Sofia 2018

SUMMARIES OF THE SESSIONS

Key outputs from the sessions

MACRO-ECONOMIC AND POLITICAL CHALLENGES

Deepening the EMU: what next?

1. The future of the EMU: priorities, sequence and timelines

The moderator introduced the topics for discussion. There is a broad consensus that the Economic and Monetary Union (EMU) should be deepened, but there is not necessarily a consensus on priorities, timeline and sequencing.

One minister stated that the progress to be decided in the discussion of EMU is familiar to Member States, but the sequencing and process is much less discussed. The sequencing of EMU is just as important as where Europe wants to go. Hopefully, several main pillars of the institutional architecture for EMU will be achieved in the near future. Some issues have already been agreed, such as the backstop to support the Single Resolution Fund (SRF). However the fiscal pillar of the monetary union remains a non-consensual issue.

Another minister suggested that Europe must find a minimum common denominator on EMU. The European Council instructed the Ministers of Finance to concentrate on the ESM and deepening the Banking Union, which is already a substantial task. If the topic is broadened, this only adds further complexity. It is also important to distinguish between issues which are intended to be appropriate for Europe or which are institutionally or politically necessary and, second, issues which are about economic integration and risk sharing. Mixing these two categories makes it very difficult to find solutions.

In addition, the role of the ESM as a backstop is not fully agreed. The countries that are hesitant on this subject will probably be prepared to support the backstop if there is more risk reduction. It is not realistic to suggest that so much risk reduction has been done that it is now time to address the 'wish lists' of different countries. Another policymaker stressed that, while the ESM does not need to function as a backstop tomorrow, Europe has agreed on the backstop and should now decide how to implement it. According to him, it is not realistic to suggest that so much risk reduction has been achieved that it is now time to address the 'wish lists' of different countries.

The moderator pointed out the different positions within this debate. Quite often there is agreement on where Europe should be in 20 years 'time, but in politics the question is always about how to go from here to there.

2. Risk sharing and risk reduction in different euro area countries

Public decision makers must agree both on the level of risk reduction and risk sharing, the relationship between the two, and the appropriate speed of change.

2.1. The level of risk sharing and risk reduction and the balance between them

A minister emphasised the importance of the long debated issue of risk sharing versus risk reduction. There are different views on the appropriate level of risk sharing and risk reduction and their balance. The policymaker stated that much has been done on risk reduction but not enough on risk sharing. This sequencing process relates to a non-technical but deeply political issue: mutual trust. Without sufficient risk sharing, there will be scant progress on the EMU.

Risk sharing means implementing what has been decided, such as the backstop to the SRF, and considering how to implement the missing pillar of the Banking Union, which predominantly consists of the European Deposit Insurance Scheme (EDIS). Politicians must continue to build consensus for further risk sharing. Ultimately, Europe needs the backstop to the SRF, EDIS, and a stronger ESM.

However, risk sharing is not an alternative to risk reduction; rather, it is complementary. There can be more risk reduction in several areas if there are more risk sharing instruments to generate incentives to go further.

2.2. The appropriate speed of the process

The issue of NPLs is a productive question. To take an example from Italy, it is essential to reduce the exposure to NPLs on banks' balance sheets. This is relevant for the country, for the banks and for Europe. There is a question about the appropriate speed of this process. If it is too slow, progress is invisible, and it could be an obstacle to managing a critical situation if another crisis occurs. If the process is too slow, it also generates additional risk because banks do not have sufficient time to adjust their balance sheets to the targets. Therefore Europe must determine the appropriate sequencing and timing of the reduction in NPLs. However any policy decision which introduces targets, constraints or requirements on key variables can potentially be poorly calibrated, and therefore there is an implicit risk of generating more, not less, fragility. In addition, the introduction of new regulations and requirements in areas such as NPLs or capital ratios generates a risk of provoking unwanted market reactions, which would increase fragility. Regulators must be aware of this when introducing new requirements.

When policymakers agree to carry out risk reduction before risk sharing, there is then a debate about how much risk reduction is sufficient. Subsequently, the goalposts are moved and countries are asked to make more risk reduction. This does not support mutual trust, which is the essential ingredient for making progress on monetary union.

One minister responded that reducing NPLs is very important, but if one country asks for more time to carry out the reduction of NPLs then others, which perceive this as a risky activity, will ask for more time to complete other steps related to risk sharing. All of these measures must happen in parallel: EMU is a matter of timing and sequence.

3. The development of a fiscal capacity or stabilisation mechanism in the euro area

Reflecting on what could be an acceptable "fiscal union" and restoring a coherent Monetary Union in macro-economic terms remain contentious issues.

3.1. The importance of developing a fiscal capacity in the euro area

A minister highlighted the importance of the fiscal capacity/stabilisation pillar. When the monetary union happened, countries lost their power of devaluation and there was nothing to take its stead. Until that is rectified, the eurozone will always be unstable. There is a suggestion that the Banking Union and the implementation of the Capital Markets Union will obviate the need for a fiscal capacity, but this opinion fundamentally misconceives how crises develop. Ultimately, three things intertwine to create crises: finance, the sovereign and the real economy. Not having a stabilisation mechanism adds significant pressure on the real economy.

Europe does not have an alternative to internal devaluation. The austerity measures of the last ten years mean that it is very difficult to use national fiscal policy in highly indebted countries. As a result, the only adjustment mechanism in the system is the real wage. Economies are equilibrated by unemployment pushing down the real wage, whereas devaluation does that to all wages simultaneously. Devaluation removes the need to fight unemployment and pressurises workers' wages to make this adjustment.

Another minister stated that the stabilisation mechanism is very important. Once countries are within a monetary union, there will be situations such as cyclical downturns or idiosyncratic shocks that place the burden of adjustments on the labour market, specifically the wage rate and the employment level. In some cases, the pressure placed on the labour market under monetary union is simply too much. There are also long term costs. If you generate a negative shock on the labour market, it persists over time, and well beyond the time necessary for adjustment.

This question is not about replacing the exchange rate but creating mechanisms to make monetary union function better and at lower cost, in tandem with structural reforms to improve the labour market. The minister expressed strong support for structural reforms. Italy, for instance, has been through a period of structural reforms. These reforms must be continued under the next government, because they are needed in Italy. Many other countries also need further reform to facilitate resilience, increase potential growth and economic convergence and make the functioning of the monetary union smoother.

A minister stressed that devaluation is never a panacea. For example, Greece overused devaluation without making economic reforms. However, this afforded Greece with a breathing space when there was a problematic situation. However for both a country using devaluation and a monetary union using stabilisation, these tools are not a panacea.

A Central Bank official from the audience suggested that Austria has had a very active fiscal policy for 30 years and had the lowest unemployment in the EU over that period. With a fixed exchange rate, it is possible to have a very active fiscal policy if there are sufficient buffers. However, this would be easier if there existed a backstop for deep recessions at EU level.

The moderator noted the existence of solidarity from euro area countries with Greece in the form of assistance from the ESM. Greece has received more than €170 billion from the ESM at an interest rate of about 1%, which saves Greece €10 billion every year.

3.2. Issues associated with the development of a fiscal capacity in the euro area

A minister acknowledged that Europe would have to develop some form of stabilisation mechanism or fiscal capacity over the long term. It took decades to develop such a mechanism in the United States. To take the example of Bulgaria, even without a fiscal capacity Bulgaria has calculated that joining the euro is the best decision for the country. The development of a fiscal capacity is a political choice.

When people from worse off countries suggest that Europe needs these mechanisms, these people do not emphasise the fact that they will also have to adjust. This is the worst message better off countries do not want to hear. It is essential to send the message that these countries are ready to become more competitive and to make structural reforms while advocating these public risk-sharing mechanisms.

Another policymaker highlighted the importance of respecting those who take a stricter view on the fiscal capacity. There are questions about how this capacity will be structured, for example. It would be very constructive to provide investment capacity to countries experiencing countercyclical crises. It is important not to describe this fiscal capacity as a facility for money to be provided to whichever countries experience problems. This is what is known as the 'transfer union' in Germany. If a fiscal capacity is presented in this way, it will not be accepted by some Member States. Independently from the question of urgency, if Europe moves too quickly this process might become blocked.

The countries seeking the development of a fiscal buffer must preface their arguments with an admission that the first responsibility is their own. They must make it clear that they want to solve their own problems with some help from their friends. Things are always better with a little help from one's friends.

3.3. The potential political consequences of failing to develop a fiscal capacity in Europe

One policymaker underlined that Europe also needs the fiscal pillar because of its social context. When countries rely on adjustments through real wages, right wing populist politics gains support because there are poor wages and job structures with little chance of career progression or because there are middle class people who fear downward social mobility. Europe requires a fiscal capacity that is not only a stabilisation but an equalisation mechanism. If there is a crisis in Texas, federal funds go to Texas, but the bonds that pay for this federal spending are paid by all Americans. Until there is such a mechanism in Europe, there will be nationalist politics in Europe.

The most upsetting thing is the lack of urgency in Europe on this issue. A fascist party almost won the Presidency of Austria; there are a number of other fascist movements around Europe, including the Golden Dawn in Greece, or the National Front in France. This situation indicates that fiscal buffers are not working. Everywhere around Europe, there are populist forces which are centrifugal and nationalist. If they win, Europe will return to the 1930s. There may be some common ground across Europe, but no real urgency is felt.

Another minister explained that there has been growth in populism because there has been no growth in Europe for eight years. This is not because there is no fiscal capacity in Europe; it was caused by the deepest financial and economic crisis since World War II. The internal issues of the eurozone are not a panacea for everything.

The moderator noted the two broad issues being discussed: first, there are the issues connected to the Banking Union, such as the level of risk reduction and risk sharing and the appropriate balance between the two; second, there is the nature of the monetary union, at least partially connected to a potential fiscal capacity. There were countries and policymakers who were not aware of what the implications of joining the monetary union were. Some governments were not aware that they would have to keep wage developments, unit labour cost and competitiveness under control or that it would be necessary to have national fiscal buffers.

3.4. Asymmetries between euro area countries and fragmentation in banking markets

A Eurofi staff member described how several of the weaker European countries have already realised remarkable adjustments. The peripheral countries in Europe have moved from current account deficits to balance or even surplus. However, the northern parts of Europe have been running excessive surpluses. Here, there arises a question about symmetrical adjustments, which should be posed in the monetary union.

A minister added that Italy has a current account surplus. The question of asymmetry is key to the functioning of the economic union, not just the monetary union. In countries with persistent current account surpluses, there is a problem with a lack of investment. The healthy adjustment is not, as is sometimes portrayed, to ask these countries to do more fiscal expansion. These countries must develop investment friendly fiscal or structural policies.

Another minister agreed with the spirit of the question asked about current account imbalances, noting that different countries have very different debt levels. When interest rates go down in Frankfurt, they do not affect Spain, Portugal or Italy in the same way. Europe must find a different mix between monetary and fiscal policy. Otherwise, interest rates will be too low for Germany and not low enough for Spain, Portugal, Italy and Greece.

Europe must establish the goals of deepening the EMU. Some people in Europe claim the goal of EMU is to prevent financial crises, while others include addressing social issues and ensuring convergence between European economies. These two views produce very different conclusions about the scope and the depth of the issues in Europe.

A Eurofi staff member also noted that it is often said that completion of the Banking Union would produce financial stability within Europe, but this will not suppress the current fragmentation seen in the banking markets. It is important for Europe to consider how it can remove these regulatory barriers to the achievement of cross-border risk sharing within the Banking Union.

A minister responded that Europe must develop more systemic and supranational approaches to Banking Union and Capital Markets Union integration. Fragmentation is a result of a lack of appropriate supranational policies.

Another one minister felt that the question of fragmentation in the capital markets is 'totally overplayed'. This is an issue for the market. There is a reason why 19 countries have an issue with the home/host question. There must be stability in every country; depositors must be insured in every country. Europe must find the right guarantees to ensure that subsidiaries are not abandoned if there is a crisis.

