of the responsibility and even the liability of the supervisors; this issue will need to be very carefully thought out before a crisis situation occurs in which resolution will be necessary. Another speaker added that having companies, whether large or smaller, design and produce a recovery and resolution plan risk to be a 'colossal waste of time and resources': firstly, because companies should be investing their money in preventing and identifying what might be the next issue that they might face, rather than waiting for things to go wrong, and secondly because it is not possible to predict where the next crisis is going to come from.

However, an industry representative stated that their supervisor has run a pilot with the larger insurance companies in their country, and has asked them to develop recovery and resolution plans without a legal requirement. That piloting exercise has been extremely useful. In the course of the exercise, it has become clear that a firm specific resolution strategy in insurance is very important. It is especially important that the resolution strategy is determined before the resolution plan is developed.

The importance of ORSAs is something that this speaker's institution takes very seriously. An official added that resolution is different from recovery, and the question of systemicity is also about avoiding public money being drawn into private companies; as such, resolution is about what functions are critical in a company, and what functions are not critical. A recovery plan might say that a company can sell an entity or get rid of a portfolio, but if these are interconnected, the people involved are the same, or the legal structure is not simple or clear enough, there might be questions of resolvability.

### 7. Recovery and resolution: supervisors should not focus only on systemic insurance players, nor on the insurance sector

Focusing only on systemically important insurers in the area of recovery and resolution is the wrong approach. Although the attention of supervisors is very much focused on large institutions, due to the issue of systemicity, it would be easy to step back from that point of view: none of the nine G-SIIs has a market share worldwide that is more than 3%, and the largest stands at less than $1 trillion, whereas the largest banks are above $2 trillion. For example, in the context of the French market and Solvency II, there was only one company that went bankrupt, which was a very small company. Because it was very small, it was very focused on specific areas, and partially as a result went bankrupt. Another industry representative stated that it is important for all insurers to go through the process of recovery planning as an internal tool and as part of a good risk management system.

### 8. Dealing with international insurance groups requires European and international levels for supervisory, recovery and resolution cooperation, and further regulatory consistency.

The appropriate level on which to deal with the regulation of insurance groups depends very much on the institution that is under discussion, and the weight of the European operations within that institution. One would welcome an EU initiative on insurance, recovery and resolution: indeed, while a Member State has its own local framework, when it is dealing with EU insurers that have cross border activities through subsidiaries or free provision of services, it is a need for consistent frameworks and facilitating the understanding of local specificities in other jurisdictions. There needs to be efficient cooperation between the authorities, and usually, national legislation does not provide such effective cooperation.

The existence of colleges of supervisors allows different parties to share their views more easily. With free provision of services, a company can do business all across Europe from a single country. However, a supervisor based in one member-state cannot know all of the laws of each local state, so there needs to be some cooperation between supervisors in order to define how much should be kept in reserve. Additionally, although colleges of supervisors are usually primarily focused on insurance, having the vision of the whole group and where the subsidiaries are – as well as internal connection – is very important.

One official noted that colleges of supervisors, while valuable, require senior managers from across a multitude of operations to gather together and spend a great deal of their time talking to supervisors about strategic direction. If regulators are going to require these companies to gather together all of their senior people for at least one day of interviews and discussions, the least that these regulators could do is to attend these meetings and have these conversations with senior management. Bureaucratic staff within regulators are often very technically gifted in terms of financial analysis, but sometimes find it difficult to talk about strategic efforts and the strategic directions of companies.

It is also important to remember that all regulators share the same goals: to make sure that policy holders and consumers are protected. Different regulators might achieve this in different ways, but these colleges and some of the work that is taking place at the IAIS to harmonise and better understand each other's systems is very important. Regulators can have conversations and learn from each other, such as how each regulator uses its regulatory tools to arrive at its outcomes. The IAIS could serve as the mechanism for bringing some of these points together, and producing a single means of judging the relative financial or operational strength of a particular company, so that conversations that take place at the colleges of supervisors can move forward more quickly.

# CHAPTER 6

# GLOBAL REGULATORY AND SUPERVISORY COORDINATION

## The efficiency of G20 Financial Reforms

### 1. Much-needed financial sector reforms have successfully taken place but the global financial leverage is worrying

The consensus amongst policymakers is that the banking system is more resilient following the Basel global regulatory reforms and is now safer, better capitalised, less leveraged, and more liquid with improved funding structures. Although some elements of the reforms, such as the implementation of TLAC (total loss absorbing capacity) and the resolution framework, are yet to be fully implemented, the reforms have been enormously successful overall and there is great respect for the work done by the Basel Committee which has broadly achieved its objective.