In his last intervention the moderator stated that many politicians have not realised that monetary policy within a monetary union, like in any large country, is always pro cyclical. Interest rates are always too low for well performing countries and too high for countries experiencing a downturn, which can be also seen in regions of large states such as the US and China. This is the nature of a large monetary union, and this might have some consequences for fiscal policy.

None of the panellists had discussed the ESM, which might indicate that it is easier to find agreement over what to do on the ESM. On Banking Union, there is agreement on where Europe should go over time, although there will be difficult decisions on sequencing of risk reduction and risk sharing. The issue of deepening the EMU must be viewed collectively. It is about risk management. Of course, the most controversial aspect is the fiscal side. Europe is far from reaching a consensus, but this is an important topic that must be addressed.

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Forthcoming unwinding of QE: expected impacts

Introduction

It has been almost four years now since the Eurosystem incorporated several new instruments to combat the deflation risks that threatened the euro area in the wake of the crisis. One of its important tools is the Asset Purchase Programme (also referred to as APP – the euro-area version of Quantitative Easing) that was announced in its full blown version in January 2015. The size of the asset holdings related to APP is now approaching EUR 2.37 trillion and should reach EUR 2.55 trillion by the end of September 2018. Looking ahead, the net asset purchases will stop when the Governing Council see a sustained adjustment in the path of inflation ("SAPI"). We are not there yet, but the Eurosystem is confident that the three criteria of this "SAPI", namely convergence, confidence, and resilience, will be met.

A Central Bank official outlined that the Eurosystem's monetary policy is guided by the price stability outlook and, while inflation measures remain subdued, they are expected to rise gradually over the medium term. The Asset Purchase Programme (APP) of the ECB is intended to run until September or until the Governing Council sees a sustained adjustment in the path of inflation.

The Eurosystem will continue its monetary stimulus, contributing to favourable financial conditions for households, firms and States. The timing, the scope of normalisation and the low interest rate environment experienced since the financial crisis require well-structured communication to smooth the process of returning to normal. Future policy steps must be well-discussed, data-based and gradual, providing sufficient time for markets to adjust.

1. The normalization of the ECB's monetary policy: a process guided by the outlook for price stability

1.1. The intentions of the ECB

A Central Bank official underlined that a monetary policy Governing Council meeting of the ECB in Frankfurt taking place on 26 April released an introductory statement before President Draghi's press conference, which was clear about the philosophy and intention of the ECB and the Eurosystem regarding normalisation. The introductory statement has three main ideas:

The first is about interest rates. The statement says, 'We expect interest rates to remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases.'

There is then a statement about the asset-purchase programme, which says, 'Our net asset purchases, at the current monthly pace of €30 billion, are expected to run until the end of September 2018, or beyond, if necessary, and in any case until the Governing Council sees sustained adjustment in the path of inflation consistent with its inflation aim.'

The third idea is on reinvestment. Net purchases are important but reinvestment is the main instrument of the ECB to manage the normalisation process, apart from interest rates. On reinvestment, the statement says, '[The Eurosystem] will continue to reinvest the principal payments from maturing securities purchased under the asset purchase programme for an extended period of time after the time of its net asset purchases, and in any case for as long as necessary.'

This clearly states the ECB's intentions. The Eurosystem and the ECB are progressing towards the inflation rate of below, but close to 2% in the medium term, which is the official and established definition. Progress towards it should be durable and at a pace that can be sustained without monetary policy stimulus. If progression requires the help of monetary policy to sustain it, it is not sustainable or autonomous. Progress must be made without the help of monetary policy.

Members of the ECB Governing Council and Board insisted that the process requires patience because it takes time for the underlying inflation dynamics to gain momentum. It also needs persistence because the recovery in inflation still relies on monetary stimulus, and prudence because it is difficult to have a clear idea of the impact of the pass-through from monetary policy to the real economy and real data. Prudent analysis is also needed. One point of the exercise is to analyse the real economy and financial conditions to decide how sustainable and solid the recovery is along the path towards inflation. This is a difficult exercise that must be repeated often. The central banks in the Eurosystem have to go into detail about the real economy, with hard and soft data, and must have an opinion about progress and the extent to which discontinuing monetary stimulus can be considered. This is open to mistakes. The ECB and Eurosystem's central bank members try not to make them, but mistakes are possible because the exercise is subject to the known and unknown, and projections and events which are out of the Eurosystem's control.

A Central Bank official considered that normalisation requires a slow process. It is better to have delays than to be in a hurry and have to take a backward step. The ECB and the Eurosystem's first duty is to avoid mistakes and backward steps that are bad for markets and inconvenient for everyone. It is better to be slow and make a mistake that can be recovered from, rather than the other way round.

1.2. A normalisation process already underway

A Central Bank official underlined that in December 2016 the Governing Council announced a recalibration of the APP, extending the net purchases until December 2017 at a reduced monthly pace of €60 billion[1]. Following the decision made on 26 October 2017 the monthly pace has been further reduced to €30 billion from January 2018 and net purchases will be carried out until at least September 2018. The intention is for securities purchases to be carried out until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term.

Looking ahead, the evolution of monetary policy would be firmly guided by the outlook for price stability. The transition towards policy normalisation will begin once the Governing Council assesses there has been sustained adjustment in the path of inflation.

1.3. The determinant factors of the monetary strategy in the future

A Central Bank official explained that the current position of the Governing Council is based on two "Cs" and the three "Ps". The two Cs are 'confidence' and 'convergence': Convergence means looking into the medium term, headline inflation should be well on track toward reaching levels below, but close to, 2%. Confidence means that the Governing Council will need to have confidence that the convergence path is likely to materialise sustainably.

Then come the three Ps: 'patience', 'prudence' and 'persistence': Patience, as it takes time for underlying price pressures to build up; persistence, because the pick-up in inflation still needs support from the monetary policy stance and prudence as global and domestic uncertainties counsel prudence in the adjustment of the monetary policy parameters.

Once the Governing Council decides that sustainable adjustment is taking place, net asset purchases will end in line with its forward guidance. Thereafter monetary support for inflation convergence will be provided by reinvestments continuing for an extended period of time and policy rates remaining at present levels well past the end of the net asset purchases.

2. Possible impacts of the exit of QE

2.1. The overreliance of the monetary policy

A public representative stressed that there has been an overreliance on monetary policy since the crisis, with expectations that the central bank can fix everything. Central banks are assigned more responsibility and powers, without serious debate on their responsibilities, the associated risks, synergies or conflicts, or the manageability of complex and important institutions. It is not that central banks are not delivering results. In many countries, they made a significant or higher than expected contribution to the recovery of the economy and its return to sustainable growth. The question must be asked if this is an appropriate situation. The proper functioning of policies is vital for sustainable and stable economic growth. Central banks cannot complement policies with monetary policy. In any case non-standard monetary policy measures cannot act as a substitute for structural reforms, which are needed in many EU countries to improve the business climate, raise output growth and reduce unemployment.

Central banks do not have many tools. They set short-term interest rates to tackle inflation, they have a liquidity channel in place and sometimes they can issue regulations. They have a strong communication channel, based on the ability to act. The cost of money is vital for dealing with inflation, while the liquidity channel is key for the functioning of the banking sector and transmitting monetary policy signals to the real economy. In the past, central banks cut interest rates and provided liquidity to the financial sector to keep it functioning and boost monetary policy. It was an adequate response to non standard conditions.

2.2. The exit of QE is a manageable process

A public representative underlined that the European economy is returning to relatively stable growth, but inflation is being kept down due to a combination of external and internal factors. Among the internal factors is low wage growth in the eurozone, which should be temporary. The economy will return to a more inflationary path or will slow down. Confidence is returning to the financial sector. The key decision for the ECB will be the moment at which to increase interest rates. There is a question about the extent to which forward guidance should be key, despite the credibility of communications being important. Starting too early and undermining economic growth will create a loss of credibility but starting too late will mean that central banks will have to do more later and will make the cost of normalisation of monetary policy more expensive.

It is better to take a different look at the quantitative side of the central-bank operation, because an improvement in banking sector credibility and increasing interest rates should lead to the demand for quantitative operation fading away. The ECB's ability to cut the size of purchases proves this. Balance sheet normalisation will happen gradually with no disturbances, and the ECB will monitor that the banking sector remains liquid and able to transmit monetary-policy signals. There are implications of the normalisation of monetary policy, from a qualitative cost of money and a quantitative point of view, but it will not be key for the European economy in future quarters. The first impact will be on borrowers in certain markets. People active in the financial sector who finance investments through cheap money will face costs, which will impact investment and the markets where they are active. Another impact may be in long-term borrowing for flexible interest-rates, especially in mortgages. If the ECB manages things in the right way, any rate increase will be gradual, and the markets will adjust without any huge cost.

A public representative noted that the effect of increased exchange rates should not be underestimated for international variables. The interest rate differential between euro interest rates and other currencies interest rates plays an important role. There are factors that have more influence on the exchange rate, such as the strong export position of European economies in the global economy, where many countries are flirting with stepping down from free trade.

As long as the unwinding of the expansion of the ECB's balance sheets occurs gradually, in relatively good market conditions and with a careful communication strategy, the effects on the market in the future should not be disruptive. The exit of QE is a manageable process that the ECB is well-equipped to handle, and the market is getting ready for it. In addition, many countries have in recent years built up an extensive network of institutions that take care off financial stability and deal with macroprudential policy, using many other instruments besides monetary policy interest rates in order to address potential financial stability risks. If such risks do materialise, monetary policy can buy some time, but cannot address the underlying causes, such as delaying the implementation of reforms in individual member states. Key measures of the economy's strength or weakness lie outside of monetary policy and must be addressed. The ECB will support the process but cannot replace adequate economic policy.

2.2. The influence of the unwinding of QE on countries and companies with high levels of indebtedness

A Central Bank official stressed that normalisation will happen, and there is a question of impact, considering the level of public and private debt in Europe. It is reasonable to expect that the impact will be manageable, provided certain conditions are met for public and private debt, with the proviso of taking account of sudden market reversals or disturbances. Careful implementation and communication is key, as is the ability to respond to unforeseen circumstances.

A Central Bank official noted that the ratio of debt to GDP in the Euro area having peaked in 2014, has reduced slowly and is projected to contract still further. The Commission's projections include an increase in interest rates and a reduction of the debt-to-GDP ratio in the coming decade. This does not look unmanageable but there are issues, the most important being heterogeneity across the Euro area and the level of debt-to-GDP ratio. Normalisation is sometimes predicted to be a disaster for public finances in places like Italy, but this is wrong. The current average cost of public debt in Italy is 3%, which is above the current interest rates on new issuances, so there is some way to go. The average duration of debt has increased in recent years and is now 7.5 yr. Monetary normalisation is manageable. An increase in interest rates, under orderly conditions and in the context of reasonable recovery, need not put the sustainability of public finances at risk.

A Central Bank official underlined that countries with a high debt-to-GDP ratio are vulnerable, and this point has been made to the public, parliament and government. The higher the debt-to-GDP ratio, the more vulnerable the country is to sudden market reversals. It is important to ensure a visible and continuing commitment to sound public finances and to maintaining and preserving a primary surplus. The commitment to prudent management of public finances is critical to ensuring resilience and the ability to withstand market disturbances. Normalisation itself is not a problem but there is a need to ensure a continued commitment to sound public finances. The situation is similar for private debt, although heterogeneity goes a different way. It is similar in the sense that, at the Euro area level, debt peaked around 2015. It has come down but the same reasoning about heterogeneity still applies. In Italy, corporate and household indebtedness is low compared to other Euro area countries, but there are concerns about household indebtedness for other countries.

A Central Bank official noted that Italy has some awareness and has implemented policies to ensure the existence of a primary surplus for many years. There are a variety of reasons for private-household insurance being so high in other countries, including the level of interest rates but also tax incentives, market practices, and structural and legal factors of various kinds. There has been a commitment in some countries to review that through the introduction of macroprudential measures. In countries with high levels of public debt, there is a need to ensure the visibility of the commitment to sound public finance. Meanwhile, in countries with an excessive level or an inordinate increase in private indebtedness, this must be brought under control with appropriate measures, which differ per country, but are important for the whole Euro area.

A Central Bank official turned to a question on the effect of QE unwinding on exchange rates and inflation in Croatia and central and Eastern Europe. It is country-specific, but taking Croatia or the Czech Republic as an example, it helps alleviate pressure on the appreciation of the exchange rate. At the moment, foreign exchange flows and even goes into negative interest rate territory. It reduces pressure on the appreciation of the exchange rates in countries that experience it, so will not create a reversal of flows to the extent of causing concern about the change in the nature of the flows and depreciation pressures. It is dependent on countries but generally in central and Eastern Europe, domestic interest rates go up, which compensates.

A Central Bank official stressed that the million-dollar question is about the effectiveness of monetary policy in influencing inflation. It is necessary to wait for the research, as 10 years down the road, it will be easier to say. If it is not effective in increasing it, the unwinding of QE will not reduce it much. That said, again the issue is heterogeneous in that, for countries with larger indebtedness, the costs of financing in the later stage of unwinding or an increase in interest rates which dries up the structural-liquidity surplus and the effects of the costs of financing, the effect on inflation will be higher than in countries with lower indebtedness. This is because there will be a higher cost of servicing the debt, which will dent consumption if it is private-sector or an investment, or government expenditure or tax, if it is a government. There will be a heterogeneous effect on inflation itself, in central and Eastern Europe as well as in Western Europe.

2.3. The possible impacts of the normalisation strategy on non-euro EU countries

A Central Bank official from a non-Euro zone country stated that the ECB's actions are considered carefully. As a small, open economy close to such a large central bank, it matters a great deal. There are two risks: an abrupt normalisation with either too rapid tightening or guidance to the market that is not clear enough, and results in too rapid tightening; the other risk would be waiting too long to tighten.

Reviewing the possible consequences of tightening on the primarily fiscal position is key. From projections, if the ECB increases interest rates or introduces monetary policy resulting in exogenous long-term increased interest rates of 100 basis points, it will have a moderate impact on the fiscal position. In the four year horizon, in Croatia's case, a 50-basis-point tightening would reduce public debt to GDP from 78% to 60.8% without a tightening, or one percentage point higher with tightening, at 61.8%. If this process is done smoothly, there is little risk of overreaction and impact on the fiscal position. This assumes that the rating stays the same and with a decline in public debt to GDP, it will have a positive effect on the rating.

This Central Bank official outlined that the current focus is not the level of interest rates, but asset purchases. As long as there is a large structural-liquidity surplus, as in the eurozone where it is 11-12% of GDP, interest-rate moves have little effect, because the structural-liquidity surplus has to be dealt with first. Croatia also has a large structural-liquidity surplus, but through FX purchases, not asset purchases as for the ECB. Reserves are now almost one-third of GDP due to buying capital inflows.

There is a risk in waiting too long. Central and Eastern European labour markets are tightening rapidly. There is a relatively rapid increase in wages overall, particularly in some countries, and inflation rates are picking up. Although the Philips curve seems flatter, it is steeper than in Western Europe. Tightening would be helpful at this stage of the cycle to create space for the next downturn. If rates are close to zero, there is little monetary-policy space.

A Central Bank official noted that central and Eastern Europe could tighten if the stage of the cycle warrants it, but it is difficult because of the pool of liquidity created by the ECB. If interest rates rise, commercial banks refinance with the ECB will bring money into the country. That money creates more liquidity surplus if not stabilised. If there is an increase in wages due to labour market tightening, unit labour costs go up. Nominal exchange rate appreciation coupled with a unit labour cost increase, decreases competitiveness.

A Central Bank official stressed that another risk is that Europe has relatively little fiscal space, around maybe 150 to 200 basis points, that is unevenly distributed between countries. Those that have fiscal space are less likely to use it at the next downturn. This increases risk, particularly if coupled with asset price declines when asset prices are high. If there is little monetary policy or fiscal space and asset prices decline when margins are low, and there is a decline in credit demand, that creates capital losses for banks which have seen capital gains during this part of the cycle. The cycle for central and Eastern Europe is more advanced than in the rest of Europe, and so the second type of risk (waiting too long to tighten) is more likely.

3. Conclusion

A Central Bank official concluded that an accommodative monetary policy provides a window of opportunity for building buffers and accelerate structural reforms in Eurozone countries. Monetary accommodation cannot be the only game in town for a long time, so structural reforms must be speeded up by Member States. It is of benefit to use the calm times to make some effort in that area.

1. To accelerate the return of inflation rates to levels consistent with the ECB's definition of price stability, monthly purchases were increased to €80 billion from April 2016 to March 2017.

Are public and private debts sustainable in the EU?

1. Vulnerabilities created by high levels of public or private debt: no immediate threat?

The Chair explained how high levels of private debt - and the way it was packaged in the US - contributed to the global financial crisis, and high levels of public debt contributed to the Eurozone sovereign debt crisis several years later. The industry must consider the high levels of debt in Europe as the process of policy normalisation continues around the world.

An industry representative stressed that their firm spends a lot of time thinking about how to define debt sustainability. Debt sustainability essentially means the ability of borrowers to avoid default. When assessing debt risk and sustainability, there is no 'magic number' or ratio that definitively predicts imminent default. The specificities of different conditions including the ability of market participants to assess and price risks are a key determining factor. For example, while household debt in some European countries is quite high relative to income, it is sustainable in a way that similar levels would not be in other markets. After house prices stop rising, it is also normal to see household debt- to-income ratio rise for 5-10 years, depending on the turnover rate of the housing stock.

An official underlined that there are high levels of public and private debt in Europe. While public debt increased during the crisis, private debt has declined modestly, yet remains at very high levels. High debt levels increase the sensitivity of government, corporate and household balance sheets to shocks such as interest rate hikes. However, there is no major risk of disruption at this stage, especially since prospective interest rate increases will be phased in gradually.

2. Public debt vulnerabilities remain high in Europe

An industry representative noted that public sector fiscal capacity is demonstrably worse than it was 12 years ago. The vast majority of Euro area governments have debt to GDP ratios above where they were in 2006, which matters in a currency union. There have been three sovereign defaults in the Euro area since 2012 (Greece twice in 2012, and Cyprus in 2013), and investors worry about this. Even if sovereigns are resilient to rate rises, the potential to resist further shocks remains a concern.

A policymaker agreed that there is no magic number which defines sustainability in the public or private sectors. Sustainability is defined by country specificities, the moment, the context and general global conditions.

Current debt risks include increases in interest rates and changes in financial architecture. Additionally, there is geopolitical risk and risk to the political economy. While the EU is doing its best to prevent this risk, the matter is not entirely under the EU's control. When risk occurs in the context of high private and public debt there is less ability to manage shocks. In the face of the risk of adverse shocks, there is a diminished ability to cope with the loosening of taxes, consumption and investment.

A regulator stressed that the ESM's key priority is medium term preparedness. Broadly, private debt across the Euro area has reached its pre crisis level, at least on aggregate. While this is not the case for public debt, there are still risks there. Over the short-term, there are fewer concerns. Credit must also be given to the European fiscal framework. It is not perfect, but there have not been any policy aberrations such as substantial fiscal expansions at the height of the cycle, as can be seen in other countries.

The normalisation of the monetary policy is meant to be gradual in the euro area. In the last few years, countries have extended the maturity of their bonded debt, which means that any interest rate moves only become budgetary costs over time, which is a manageable situation. The ESM is not concerned about the immediate future; however, there are questions over preparedness for the next downturn.

3. Interest rate risk to countries with high levels of private debt

3.1. General issues

An industry representative noted that, while interest rates are low and they will soon be raised, their firm does not see a risk of any sudden snapback from a jump in medium term inflation expectations, which are well anchored. The industry has been expecting rises in rates for a long time. The speaker's firm modelled different interest rate scenarios, assessing debt and interest coverage, and running stress tests for particular sectors. Most industry base cases use gradual and moderate rises in rates, and there is no picture of sustained macroeconomic disruption emerging from these analyses.

However if the speaker's firm is positive on a macro level, the substantial amount of high-risk bond debt in the market may be concerning. High yield issuance has surged since 2012. 40% of global corporate financial ratings are rated B or lower. This constitutes approximately $2 trillion of debt, not all of which is US based; a significant chunk is in Europe. Many of those bonds are likely to default, as reflected in the low ratings. If investors understand these risks and they are adequately prepared, this need not be extremely disruptive from a macroeconomic perspective. However, if those risks are not well understood, Europe could see something far worse.

An official explained that there is a disconnect in many advanced economies between corporate debt and investment. If borrowing is spent appropriately, it increases growth by raising proactive capacity or productivity, which ultimately helps increase the resilience of economies in the face of high debt. However, rising corporate debt has been accompanied by very high share buy backs, which suggests that corporates are taking on debt not to invest, but to repay money to shareholders. Additionally, overly indebted firms often fail to secure the investment necessary to remain competitive. So-called 'zombie' firms chronically under-invest. Investment in such firms is low, but also crowds out investment in viable firms.

Additional vulnerabilities have emerged due to changes in the structure of financing. The increase in bond issuance has shifted risk from the banking system to less monitored and less well understood financial intermediaries. The increase in bonds denominated in foreign currencies has increased the channels for cross-border spill overs for credit risk. Finally, there has been a decline in the quality of debt. The very low interest rate environment has led investors to accept more risk, producing a prevalence of non investment grade bonds.

3.2. Specific vulnerabilities in the euro area

3.2.1. Household debt sustainability is all relative

An industry representative highlighted the huge variations between levels of household debt across European countries. In general, the debt has stabilised. However, the ratio of household debt to disposable income has been rising across Europe with very few exceptions (e.g. Ireland and Spain). The ratio of household debt to net disposable income is above 200% in a number of countries (e.g. Denmark, Ireland, Netherlands, Luxembourg, Sweden, United Kingdom), and there are many countries with levels exceeding 100%.

One can argue that that is potentially serviceable in different countries and the majority of household debt is backed by residential mortgages. However, the savings ratio has declined across most countries, and the level of liquid financial assets available to households has also fallen.

3.2.2. The normalisation of interest rates will have mixed effects depending on the interest rates structure of mortgages in Europe

There are a few countries (e.g. Belgium, Germany, and Netherlands) where the majority of mortgage debt is based on long term fixed rates, but there are many countries in Europe (e.g. Sweden, Spain, Portugal, Italy, Ireland and the U.K.) where the majority of debt is floaters or short term fix, which will be very quickly affected by rising rates.

This speaker's firm has tried to estimate sensitivity to interest risk using data from securitised pools in Europe with loan by loan information about mortgages. This indicates that an interest rate increase of 1% will push the ratio of people with debt service above 40% by about 50 100%; an increase of 2% will double it; and 3% may even triple it. This will create a situation in which there are more and more people with difficulty servicing their debt. During the last Eurozone crisis, the first political reaction was to undertake debt forgiveness, rescheduling and so on. However, the latest academic research actually shows that postponing foreclosure or reducing foreclosure risk actually increases moral hazard and default risk.

3.2.3. European mortgage debt also poses a systemic risk linked to the correlation between mortgages, covered bonds and banks (as issuers and investors)

The favourable regulatory treatment of covered bonds has produced an expansion in the use of covered bonds in mortgage funding. On average, covered bonds fund 25% of outstanding mortgages in the EU; however, in some countries this proportion can be as high as 60%. A covered bond is a bank instrument backed by mortgages. It is issued by a bank and 50% of the bond is sold to other banks. Most of the sale goes to domestic banks, and most of the banks who buy have the exact same mortgages on their balance sheet. Thus there is a significant systemic aspect to the market. If certain banks go bust due to significant increases in interest rates or a significant tightening of monetary policy, there could be significant contagion in the covered bond market, which should not be allowed. This financial product is systemically important and it should face systemic support, but that is not necessarily a good thing if banks are seeking to transfer funding back from their capital markets operations.