An official stated that the Basel Committee did not go too far: the banking industry has raised significant amounts of capital without restricting credit to the real economy. A leader of the industry disagreed on that point: There are some consequences of the reforms which were underestimated by the Basel Committee with de-leveraging resulting in billions of euros being wiped from bank balance sheets, and significant reductions in lending contributing to lower growth, lower GDP and higher unemployment in Europe.

High-quality inclusive supervision is also key to the safeness and soundness of banks and is something that has been traditionally greatly invested in though often forgotten when compared to enhanced capital buffers and better crisis management both nationally and at the European and global levels. There are specific challenges in terms of integrating supervision and, at the international level, making sure that the highest supervisory standards are in place. There also needs to be a stronger focus on addressing the financial stability risks in areas beyond banking such as insurance, asset management and the markets.

The derivatives market is now more secure, particularly as a result of the approach taken by the G20 in 2009 with regard to the execution and clearing of standardised contracts, and the reporting and capital amounts of swaps. This is particularly important given the contribution of the derivatives market to the propagation of the global financial crisis through the domino effects from fire sales and the toxic form of shadow banking.

The implementation of the reforms on derivatives, however, has not been ideal. Inconsistencies in content and timings across different countries have been unnecessarily painful for the industry. Harmonisation can be very beneficial in this regard but harmonisation requires confidence and trust. In particular, the equivalence determination in February 2016 needs to be honoured and built upon with trust and transparency. In addition reliable consistent data and a common language in the derivatives market has not yet already been achieved, though a recent report from the Financial Stability Board (FSB) notes some successes in this area.

A particular area of concern is enforcement, since rules that cannot be enforced are not worth very much. Information on bad actors and repeat offenders should be shared since they can move and re-appear in different markets and countries. Similarly, there should be no barriers to sharing data that would impede the ability to work together, particularly in relation to cybercrime and high-frequency trading. It is important to note, however, that derivatives are intertwined with government bond markets so that any restrictive measure that is taken on derivatives has an impact on the government bond market. In the wake of the Basel reforms, both big players and mid-sized players have withdrawn from government bond markets, reducing their liquidity.

Although the financial system is stronger overall following the reforms, it is important to remember that the financial system is only a part of the economy and of society. In particular the last financial crisis was produced by rapid leveraging, particularly in the US, and current global leveraging is moving faster than it had done during the pre crisis period. Indeed, during the six years from 2001 to 2007, the ratio of credit to the non-financial sector to GDP rose by 39 points (from 190% to 228%) in the US. During the seven-and-a-half-years from 2008 to mid-2016, the same ratio for all BIS reporting countries rose by 44 points (from 202% to 246%).

Moreover, an aging society and a persistently low and flat yield curve are compressing bank profitability, which is the first line of defence against any shocks and is perhaps more important than capital and liquidity. Stronger anti-globalisation sentiments are also putting greater pressure from the public on resolution authorities to ring fence. It is therefore premature to declare victory in preventing the next crisis.

### 2. The risk of fragmentation threatens globalised financial markets

Co-ordinated global financial rules have both benefits and drawbacks, and a review of good and bad reasons for setting global standards may help in the design of a smarter globalisation of financial regulation. Examples of good reasons for global standard setting include promoting good practices, preventing negative spill-overs, pooling scarce expert resources, reaping the benefits of common metrics and languages, reducing arbitrage opportunities, avoiding impositions of conflicting requirements, reducing compliance costs, and leveling playing fields. Examples of bad reasons for national regulatory discretions include short cutting the painful process of persuading domestic stakeholders and concealing the vulnerabilities unique to a country.

Benefits and costs of harmonisation differ across regulatory areas which operate in different ways and have different priorities and different political realities. Any additional global regulation should be subject to a marginal benefit / marginal cost analysis. There are differences, for instance, in the balance sheets of banks, differences in the way that economies are financed. These differences will not disappear and it is not necessarily desirable that they should. Instead, these differences should be taken into account in the regulation or else the single international standard will play out very differently across jurisdictions. These intractable differences should be taken into account because supporting an international standard requires a recognition of the limits of that standard rather than treating very different situations in the same way, which creates the risk of divergence whereby the differences are not erased and instead the international standard is fractured.