4. How current private debt levels compromises an economy's macroeconomic and financial stability

4.1. Measures for addressing vulnerabilities linked to high private debt levels

An official explained that the OECD sees four main measures for reducing vulnerabilities to high debt levels: strengthening macro prudential regulation, reducing the debt/equity ratio for corporates (in many countries, tax systems favour debt over equity), reducing incentives to home ownership and improving insolvency frameworks.

An industry representative felt that the industry is entering into monetary policy tightening at a time when the consumer debt to disposable income ratio is very high. It is unclear how effective monetary policy will be, and some studies suggest that it will become very asymmetrical. If rates are cut when there are high levels of debt, people wait for rates to be cut further before they cut spending, and this delays the transmission mechanism. On the other hand, if debt rises when people have high debt service, they will cut expenses much faster. It could be positive because it obviates the need for larger interest rate hikes, but it could also be negative because it might slow down consumption at the moment it is needed.

The very low interest rates over a prolonged period of time have led some regulators and policymakers to consider deflating housing prices or reducing debt accumulation using prudential and tax measures. This suggests that there is a possibility that the industry will simultaneously face tightening of monetary policy, stricter prudential policy and the introduction of irreversible tax measures. These areas all affect debt service, debt creation and credit creation, and would be created by three different institutions that cannot be perfectly coordinated.

Monetary policy will play a major role, but it is not the only factor that affects consumer debt. The industry does not know how the ECB is going to carry the reinvestment possibility of its current QE stock, and this will affect the funding instruments on the market. The policy changes will be very gradual and very slow, unless there is an external shock such as a skyrocketing oil price.

There are several policymakers in Europe and other parts of the world who are using prudential mechanisms to slow down debt accumulation and house-price inflation whilst unemployment is falling and rates are low. These measures have been quite successful in countries such as Sweden. There will also be a greater role for prudential and fiscal policies, allowing for much more flexibility in adjusting monetary policy effects.

4.2. Strengthening fiscal sustainability and restoring a coherent Monetary Union in macro-economic terms

Highly indebted euro area sovereigns are more vulnerable to rising financing costs than countries with lower debt levels. An official suggested that there is a need for fiscal consolidation in some countries, and this should be done in the least socially harmful way. The impacts of fiscal consolidation measures on growth and equity vary greatly. In terms of growth, reductions in government consumption and investment cause larger short term negative effects than tax raises or cuts in transfers. But in the long run, some consolidation measures may be positive for growth and socially beneficial, such as cutting distortive subsidies or cutting measures that reduce incentives to work. It is harder to find appropriate measures to address the equity side, because transfers are progressive. Nonetheless, measures such as raising capital gains or inheritance taxes can assist consolidation and are positive in terms of equity. In any case, comprehensive national structural reforms are crucial if we want to sustain growth beyond the cyclical upswing, boost investment and productivity, create more and better paying jobs, and strengthen inclusion.

A policymaker agreed that the risk in the area exists over the medium term. In the present economic environment, the monetary policy transition might involve rebuilding fiscal buffers at the national level. Policies across different countries must be differentiated because Member States face very different situations. While some countries with fiscal space should try to develop their potential growth through investment and structural reforms, others must perform fiscal consolidation.

At the national level, some countries require fiscal consolidation while others have potential spending for growth. Simultaneously, the EU must do more on risk sharing. The patterns of adjustment that would rely only on "weaker" countries is not feasible neither politically nor economically. Stabilisation tools must be created at the European level because some Member States do not have sufficient fiscal space to manage potential shocks. In the current situation, discussing sovereign debt restructuring is merely counterproductive. The debate must focus on the development and implementation of the appropriate policies at the national and EU level.

4.3. The financial power of the ESM: an asset for the EU resolution framework

The ESM is a lender of last resort for countries that lose market access, or are close to losing market access. This is a function that did not exist before the crisis. A regulator noted that that the ESM can be an appropriate stabilisation mechanism as the process of normalisation continues. Compared to the previous crisis, Europe is prepared to a much greater extent. The ESM exists as a crisis resolution mechanism, which should give the industry confidence. The crisis resolution mechanism for sovereigns has helped several countries. Since 2011, the ESM has indeed disbursed €280 billion to five programme countries: Greece, Ireland, Portugal, Spain and Cyprus.

The ESM could play a role in a Sovereign Debt Restructuring Framework, if Europe were to put this in place to make settlements with private creditors more transparent and more predictable. The ESM, which now has solid experience in debt sustainability analysis and is close to markets, could play the role of the neutral moderator.

According to an industry representative, and contrary to what is often suggested, discussing new sovereign restructuring mechanisms should not be particularly disruptive for markets, because investors are clever and it does not necessarily imply higher credit risk. The question of whether governments in the Euro area can default has been definitively answered, because this has happened three times. However, there are questions around the management of crises in the future. This matters because it underpins market confidence.

4.4. Developing private risk sharing in the euro area

A regulator added that the Banking Union is being implemented. This process will help end the vicious cycle between banks and sovereigns and make the banking system safer. The question over where the industry wants to go in the future is related to the European agenda of deepening EMU. The completion of the Banking Union and the strengthening of Capital Markets Union (CMU) will be critical factors there. The crisis resolution framework must also be strengthened. The ESM can take a stronger policy role in that process, and it is prepared to do so. Additionally, it is important to develop further measures for developing fiscal stabilisation before a country actually enters a crisis.

An industry representative felt that the CMU is a very good idea, but it is unclear as to whether it will be a very effective risk sharing mechanism after a downturn has been triggered, as opposed to prior to a crisis. It has been under discussion for several years now, and Europe is yet to make material progress even on parts of the schedule such as harmonising insolvency processes. Central banks have bought the time for these reforms to happen, but many important ones such as EDIS and the completion of the Banking Union remain outstanding.

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Developing regional financial markets in South East Europe

The development of regional capital and financial markets in the West and Southeast of Europe, including the Western Balkans, is one of the priorities of the Bulgarian EU Presidency. The panel examined the current situation of financial markets in the region, the challenges they face and the opportunities for further developing and integrating them in the future.

1. Current status and challenges in the development of SEE financial markets

1.1. Financial intermediation is mainly bank-based

The panellists stressed that financial intermediation in the region is largely bank based. Banks represent for example around 90% of financial assets in Albania and Serbia, 95% in Bulgaria. In the Former Yugoslav Republic of Macedonia (FYROM) banks represent 85% of total financial markets; this is the best rate in the West Balkans due to efforts made to improve the share of the non banking sector, mainly through pension funds and insurance companies.

The banking sector in the Western Balkans is considered to be competitive and stable and shares common characteristics across different countries in the region, an industry representative stated.

Banks in the region are generally well capitalised (almost double the regulatory minimum) and there is also an excess of liquidity. For example the loan to deposit ratio of banks in the FYROM is 88%. There is also a high level of foreign ownership; for example in Bulgaria where the rate of foreign ownership is roughly 77% and in Croatia where it is 88%. This has its advantages, the speaker believed. In a crisis, foreign owned banks tend to be safe havens. In addition this facilitates the spreading of good practices such as IFRS 9, MiFID and other rules. The rate of state-ownership of banks is also low.

1.2. An insufficient supply of financing for SMEs and an excessive level of debt financing

An industry representative explained that the funding provided by banking intermediation is still at a low level compared to the needs. The ratio of total loans to GDP is 42% in SEE, compared to 56% in Central and Eastern Europe and far above 100% in the Eurozone.

An International Financial Institution (IFI) representative underlined that a survey conducted in the context of the Vienna Initiative reveals some of the constraints on investment in the SEE region. The dominance of banks in economic financing is stable, but credit supply conditions remain less accommodative compared with demand. This dominance of debt has proved to be sub-optimal for the stability of the economic systems through crisis periods and is sub-optimal for the companies themselves. Banks are also less capable of financing some of the most important investments currently being considered in the region, e.g. in intangible capital and innovation. In this context, a key question is how to expand the set of available instruments for corporate financing. Firms have a strong bias in favour of debt, particularly bank debt and it is difficult to enlarge the set of instruments available for financing. The importance of bank debt can be partly explained by a tax bias in favour of debt in the region (which is true also for the rest of Europe). However there are other issues. The incentive that needs to be provided for issuers to opt for an equity rather than a debt option is so huge that there is a natural bias against it. In Europe and even more so in the SEE region less than 1% of firms say they want more equity. Diversifying funding requires working on these incentives both on the supply and demand sides.

The EIB is moreover very active in the region and offers a diversity of products, including long term bank funding in support of SME lending and a first loss guarantee for banks that lend to SMEs. This can help to solve some of the funding problems mentioned above, notably more innovative financing, since it allows banks to lend without collateral.

The issue with bank domination, an official pointed out, is that SMEs without proven credit cannot finance their business operations at favourable interest rates. Another official confirmed that the excess of liquidity in banks is not transferred to corporates. This must become a direction of focus. Credit growth in the FYROM is 9%, but mostly through household lending. It is very low in corporates, only 2%. The primary capital market is insignificant, so there is abundant room for progress.

An industry representative added that the very high dependence of Bulgaria for instance on the banking sector prevents companies from reaching their optimum capital structure, because they cannot rely on equity financing. This reduces their profitability and it is particularly problematic for SMEs. Most exchanges within the region rely heavily on SMEs. They account for 60% of Bulgaria's market capitalisation and, from a structural point of view, Bulgaria does not have any very large cap companies in its listings.

Another IFI representative added that equity markets only represent 2% of the GDP of the region, compared to 60 80% in comparable middle income countries, which is a significant gap.

1.3. NPL issues are progressively being addressed

An industry representative stated that NPLs (Non-Performing Loans) tend to be on the high side in SEE compared with Western and Central Europe. Many countries have between 10% and 15% of NPLs, which is far above the ECB's acceptable level. The region has a strategy for reducing them, but progress is slow. The current bull market should however be a good opportunity for banks to reduce their NPLs further. An official confirmed that FYROM in particular has a strategy for reducing NPLs and, from the latest data, these stand at 5.6%, which is a significant decrease.

An IFI representative agreed that the situation with NPLs is far from satisfactory in the region, despite some improvements. If a new financial crisis was to emerge, this would be one of the major weaknesses of the region. Increasing the resilience of the region's financial systems and tackling NPLs are important elements of the Vienna initiative. Solving the impediments from the NPL issue includes addressing the inadequacy of and disparities in the enforcement of insolvency laws and in the judicial infrastructure, and the absence of out of court NPL resolutions. IFIs can also act on the investment side, helping to revive an interest in investing in NPL transactions. EBRD has just created an investment framework of €300 million in NPLs, which could attract up to €1.5 billion co investment and would be crucial in solving that issue.

1.4. Obstacles and issues on the demand side

An IFI representative emphasized the low saving rate in the region and low level of trust in the local currencies shown by a reliance on dollars by several countries. The domestic institutional investors' base is also very poorly developed. Some countries, for example FYROM (with the issuance of 30 year bonds on the domestic market to support the development of pension funds) and Romania are now actively reforming their pension systems, developing a new funded Pillar 2 pension system. The IFI speaker added that a key issue to be addressed on the demand side is dormant accounts, which exist in several countries in the region, such as Romania and Bulgaria (Romania has 8 million dormant accounts for example). This is due to the fact that after countries engaged in privatisation, a number of shares were not claimed. This is both a problem and an opportunity, since these accounts have the potential to bring a great deal of liquidity to the regional infrastructure that is being developed if they were reactivated. Solutions are being looked for to deal with this issue.

An industry speaker added that foreign currency lending is very high in the SEE region compared with central Europe (at 43% for the whole SEE region), although that is not dangerous, because it is mostly in euros. Euros are almost seen as the second home currency and this was not an issue during the crisis. Bulgaria has a foreign currency board and Croatia is very stable. The problems previously experienced in some SEE countries with lending in Swiss Francs have been solved.

1.5. Corporate governance issues

An industry representative considered that from a Bulgarian perspective, the biggest challenge has been the corporate governance scandals experienced over the last 20 years. Since launching the country's primary index, 25% of member companies have, at one point or another, gone belly up because of corporate governance issues. A dramatic change is required if Bulgaria wants to develop its financial markets further. This is related to the concern about dormant accounts mentioned by a previous speaker. The greatest scandals indeed happened in companies with a large number of dormant accounts and where shareholders were not able to properly exercise their rights. This allowed the management to act with practically no control.

2. Priorities for further developing and integrating SEE financial markets

2.1. Actions to further develop regional financial markets

An IFI representative explained that the Vienna Initiative is a coordination platform among EU public institutions, local authorities and private banks that has been active in the region for the last 10 years. It has recently published a report written in coordination with the Commission proposing recommendations of policies intended to develop capital markets in Central, Eastern and South Eastern Europe following an assessment of the problems in each of the countries of the region.

On the supply side, specific measures targeting local markets have been proposed, based on recommendations of the Capital Markets Union (CMU) action plan. The CMU indeed promotes the development of local strategies to improve the legal and administrative framework of domestic capital markets in the EU and the provision of incentives through public intervention to encourage SME listings and the investment of institutional investors in their domestic markets. It is important however to combine these local development objectives with actions promoting the integration of regional markets and, ultimately, their integration into the EU capital market, even if the latter is not completely integrated yet. In this perspective policies aim to develop the listing of firms on local stock markets and also internationally. This could then help to develop more coordination across central securities depositories (CSDs) and central counterparties (CCPs), which already exists in some cases but could be improved.

One area that has a strong potential in the SEE region, the IFI representative believed, is venture capital and private equity. Currently, this is a very small market in the region at less than €2 billion overall, but developing it would have the advantage of bringing additional managerial competences and increasing international links, which may have a strong positive impact on firms. Policies should go further in this direction, even if this is complicated.

An industry representative believed that stock exchanges also should play a larger role in SME financing in the region. Stock exchanges should accompany the growth of SMEs which represent the largest part of market capitalisation in SEE countries and are their economic future. On-going initiatives to better address the needs of SME issuers need to be pursued. The Zagreb Stock Exchange for example is providing a new trading facility called Progress that helps SMEs find financing. This includes licensing advisers who may help potential issuers to go public. Other countries in Central, Eastern and South Eastern Europe, such as Hungary, the Czech Republic and Bulgaria have similar initiatives.

Another IFI representative added that developing IPOs and privatisations in the region is also important and would foster the growth of local stock exchanges.

An official explained that the FYROM has introduced a fund for innovation and development, which is supported by the World Bank and has significant financing from the state. There are also important credit lines from the EIB and the Macedonian Bank for Reconstruction and Development, which have generally lowered interest rates for corporates. When considering the development of the financial sector, the importance of infrastructure investment must also be kept in mind. If transport and communications can improve, companies in the financial sector will improve also.

2.2. Improvements expected from further cooperation and market integration

An official stated that the path forward in SEE must be regional integration and one of the most important areas is market infrastructure and the SEE Link project. The SEE Link project supported by the EBRD was started by the Bulgarian, Macedonian and Zagreb stock exchanges with the objective of creating a regional infrastructure for the trading of securities listed on those three markets. There are currently seven stock exchanges involved in this initiative and the objective also exists to create a securities clearing, settlement and depository architecture at the regional level. The idea behind this cross-border initiative is to integrate regional equity markets without merger or corporate integration, using only technology that will enable participating stock exchanges to remain independent yet complement each other and to provide investors with an easier and more efficient approach to those different markets through a local broker. In this context the participating countries are focused on the harmonisation of financial market legislation with EU standards. Developing a more level playing field in this regard will also allow all agents to improve their capacity.

An IFI representative agreed, emphasizing that size is a key issue for SEE markets and that growth opportunities solely at the individual country level will not be sufficient. The issue of size is also closely linked to the predominance of SMEs in the region. Initiatives such as SEE Link on the infrastructure side and other actions on the demand side will open new ways of solving the economic problems of the region. Another important action of the Vienna Initiative is the workstream aiming to improve the equivalence of supervision systems in the region with the EU. This has implications for the parent companies of banks established in Western Balkan countries in particular. This is a subject of focus because some new EU regulations are being implemented that could possibly have unexpected and unintended negative impacts on financial institutions in the region.

An industry participant clarified that integration does not mean combining a number of weak domestic markets. That will not make them stronger. Internal issues need to be addressed first. Indeed the benefit of integration is not measured simply by belonging to a larger group but also by the degree of resilience to external factors it may provide and the improvement in the time needed to recover from external shocks.

GLOBAL COORDINATION AND BREXIT IMPACTS

Future of global financial regulatory and supervisory coordination

1. International cooperation and convergence in financial regulation play an essential role in strengthening the global financial system

1.1. The importance of coordinated and proportionate regulation

A regulator stressed that supervision and regulation require a delicate balancing act between facilitating creativity, financing innovation and financing growth and productivity while at the same time preventing excessive exuberance that leads to excessive debt and financial crises. This requires working on the minimum standards for what have been identified as the vulnerabilities in the last crisis such as capital requirements, liquidity and so forth. This is on-going and needs to be implemented in a full, timely and consistent fashion across jurisdictions.

As the financial system becomes more integrated, consideration needs to be given towards international co-ordination in order to avoid regulatory leakages and the spillover of policies. Regulation needs to allow for some transition of capital flows into other jurisdictions without transmitting excessive exuberance. Too loose regulation that then transmits into other jurisdictions creates leakages and spillovers that are negative. Similarly, too much of an accommodating policy in one jurisdiction might create excessive exuberance and transmit financial exuberance into other jurisdictions.

The countercyclical capital buffer with a reciprocity across jurisdictions for implementation illustrates the need to look into the international transmission of financial cycles and to take care of everybody else's financial stability alongside one's own. Many advanced economies have noticed that crises in big emerging markets can create spillback effects into those advanced economies. It is therefore not prudent for one to allow spillovers to affect everybody else and to simply believe that it is their problem since there will be a spillback into one's own jurisdiction.

In such a context, collective action, co-operation and co-ordination are required. People need to build upon the solid ground of minimum standards but they also need to think about the instruments that allow some co operation to favour financial stability globally.

An official stated that given the diversity of local markets, proportionality and local specificity should be appropriately considered when implementing regulatory measures to domestic firms. International standard-setters have focused on internationally active banks but there is a need to think about proportionality when applying the international minimum standards to domestic firms.

International standards are often said to be 'minimum requirements' which each jurisdiction free to engage in 'gold plating'. However, prudential measures taken unilaterally by one jurisdiction may have disproportionate effects on foreign financial institutions.

An industry speaker stressed that excessive and unjustified compliance costs need to be avoided. Considering the market value of the G-SIBs, there is still a worry that the global banks model may not work in terms of having efficient capital management, liquidity management and efficient cost operation under this regulatory regime. In addition, creating an IPU (intermediate parent undertaking) in Europe regardless the size of operation can have 'catastrophic' effects on the profits of banks. Proportionality is needed in this respect.

Another speaker of the industry noted that deference, equivalence, substituted compliance and jurisdictional recognition need to be made functional so that the flows of capital can occur with the minimum amounts of friction. It may be that global standards and consistent implementation is not enforced but the framework works because capital will flow where markets function, where they are efficient and where institutions are operating in a safe and sound way.

1.2. No erosion of trust among the Central Bank Governors and the Head of supervision

An official outlined that there is a need to distinguish between the rhetoric from the actual experience of working with internal standard-setters. From his experience at GHOS (Group of Central Bank Governors and Heads of Supervision), he does not believe that there has been an erosion of trust. It is true that there has been a great deal of standard-setting over the last eight years but this was absolutely necessary. This has been completed and the priority should now be the implementation of ex-post evaluation. The market needs to digest the flow of reform. This does not mean that nothing more should be done; if there are real pressing issues then they should be addressed. For example, Basel III should be implemented for some time and then seriously evaluated before the Basel Committee starts a new round. The temptation to perpetually be moving should be resisted.

1.3. The focus is shifting from policy-making to implementation and evaluation

A policy-maker stated that the focus of the international organisations, including the BCBS (Basel Committee on Banking Supervision), is shifting from policy making to the implementation and ex-post evaluation. Basel III has been praised as a major achievement by GHOS (Group of Central Bank Governors and Heads of Supervision) and BCBS as it safeguards the multilateralism of the financial regulations.

1.4. Main priorities of the BCBS for 2018/2019 following the agreement on the Basel III reforms

A regulator explained that with Basel III now complete, the main focus of the BCBS over the next two years will be on: implementation; evaluating and monitoring the effects of reforms; promoting strong supervision; and completing a few on-going policy initiatives, particularly the fundamental review of the trading book as well as the Pillar III framework and the final treatment of short-term STC (simple, transparent and comparable) securitisation.

Clearly, there will be a shift in the Committee's focus from policy-making to ensuring full, timely and consistent implementation of the standards. The rationale behind this is that not implementing the standards according to the agreed timeline, or implementing diluted or weaker versions rather than the full standards, will be unsafe and could result in fragmentation.

To this end, the BCBS has developed an implementation programme, called the Regulatory Consistency Assessment Programme (RCAP), which looks at domestic regulations, assesses them line-by-line with the Basel Standards and identifies deviation. It then assesses the materiality of this deviation by applying a grading system and publishing the results. This has been a very effective tool in promoting consistent implementation, rectifying hundreds of gaps amongst member jurisdictions in the implementation of, for example, the risk based capital framework and the liquidity coverage ratio. Most of the remaining gaps relate to local specificities that have been assessed to be immaterial.

1.5. Implementing consistently global regulations across jurisdictions remains challenging

An industry representative suggested that it will be a challenge to attain consistency of implementation across jurisdictions because, while there is agreement that the net impact on all jurisdictions will be the same and equitable, the point from here to compliance in 2020 varies dramatically, based on institutions, models, balance sheets, size and the current capital framework in each jurisdiction. As such, all actors are encouraged to focus on what needs to be delivered from a trust perspective and from a financial stability perspective and to not be sidelined by impact conversations.

Another challenge is to be open to refining, recalibrating and addressing inconsistencies in the existing framework. Too frequently, prudential rules are not linked up as they apply to the impacts on capital markets. Without the right coherence and calibration, safety and soundness will not be enhanced but, rather, access and investment opportunities will be reduced while costs will be increased.

The industry representative outlined an example in relation to the derivatives market. The G-SIB (global systemically important bank) framework in and of itself provides no component to address the fact that all of the standardised clearing has now moved to CCPs (central counterparty clearing house), which is a dramatic decrease in systemic risk. Yet it treats that activity the same as bilateral. In addition to that, derivatives hit four of the five factors in the G-SIB surcharge. This may be very technical but it is duplicative, triplicative or quadruplicative. This has resulted in a 40% decline in global clearing memberships because the risk return and capital charges are not coherent. This is significant because it reduces access for people that might be trying to hedge, which is a bad outcome.

1.6. There is still a long way before an international binding dispute settlement mechanism is put in place

An official highlighted the concern that regulators and supervisors lack the tools, by way of enforcement, dispute settlement and treaties, to ensure consistent implementation. There are currently no mechanisms to deal with large disputes where a Member State or member organisation jurisdiction does not apply the standard in the correct way.

An industry representative responded by saying that, although the Basel Committee produces international financial regulatory standards, the implementation should indeed be borne by each jurisdiction and each authority. It may be inevitable that some parts of the international agreement cannot be fully consistent across the jurisdictions. It may be ideal to have some kind of dispute settlement arrangement but it may take some time for agreement to be reached on such an international framework.