Going beyond the limits of the international standard risks jeopardising it. A smarter globalisation of regulatory frameworks might be explored instead since, if bank regulators impose certain regulations on community banks simply because it has been decided in Basel, the legitimacy of the process can be undermined. Harmonisation should depend upon the nature of the issue.

In any case, there is a need to address the divergences in the implementation of the Basel requirements between the EU and the US: a unilateral implementation of Basel standards by the EU like the Fundamental Review of the Trading Book (FRTB) - the US has signalled an intent to halt its implementation - would increase the cost of some market activities for European banks, undermining their competitiveness and leading to unlevel playing field issues and so forth. Overall, the "Basel IV package" is about operational risk, market risk and credit risks and its implementation needs to be consistent across the board.

Differentiated reallocation of responsibility between national authorities and global standard setters would help defend the globalised financial markets from the risk of fragmentation.

Divergences in prudential standards are much more manageable than in cross border trades of derivatives or anything else. Regulators have to correctly manage the reality of cross border markets in a way that ultimately benefits everyone. This was an enormous issue when Gary Gensler was the chairman of the CFTC. The battle at that time was between substituted compliance and equivalence determinations but it seemed as though the substituted compliance side of the debate was much more focused on the design of the rule rather than on whether the substantive impact was ultimately equivalent, unlike in Europe where the focus was more on the outcomes rather than the letter of the law.

In this age of anti-globalisation sentiment, regulators need to think very carefully before assuming that everything needs to be harmonised. Brexit is a particular example of this sentiment. European officials and the European Commission state that there is a reassessment of the framework of equivalence determination, certainly in the context of Brexit but also more generally, in terms of whether traditional equivalence determinations in large markets are no longer the right thing and whether locational requirements need to be added in. This is a big, complicated problem that is playing itself out in terms of the treatment of the UK post Brexit.

More needs to be done regarding the Basel prudential requirements, according to an official. Glaring deficiencies and obvious inadequacies of the system have been addressed. However, there is a concern about the uncertainty of the impact of using internal models for regulatory capital purposes. This is why the focus of the Basel Committee is now about establishing the right level of a capital floor. These measures may not come into effect until 2021 at the earliest. There is therefore time for banks to adjust to the revisions to the framework.

Both the official sector and the industry, across Europe and the US, are worried about duplications of rules, rule burdens, liquidity impacts and level playing field issues. Questions are being raised whether due account is being taken of unintended consequences of the introduction of such floors. A leader of the industry pointed out that such a development would be damaging in Europe to banks with lower risk profiles and could encourage banks to concentrate their activity on the worst risks since the latter are not affected by the "floors". Such anomalies would notably hinder the business model of European banks without justification and raise the question of the ability of a global framework to adapt to the realities of regional risk profiles.

An examination of the resilience of such reforms reveals that the power of what has been done lies in the degree to which there has been a globally co-ordinated and globally consistent approach to critical regulations. Many things have placed a stress on that, such as Brexit, and a question has arisen about whether the ongoing work at the Basel Committee is adding to that stress. The US and the Europeans are actively thinking about meaningful divergences from the global standards, and the question is whether there is now an opportunity to take a step back and look at those issues that concern both the official and industry sectors.

Global regulators may require powers of enforcement to ensure the success of international standards. The European Court of Justice can enforce European Union law but there is no equivalent enforcement mechanism at the global level, which is a major weakness of the global system. A representative of the public authorities agreed about granting greater powers to international organizations and suggested creating a world derivatives organisation with policing powers.

## Prospects of global coordination in the new political, economic and monetary environment

While recent events may bring into question the future prospects of global financial regulation, global coordination of financial regulation continues to be needed. Indeed, it helps to create a level playing field for market participants by defining a common set of requirements and timelines, helping thus to protect and promote financial stability globally.

### 1. Agreed international commitments on banking regulation need to be fulfilled

An official pointed out that it is too early to say what the final position of the US will be on the implementation of the Fundamental Review of the Trading Book (FRTB) and the Net Stable Funding Ratio (NSFR). The US Treasury has reviewed thus but only made recommendations.