A regulator did not believe that a binding mechanism is necessarily appropriate, highlighting that international standard-setting bodies have developed as consensus-based organisations. In particular, the fact that jurisdictions have collectively come to an arrangement and largely completed the post crisis reforms is evidence that that process has been working. A commitment to further international financial regulatory co-operation, which can facilitate the exchange of information and the development of trust, is helpful in order to continue an outcomes-based standard setting process where jurisdictions can defer to each other as appropriate when there are appropriate prudential regulations in place. Ultimately, it is up to the sovereign jurisdictions to implement the reforms in accordance with their domestic laws and regulations.

A policy-maker outlined that the alternative tool to an international binding dispute resolution mechanism is an incentive-based system such as the IOSCO Multilateral Memorandum of Understanding (MMoU). The MMoU is a 10 years old incentive-based system through which standardises the process by which securities regulators who are members of IOSCO can obtain information from other members for enforcement purposes. This MMoU has proved instrumental, for example, in obtaining the necessary information in the LIBOR (London Interbank Offered Rate) case or to track market abuse and insider trading.

The way the MMoU works is that, first, 'you have to be accepted in the club'. This is quite tough, entailing scrutinisation by the members of the club and an examination to prove that the candidate complies with all the aspects of the MMoU including the provision of telephone and bank records, transaction reports and so forth. At the moment, 110 jurisdictions around the world are signatories of the MMoU and they share essential information on over 3,000 cases per year. The significance of the MMoU is that it aligns the incentive and everyone runs to join the system, thereby precluding the need for a binding mechanism. The MMoU aligns incentives such that jurisdictions wish to be a part of it, thereby precluding the need for a binding mechanism.

Data protection rules, however, can have the effect of weakening multilateral cooperation by hampering this exchange of information. Whether or not the GDPR (General Data Protection Regulation), in particular, poses a threat in this regard depends upon how it is implemented. The work of the Article 29 Data Protection Working Party is not yet finished but it is hoped that there will be some form of public authority carve-out, in particular in financial services.

2. Key new areas where global co ordination is necessary

An official highlighted three areas in this regard: anti-money laundering, where international co operation needs to be stepped up; cyber; and shadow banking, which is yet to be fully and finally addressed. A possible fourth area is sustainable finance. International co-operation on sustainable finance is less vital but it is vital that everyone is interested in the subject because Earth is a 'common good' for everyone.

2.1. Cyber

Another official commented, with regards to cybersecurity and fintech, that consideration needs to be given to facilitating innovation when calibrating the appropriate regulatory and supervisory needs. There is a question of whether cybersecurity is ripe for international standards since there is still a great deal of domestic discussion. Even if it is, there is a question as to which international fora is appropriate to discuss this since cybersecurity carries some national security implications.

A regulator outlined the recent experience in Japan in relation to crypto assets and cyber security, which are closely interrelated. Last April, Japan introduced a registration system for virtual currency broker-dealers. The regulation was established not only in accordance with FATF guidance to respond to AML/CFT requirements but also to protect consumers by introducing additional rules to oblige broker-dealers to provide the necessary information to customers and to separately hold and manage their customers' virtual currency holdings. However, there was a serious cyber-attack incident against one Japanese virtual currency broker-dealer, which was not registered by the JFSA (Japanese Financial Services Agency). US $530 million of virtual currency was lost and 260,000 customers were affected. This was a serious incident. The JFSA took a series of administrative measures after this incident. It issued business improvement orders to this particular broker dealer and conducted on-site inspections on other virtual currency exchanges and so on. Lastly he stressed that authorities are 'learning by doing'. The area of AML (anti money laundering) and CFT (combating the financing of terrorism) particularly requires international co-ordination. Accordingly, there is a call for the 2015 FATF (Financial Action Task Force on Money Laundering) guidance to be upgraded to mandatory FATF standards.

An industry representative outlined that cyber risks have no borders and that collective thought needs to be given towards expanding the regulatory perimeter and considering all the mechanisms through which payments are delivered, not just the banking system. Data privacy, data use, transparency and disclosure are no longer issues solely in the purview of banking institutions. There is an opportunity here to develop consistent lexicons and taxonomies and a framework for supervisory oversight because the current fragmented approach leads not only to inefficiency but the diversion of resources away from stopping the cybercriminals.

2.2. Improving data systems to assess financial markets risks

An industry representative stated that regular data use is important to, for example, analyse where risks are building up and to identify regulatory inconsistencies but that this data does not need to be in real time as things do not move that quickly. It should, however, be in useable appropriate time without the current lags. The industry representative also questioned why certain standards such as UPIs (unique product identifiers) and UTIs (unique transaction identifiers) are not consistently being used or required to be used.

There has been a great deal of talk about getting information and data around financial services but the reality is that the entire ecosystem needs to be looked at. Financial risks and systemic risks are driven by concentrations or a consistency in the need for transforming a particular set of assets, particularly if holdings are sitting in the hands of a few. That could as easily be sovereign wealth funds as it could be asset managers as it could be financial institutions. Broader consideration needs to be given because the ecosystem is broader than just banks.

2.3. Considerations should be given to emerging risks

A regulator explained that GAFAs (Google, Apple, Facebook and Amazon) are facilitating payments and bring a significant number of very positive effects, including in terms of information connectivity. However, if they move into the credit allocation business, there are questions concerning what happens if they face an incident such as the recent Facebook issue with a sudden loss of reputation and a massive loss of capital. Such an incident could affect financial stability worldwide. Regulators need to be prepared to tackle this, which requires clever dialogue between banking and non-banking authorities and the actors in this global integrated financial system.

An industry representative noted that there are two approaches related to GAFAs and big tech companies: first, to try to keep their innovative power but to regulate them with their own or new regulators, and; second, to decompose the risks of those companies and, if there is a payment risk, that that part should be regulated or have a banking system at the bottom. Rather than letting Facebook or Alipay do everything, the bank should be integrated in that system. That is the second approach.

An official suggested that in addition to evaluating and monitoring the effects of reforms, the BCBS intends to monitor and assess increasing or emerging risks and challenges posed to banks and supervisors, including in terms of fintech developments and cyber risk or, more broadly, operational resilience. The Committee has quite recently established a new operational resilience working group. Though the trend has been to reduce the number of working groups, in this case, it was believed that setting up a new working group was necessary. The broad mandate of this group is to monitor and assess risks that may arise from banks' increasing reliance on IT developments. As a first step, the focus of that group will be to look at how national level supervisors are mitigating cyber-risk. Clearly, operational resilience is a topic for the future and will be on the agenda of the Committee.

The Committee has paid a great deal of attention to the implementation of the risk data aggregation and risk reporting principles that it published in 2013. This is especially the case with the flow of incoming standards to be implemented. It is important, not only for supervisors but for banks themselves, to be able to build a strong infrastructure to provide internally, as well as to stakeholders and supervisors, very good data. One of the issues arising from the finalisation of the fundamental review of the trading book is the lack of very good data to fine-tune the calibration of that framework. This illustrates the importance of paying attention to the risk data issue.

Brexit: what way forward less than one year from the Article 50 deadline?

1. Main possible options for future EU-UK financial service relationships post-Brexit

1.1. The UK perspective

An official explained that in March the Chancellor had given a speech setting out a model for the future EU-UK relationship in financial services, which the UK is ready to discuss with the EU. It is framed in the context of a free trade agreement (FTA) including three components: (i) a comprehensive and on-going regulatory dialogue between the UK and the EU about risks arising in the financial sector and possible regulatory solutions, (ii) supervisory cooperation in order to ensure that standards are appropriately implemented and cross-border risks managed (iii) a regime to determine access to each other's jurisdictions, based on equivalence of outcomes. At this stage proposals should not be bound by existing wording or concepts such as equivalence or mutual recognition, in order to keep possibilities open. The chosen solution for access should be reciprocal, framed in a predictable way, operate on very clear terms, be technically informed, apolitical and with proportionate remedies agreed ex ante to address cases of divergence.

The third country regime in the existing 'EU acquis' however provides none of these three components. Therefore a new framework needs to be created. Without this kind of structure, the outcome will be a rapid fragmentation of liquidity pools and capital, and the erosion of shared interests. This will have negative implications for the competitiveness of Europe as a region against its US and Asian competitors, a situation which will be reinforced if the EU and UK approach this issue in a confrontational manner. This is a conversation about how Europe participates in a global system of open markets and how it exerts its influence within that system for stability, competitiveness and efficiency.

Answering a remark from another panellist that this proposed arrangement would give even more power than today to the UK and would be difficult to manage if there are divergences, the official made it clear that the intention of the regulatory dialogue is not for each side to restrict the ability of one side to change its rules in the future but it is to ensure that rules exist and are compatible. This process already exists (e.g. between the EU and the US), but would have to be deepened to take account of the volume of trade between the EU and the UK. In addition this proposed framework is not 'cherry-picking' or a copy of the Single Market, the official stated, but a proposal for making the relationship work in the future in the best interests of both parties.

Defining an appropriate dispute resolution system is challenging but feasible. In an FTA, there is a particular approach to dispute resolution and the UK envisages the process for financial services as being part of that horizontal approach. Without a FTA structure, this issue would need to be reconsidered.

1.2. The EU perspective

An official recognised that some progress has been made in discussions over the last months; however it is still unclear whether it will be sufficient to meet the March 2019 deadline and whether it is going in the right direction.

The UK red lines reduce the options available for the future EU-UK relationship. A Norway like EEA agreement remains the best possible outcome from an economic perspective, and the EU remains open to that, the official stated, but it does not suit the current constraints imposed by the UK government. The alternative is negotiating an FTA. As the two sides' markets are greatly integrated, continued cooperation between regulators and supervisors is needed in addition to common standards.

The main question, the official felt, is how to deal with divergences between legal systems, which will most likely happen over time. It is not yet clear whether an FTA will allow dealing with disagreements. Both jurisdictions will therefore need to have the power to unilaterally withdraw from the agreement, because neither side wants to be bound by a sovereign decision from the other side to modify their standards.

What is being looked for is a way to pursue enhanced cooperation between the EU and the UK, a market observer felt. This is also being assessed with the US. Enhanced cooperation however cannot lead to a situation which is very close to the Single Market. Although there can be some delegations and back to back transactions, it cannot lead to empty boxes. Moreover such an agreement has to work in a balanced way for both parties, which is more or less the case at present with the US. In addition, regulatory convergence and supervisory cooperation are needed also at the global level, as was shown by the financial crisis.

1.3. Industry views on the current negotiation process

An industry representative stressed that Brexit and the way the EU and UK will adapt to it, has global implications. One of the most important questions that Europe has to answer concerns the architecture of capital markets that is needed to support its economy and whether it wants the Capital Markets Union (CMU) to be a closed regional market or an open global market. At present London is the EU's financial hub and it is open to the rest of the world. If the EU27 wishes to acquire this global reach it will have 'quite a long way to travel'. Understanding in which direction the EU is moving is also important for the private sector to prepare its contingency and location choices.

Another industry speaker added that as a result of the 2008 crisis, institutions have done a huge amount of work on global booking models, as these relate to resolution planning. The speaker felt that European regulators should be more actively involved in global supervisory processes such as global banking colleges. That is not yet the case, but will be an important step going forward.

A third industry representative introduced a perspective from a financial services firm headquartered in a third country. These firms have a small presence individually in the EU and UK, but their activities and the clients they serve have a material impact when taken together. The perception of third-country stakeholders is that costs in the EMEA region will increase as a result of Brexit and that the efficiency of their EMEA operations will go down with more fragmentation and no revenue increase. All this may have a negative impact on investment in the region compared to the US and fast-growing Asian economies. What they want to see now is a tone of practical cooperation between the EU and the UK in dealing with issues such as outsourcing or market risk that may lead to a positive outcome for the EMEA region.

Another industry speaker suggested that the political process needs to delegate permission to the regulatory authorities to have more visible conversations with the industry about the way forward, rather than bilateral discussions that not everybody can see or participate in.

2. A possible need to review the equivalence arrangements of EU legislations

The Chair asked whether the current equivalence regimes of EU legislations could be improved to be used as a basis for the future EU-UK relationship and what are the main issues they pose. The insufficient transparency and certainty of these regimes are often pointed out. But they are also complicated and time-consuming to put in place. As the need for more equivalence determinations grows with new capital markets the equivalence process will become increasingly burdensome, which calls for a maximum amount of supervisory and regulatory cooperation.

A regulator considered that the criticism of EU equivalence arrangements is largely unjustified. The 'base case' offered by most other jurisdictions to third-country entities is to register as a local entity and go through full registration and supervision in the host country. Whereas EU equivalence arrangements, once they have been agreed with a third-country, allow full access to the EU for entities based in that country and a full-reliance on their home regulation and supervision. This is a much more open approach, so it is not fair to give the impression that equivalence is hurting global capital markets. The transparency of these arrangements and the process for putting them in place could however be improved.

Several speakers however considered that the existing equivalence arrangements used by the EU are not designed to handle relationships with such an important jurisdiction for financial services as the UK. They would need strengthening for that to be possible.

An official stated that for such a massive relationship, you need to make sure that not only the rulebook and the standards are equivalent, but also that their implementation and supervision is effective and convergent too. That is not something that can be achieved 'merely by having cooperation and conversations'.

A market observer believed that equivalence arrangements need to be enhanced within the short timeframe available, with more reciprocity and stability and a process of review to allow for regulatory evolution. It is however doubtful that such regimes can be introduced in time to any new domains such as banking and insurance.

An industry representative emphasized that Brexit has shown that the most important element for industry players is certainty. Financial services firms have to be sure that they will still be able to service their clients after Brexit, so an orderly process is needed to make a final determination on equivalence. That is essential for the private sector. On top of that are issues relative to transparency, objectivity and de-politicisation. The speaker wondered whether the improved equivalence regime will dictate requirements line-by-line or be based on outcomes. The truth is that it will probably be both. Trading margins, for example, should remain the same to avoid confusion, whereas conduct-related matters could be more outcome focused. Those technical issues need to be negotiated now.

A regulator mentioned that a new approach to equivalence arrangements has been proposed in the context of the EMIR review for tackling the risks associated with third country systemic CCPs. Reliance on third-country regulatory requirements and supervision will continue but in some cases the EU27 needs to have additional supervisory tools, similar to those that are available in other jurisdictions such as the US, in order to ensure that risks concerning the EU27, are appropriately addressed. Another important element is improving supervisory convergence and cooperation within the EU for the wholesale market to ensure that there is an optimal use of the available skills, expertise and resources. The speaker supported the proposals made by the Commission to have direct supervision at the EU level for CCPs and benchmarks, in addition to credit rating agencies and trade repositories, which already exists. A further improvement is to have more regular equivalence assessments, as has been proposed in the ESA review.

3. Main issues that need addressing in the short term

3.1. The transition agreement does not remove cliff-edge risks

The agreement on transition was welcomed by the panellists, as it provides more time to prepare the end state and more time for the industry to adapt to it. During this period, the UK intends to import into its own legislation the entire EU acquis for financial services in order to ensure continuity for businesses.

Some speakers however emphasized that this does not eliminate cliff-edge risks; it only defers them and they will reappear in December 2019 if an appropriate 'landing path' is not clearly defined. In addition December 2020 (the end of the transition period) is not that far away and the transition agreement will only become effective when the overall agreement becomes legally effective, which is by no means certain at present. The speakers therefore concurred that supervisors, regulators and the industry ought to continue to prepare for a situation of no agreement.

An industry observer was concerned by all that remains to be done in the limited timeframe. Many corporate clients still do not fully understand the implications of Brexit and it is also very difficult for financial institutions to communicate what the end state will be. Broader geopolitical and macro factors that have to be considered such as trade wars and tax reform in the US add to the difficulty. An industry speaker agreed that the clients of financial institutions are nowhere near as prepared as they should or need to be if a hard Brexit happens. No matter how diligently financial services prepare for it, more visibility and certainty are needed from regulators.

An industry representative agreed that the industry is doing everything it can to meet its fiduciary responsibilities in preparing for Brexit, as required by its boards and customers, but it may already be too late if there is no deal and no transition agreement. All questions cannot be answered by the private sector given their cross-border financial stability implications.

3.2. Contingency planning must continue

Given the current uncertainty, some panellists suggested that continuation of contingency planning should be on the basis of a hard Brexit and the UK becoming a third-country by March 2019. An industry speaker felt that the confirmation that Brexit would happen and that 'nothing would be agreed until everything is agreed' also concerning the transition period is a strong incentive for industry players to move quickly. Industry players cannot wait longer for more certainty.

An official remarked that a consequence of the present uncertainty regarding the future EU-UK relationship is that individual firms will be making changes through their contingency plans in a way that is optimal for them individually, but these decisions are likely to aggregate to a suboptimal outcome if no overall scenario is defined. An industry speaker regretted this but stressed that the industry's role is to ensure the least disruption possible for its clients, not to find the best general outcome; that is the role of policy-makers. In the current circumstances, banks must progress fast in the interest of their clients, staff and shareholders, and be completely transparent. From a risk management perspective, a positive outcome of Brexit is that it is leading to an alignment of the industry's capital, liquidity and risk in one place, at its headquarters. That means changing the booking model as well. That may be painful for some companies but is positive from a risk mitigation perspective. A second industry speaker agreed that speed is essential in this context and urged that 'perfect should not become the enemy of good'. This principle should be applied to contingency planning but also to the elaboration of the final agreement, even if a reassessment might be needed in five to 10 years' time.

The Chair queried whether the present uncertainty will have more impact than initially expected on the City. An industry player answered that it is too early to say. Many financial institutions are still making decisions and the issue for them at present is not so much human capital, but the fragmentation of capital and liquidity these changes will lead to. In addition, people are not going to migrate to continental offices if they do not know what their job is. Therefore policymakers need to be very mindful of the impact of their decisions on human capital.

A market observer considered that there are still many unresolved regulatory issues hindering contingency planning and more to do than can be achieved before the end of 2020. On subsidiarisation and the way to treat it, for example, the ECB is currently remaining silent, so no one can be clear on the final position. This makes it difficult to take decisions, even in the short term.

Looking through the ecosystem, the precise impacts on capital market activities for example of the CMU and of some other EU regulations underway are not yet precisely known. There are many technical details to be clarified and much plumbing and rewiring needs to be undertaken against challenging timescales.

3.3. Contract and service continuity issues

Several industry representatives emphasized that contract and service continuity issues are posed by Brexit. An enormous amount of time and resources has already been spent on dealing with these problems, but the industry cannot solve all of them on its own. Transition mechanisms are needed. In addition, many contractual issues have legal ramifications that lawmakers have to deal with.

The UK has sorted out many of these processes for itself, with the regulators telling financial institutions that they can continue with some kind of interim licensing regime to avoid short term problems, but there has been no such process on the EU side, an industry player stressed. An official confirmed that since the end of 2017, all the authorities in the UK have been advocating regulatory engagement to address the issues arising that firms cannot fully internalise. Contract continuity is one of the most heavily discussed, both in derivative and insurance markets, but there are other issues concerning supervisory cooperation and the clarity that is needed in terms of regulation.

An industry representative emphasized that there are major contract continuity issues in insurance with 38 million insurance policyholders in the EEA who are serviced through the UK, and 10 million in the UK serviced in Europe. There are also issues regarding cleared and uncleared derivative contracts as well as data exchange issues. The UK has said that it will adopt the GDPR, but it is unclear whether it will have equivalence.

An industry observer remarked that there is much talk about insurance contract certainty, but that may be resolved bilaterally. There is much more work to do on contractual certainty in other areas. Derivative contracts are one. They are multilateral and require sovereign states to be involved, because of the denomination of the contracts. There are also issues about commercial contract certainty, which is not necessarily something that the regulators deal with. These are huge issues that affect the real economy every day. A further point that has not yet been considered by regulators concerns the market structure related to securitisation, including consumer finance in the auto industry and structured note programmes.

While a regulator considered that the industry is in the best position in most cases to find solutions regarding contract continuity issues, an official felt that contingency planning is not a task for the private sector alone and should be a matter addressed in the withdrawal discussions. The official sector must also consider unilateral transition measures, which do not have to match the transition agreement, but that require discussion and participation from both sides.

An industry observer suggested that there should be a grandfathering principle, possibly unilaterally decided by the EU27, which should provide industry players in each sector with sufficient time to adapt and sign contracts. For insurance contracts and even more importantly derivatives, new contracts will have to be signed with thousands of clients. That process may extend beyond the 21 months of transition, so more time, perhaps three or four years, may be necessary to re sign all these contracts. Two years is almost certainly not long enough, so the EU needs to set deadlines with a longer horizon, which would reassure the industry and alleviate such problems.

A regulator mentioned that delegation and outsourcing issues had been also discussed since the beginning of Brexit process. UK market participants were looking for authorisation from some EU27 authorities to continue having access after Brexit. In order to avoid competition on regulatory and supervisory standards among EU27 financial centres, ESMA then published general and sectoral opinions to foster a common supervisory approach at EU level on these issues. These opinions do not aim to introduce new rules but simply ensure that the existing ones are applied, the essence being that entities operating from the EU27 must be supervisable and appropriately managed. That has now been formalised, to some extent, in a proposal from the Commission. In addition, a network bringing together supervisors from the EU27 chaired by ESMA has been created to share experience and ensure a common understanding of requirements across the EU27.

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Impact of Brexit on EU priorities in the financial sector

1. Short term and transitional risks posed by Brexit

An official emphasized that there are three main challenges associated with the transition towards a new Brexit end-state. The first is the question of the time that will be needed to adapt, probably several years. The second challenge is the legal uncertainty created by the impacts on contracts. Contracts that have been entered into before an event are usually allowed to apply in some way after the event. The third issue is the willingness and the ability of the different stakeholders concerned to act. The private sector is expected to make the changes necessary to adapt in the first place but there are some cases where the public authorities will need to step in. These three issues are interrelated, since the more time is available, the more possibilities there are to solve contractual issues for example.

Different areas of transitional risks have been identified by the Bank of England. The first is insurance contracts. About 10 million UK policyholders have insurance contracts worth about £27 billion with EEA insurers, and 38 million EU policyholders hold contracts in the UK. If there is no deal on financial services, premiums cannot be collected and contracts cannot be enforced afterwards. Contracts can be switched from the EU to the UK and vice versa, but it will be difficult to handle that scale in the current Brexit timeframe. Also, many insurance policies have been sold cross-border by companies that have no entity in the UK that could take them on. The UK has said that it will bring in legislation that will allow those contracts to be served and the contractual obligations to be maintained until they run off.

The second area is uncleared derivatives. There is about £26 trillion worth of notional value of uncleared derivatives between UK and EU firms. It is not clear that those contracts can be serviced over their lifetime if there is no deal between the UK and the EU. Some of them will run off but the majority will go past March of next year. They can be novated and repapered but some of the banks that deal with this have thousands of counterparties. This process will take several years to finalize and requires agreement of both sides.

The third area is cleared derivatives. If nothing is done, there will be a £70 trillion notional value of contracts where EU members of UK clearing houses will not be able to fulfil their contractual obligations and will be in default. These contracts can be moved elsewhere but cannot be terminated so other entities that are not in the EEA would need to be found to take them over, which is expensive and potentially disruptive.