The EU Commission has also slightly departed from Basel on NSFR because the Basel standard was conducive to disincentivising central clearing. A call for evidence was being conducted by the Commission to see what the issues and problems were and how they could be fixed. However, should the US significantly depart from or choose not to implement the FRTB, this would create a question about whether other jurisdictions should implement it or altogether rework that part of the standard.

An official stated that once commitments are made at the international level it is important that they should be fulfilled. Reforms and commitments have been made and it is now time to deliver. There is room within the agreed rules to find solutions to a number of national specificities. This speaker noted that international standards represent what the US's independent regulators have agreed to do in standard setting bodies. They then come home and consult on how these standards fit into the US regulatory and industrial structure and implement them accordingly.

Various reviews at Basel have shown that the US is implementing Basel standards at least as robustly as most countries. The US Treasury report from June emphasised the US's continued engagement and commitment to engage in international processes.

It is important to make progress on the last element of the capital reform of Basel III. Utilising an output floor is considered the best solution, given the diversity of all the modelling practices according to an official. There will need to be compromises, but it is important that the finalisation of Basel III should be done quickly so that firms have the certainty about the regulatory standards. However it was stressed during the exchange of views that although floors reduce RWA variability, they only do so for the lowest risk assets since these floors only come into play by definition for risks with lower probability of default or loss given default.

### 2. Developing common frameworks with relevant calibration which suit banks and exposure types across jurisdictions is challenging but feasible

An industry representative stated that much regulation has been implemented over the last eight years and each individual piece has been well designed and thought through. Appropriately, different jurisdictions have been moving at different speeds. The US has been in the fortunate position of having had a reasonably quick bounce-back, and therefore has moved quickly.

Bank of America, JPMorgan and Citigroup alone have half a trillion dollars of common equity tier 1, and each dwarfs its nearest competitors in Europe. However it is possible to conclude that the US has gone too far, too fast.

Collaboration relating to policy and minimum standards has been appropriate, but regulators and banks have had more difficulty getting implementation and consistency right. Better collaboration and trust between the regulators is essential. Cooperation between ESMA and the CFTC on CCPs could be used as a model.

An industry representative felt that the Regulatory Consistency Assessment Programme (RCAP) process by Basel is an excellent example of what can be put in place in order to monitor the implementation of global standards. The Targeted Review of Internal Models (TRIM), as implemented by the ECB since the beginning of 2017 is another appropriate approach for reducing the variability of RWA.

Getting everybody to do the same kind of thing, to collaborate and hold themselves accountable to fixing the problems that are identified, is an essential next step.

The moderator asked if respondents would be in favour of empowering a global institution or having a dispute settlement system like the WTO. A policy-maker noted that rules are followed because of a belief that they are good for the industry, and if that belief is not there then do not sign up to Basel. Elected representatives have a right to change things if they think it is wrong and that should be acknowledged.

The finalisation of Basel is about reducing the excessive variability of risk weights, and TRIM is an excellent EU way of approaching that. However, that is not the same as having a system that is benchmarked on a standardised approach. Either the job is done with the TRIM approach in Europe, which means dealing with similar risks across jurisdictions in the same way, or via an approach based on output and input floors. These floors would systemically overestimate the risk for the most solvent customers and the best guaranteed loans, assimilating it with a single constant non-risk sensitive value, which is based on the floor.

The risk sensitivity embedded in the current regulations ensures that many differences between jurisdictions are automatically reflected in banks' prudential requirements. Adequate incentives are also provided for banks to efficiently manage their risks. But introducing floors means artificially limiting the reduction in RWA and accepting as a fundamental principle that a bank with reduced RWA cannot under any circumstances be a lower risk bank. Moreover the introduction of floors would encourage banks to focus their activities on high risk/high return assets because these are not impacted by the floors.

Anything that is based on valuations around a standardised approach ends up dealing with different risks the same way across jurisdictions and that is not what should be done. Consequently the EU Commission has put much emphasis on maintaining an appropriate degree of risk sensitivity in the Basel framework.

An official stated that the United States' position is to hold regulators accountable but to accept that they are independent from government. In the US, democratically-elected legislators decide that experts should be the ones making the rules, as they have the most knowledge and experience. The official advocated both risk sensitivity and a standardised approach. All jurisdictions should adopt some humility about how well risk can be estimated in advance.