Other officials speaking on the panel stated that these short term risks notably regarding contract continuity are clearly identified and are being closely monitored by the EU authorities. They believed that they would be manageable provided that the financial industry tackles these contractual problems seriously. Lawmakers and regulators can help but these issues cannot be addressed solely by the public authorities. A policymaker felt that the industry should be able to handle most issues concerning insurance and uncleared derivative contracts which are bilateral. If there are some pending issues that are impossible or too complex to tackle then the EU authorities will step in to find solutions with their UK counterparts, but the industry must sort them out first. Cleared derivative contracts are different. If no deal is found and there is no transition period, there will be an abrupt change in the market environment. This is unlikely but still needs considering. However if the agreed transition is confirmed, there should be sufficient time during the 18 month period to negotiate equivalence agreements, which should leave enough time to solve most of the contract continuity issues mentioned, through recognition.

A public representative felt that the main short term political problems related to Brexit (e.g. with regard to citizenship, financial settlement and so on) have now been solved. There are therefore relatively few remaining issues that may jeopardize the transition. The main remaining one is the Irish issue. The closer the UK Government will be to agreeing a move towards a custom union, the easier it will be to find a solution to this. The speaker was confident that in the end rationality will prevail.

An industry representative emphasized that the financial industry understands the changes that need to happen with the UK leaving the single market and is planning for a no deal situation with related shifts in activities and staff. The speaker however felt that the public sector does not seem to be considering the risk of a hard Brexit with the same level of intensity as the industry and it is not clear whether the flexibility and the emergency powers that might be needed to manage such a situation are being appropriately prepared by the authorities. More communication on this would be helpful.

2. Longer term risks associated with the Brexit end-state

An official identified three sources of longer term financial stability risks that may result from the anticipated Brexit end-state, emphasizing however that it is very difficult to know how the financial sector will react to the situation and evolve. The first is greater complexity as more complex legal structures within firms and transactions are being put in place, which is a challenge for supervisors. The second is the reduction of the risk diversification potential due to the stronger fragmentation of liquidity pools between the UK and the EU. Third, this fragmentation and resulting higher capital requirements may make risk protection products more expensive, thus reducing their usage.

Another official responded that Brexit creates three long-term challenges from the EU's perspective. The first is the risk that EU supervisors could lose oversight of a significant portion of the financial transactions concerning the European economy if no agreement is found on supervisory cooperation and if the UK becomes similar to an offshore financial market. The second is that the access to and liquidity of certain financial services may be reduced for EU market participants (as well as for UK ones). Third, the EU economy without the UK will be less financially independent than at present, which is also an important issue from a long-term perspective. However the official believed that there are no specific risks to financial stability stemming from these challenges. The transitional risks previously mentioned can be mitigated, particularly via supervisory prudence and there are no financial services provided via London that cannot be provided by EU27 financial centres.

An industry player was worried lest European consumers (i.e. the corporate clients of banks and their customers) should not be taken sufficiently into account in this discussion. Fragmentation of the financial market and the resulting inefficiency and cost will however ultimately hit them. These effects are diffuse and somewhat long-term but they will eventually emerge. The European proposal for an IPU (intermediate parent undertaking of banks) could provide another opportunity to think about the fragmentation of the market and the impact on customers, the speaker believed.

Other representatives of the public authorities on the panel concurred with the assessment of the potential fragmentation caused by Brexit but stressed that this would be a result of the UK's decision to exit the EU, not of EU decisions. The EU is doing its utmost to find solutions to minimise these effects. A policy-maker added that it is difficult for Europeans to accept that, in order to alleviate the consequences of fragmentation that has been generated by the choices of the UK, the EU should change its rules.

3. Opportunities and challenges associated with equivalence arrangements

A policy-maker considered that equivalence arrangements are the ones best suited to manage future EU-UK relationships in the financial sector, given the desire of the UK to recover its sovereignty. Sovereignty indeed means having the ability to choose whether and where to diverge from EU rules. As the City develops new markets outside

Europe, it is likely that access to the EU will become less essential to the UK over time and the incentive to diverge from EU rules will grow. Equivalence is a framework that would allow managing this situation with sufficient flexibility and in a gradual way, avoiding major disruption in the short term. If there is sufficient convergence of rules, assessed according to a process remaining to be defined, access to the EU will be maintained and if the UK prefers to diverge, equivalence will be discontinued.

Several speakers from the public authorities commended the EU authorities for their recent push towards equivalence solutions. This shows that the EU is entering a new phase of the negotiation putting aside options that do not seem realistic such as the UK joining the EEA or mutual recognition. Equivalence should be considered as the core of the solution going forward with a focus on how to make it work in a predictable and fair way.

An industry representative stressed however that equivalence does not apply to most banking or insurance activities because the related EU legislations such as CRD IV contain no equivalence provisions that are relevant to market access. Maintaining sufficient market access is important for the financial industry and also has implications in terms of liquidity, operational efficiency and risk management. The industry is worried by the 'perilously short window of time' left to shape the debate appropriately, agree on a compromise and find any meaningful structural solutions.

Some sort of enhanced and more structural equivalence regime, if not mutual recognition, is necessary to manage this situation, the speaker believed, while being respectful of EU and UK sovereignty. The elements that need to be improved are the unilateral nature of current equivalence arrangements, their absence of coverage of certain key financial activities and also their lack of certainty, since equivalence agreements can currently be withdrawn at a 30 days' notice. A dispute resolution process is also needed, as well as an appropriate enforcement process.

One official noted that the UK Government's position is not equivalence, but a trade agreement and mutual recognition.

Another industry speaker was concerned by a possible movement towards a US-style system in Europe where access rules would be based on regulatory and supervisory standards unilaterally fixed by the EU. That may reduce connectivity at the global level.

A public representative was surprised by the comments made inferring that equivalence is fragile and would increase market fragmentation, when the US authorities are asking to maintain equivalence with the EU precisely in order to avoid fragmentation. It is on the contrary a powerful tool, if used appropriately that can help to avoid market fragmentation while providing the necessary safeguards. One of these safeguards is the unilateral nature of equivalence agreements. If there is no proper common dispute settlement system and if each side has the sovereign right to diverge, both jurisdictions need to have the right to unilaterally withdraw from the agreement, because neither side wants to be bound by a sovereign decision from the other side to modify their standards.

4. Impact of Brexit on EU priorities in the financial sector

An official stated that although the negative consequences of Brexit are more significant for the British economy, they have to be dealt with by the EU also. Impacts on the EU economy should be mainly short term, the speaker believed. In the longer term the funding of the EU should not suffer from Brexit because of the excess savings in the Eurozone in particular, which amounted to € 390 billion in 2017. A further development of the EU cross-border financial market is however needed with the acceleration of the CMU and Banking Union initiatives. Both combined should allow the creation of a 'financing union for investment' which is a key priority for the EU. The EU already has a significant financial sector to back these initiatives, but Brexit should foster the development of a more business friendly and competitive environment for financial services in the EU with the transfer of some activities from the UK.

A policy-maker agreed with the importance of the CMU but regretted that Member States do not give it more importance. A string of CMU proposals has been blocked in the Council for a long time and there are also issues with the implementation of the single rule-book which impede the project. That is a problem notably for non-EU investors who are put off by this fragmented landscape.

An industry representative agreed that the EU is in theory financially self-sufficient thanks to the savings of EU citizens. However the allocation of this capital needs improving across the Union and this problem will increase with Brexit as the City is the main 'market-based allocating mechanism' in Europe at present. The EU27 might be able to build another major financial centre on the continent, but this will involve costs and take time.

Another official considered that the objectives of the EU financial services policy need changing in this perspective. The long term financing challenges of the Union can only be addressed if a major financial centre is built on the continent. So far Europe has mainly been 'inward-looking' in its Capital Markets Union and Banking Union projects, the main intention being to strengthen the internal market. However, the time has now come to look outward and to strive for developing a financial centre on the continent with a global dimension. Digitalisation and the changing structure of financial industries may facilitate the achievement of this objective, since digital financial services can be built up from scratch and do not pose any legacy issues. This should be an important objective for the upcoming Commission, following the work that has been conducted on the Capital Markets Union and the Banking Union by the present Commission.

The official also encouraged market participants to take a more strategic and longer term view to Brexit implications. All the discussions have so far been concentrated on how to minimize the costs and risks of Brexit, the movement of people and so on, but market participants should now step back and work on business cases taking into account the new EU regulations due to be implemented and the potential of digitalisation, as well as the possible opportunity of transferring certain activities to the continent. Business strategies in the financial sector need adapting to this new market environment.

Referring to some previous comments, a third official felt that the EU has two paths before it. One is a path of financial independence and regionalisation, focusing on the best use of European savings for the European economy. The other is a path of integration and being part of a more globalised financial system, allowing a greater diversification of financial flows and risks across the world. The EU must decide what it wants to be and perhaps Brexit has exposed that choice. The speaker believed that the second option would be a more beneficial one both in economic and financial stability terms. All parties already share risk at the global level. For example, there are 150 European branches of banks in the UK and a similar number of insurance companies. Everyone uses a Belgian company for their payment systems. The main securities depositories are in Belgium and Luxembourg. A major activity at present is the provision of dollar-yen swaps by Euro area banks raising dollars in the US and swapping them with Japanese banks to allow the Japanese savings industry to invest.

An industry representative agreed that Europe 'does not have the luxury' to focus only on its own market; it has to look outwards. If Europe (i.e. the EU27 + the UK) is fragmented with a lack of clarity, there is a risk that investors or clients in other jurisdictions will go elsewhere.

A public representative was puzzled by this discussion on fragmentation. On the contrary, the EU is trying to reduce fragmentation with the Capital Markets and Banking Union and to have a more consistent implementation of its rules in order to further integrate its financial markets. This is not creating a closed environment but a more integrated market that is also open to global markets. The speaker felt that too much time and energy is being wasted on these ideological discussions when there are practical solutions that need further elaborating. The discussion needs to be more pragmatic and even technical for progress to be made. The priority is to improve the equivalence system in order to minimise the impact of Brexit and keep capital markets open.

CMU IMPLEMENTATION AND SUSTAINABLE FINANCE

Further reducing fragmentation in the CMU

1. Progress made and priorities going forward

1.1. Progress made with the CMU and with the integration of capital markets in the EU

An official stressed that there are many projects in the pipeline and many highly ambitious proposals coming from the Commission with regard to the deepening of the Union and the establishment of a framework for capital markets in Europe with the Capital Markets Union (CMU). Two particularly important proposals on which the Bulgarian EU Presidency is hoping to reach a general agreement by the end of the Presidency are the PEPP and the cross-border treatment of investment funds.

On PEPP, there are still open issues but a common understanding of the objectives of the project, beyond the creation of a common EU label, has been achieved. There are a number of other important initiatives underway including the one concerning covered bonds and the review of the European Supervisory Agencies (ESAs). This latter proposal is the most difficult and controversial one. However, the Bulgarian Presidency has managed to open discussions on it. This review will help decrease fragmentation in capital markets, especially regarding regulatory convergence.

Several speakers considered that the concrete achievements of the CMU notably with regard to reducing the fragmentation of EU capital markets are so far very limited.

A public representative emphasized that while two important pieces of legislation have been finalised, the Prospectus Directive and the Securitisation Regulation, many parts of the CMU are unfinished. The Council is moving forward as previously mentioned and the European Parliament is trying to keep on track as well, but much work still remains to be done and the European elections in 2019 will prevent any progress on new initiatives. The files currently being worked on by the Parliament are the EMIR review, the CRD/CRR banking review and investment firms.

A policymaker stressed that the Commission has always considered CMU a top priority since its inception. It is one of the key elements of the EMU together with the Banking Union. As much as possible has been done by the Commission to move the CMU forward. 30 actions of the 33 announced in the action plan of 2015 have been delivered by the Commission. An additional 12 legislative initiatives part of the mid-term review have also been delivered and presented. Others will hopefully come in May with a new package subject to the outcome of the ongoing impact assessments in the areas of sustainable finance and SMEs, notably with measures to facilitate the listing of SMEs.

However, only three of these legislative initiatives have so far been adopted by the current legislature. Continued commitment is needed on the part of the Parliament and the Council to finalise the adoption of the different CMU proposals and improve them if needed. There is strong support from the industry for the CMU because it is a pro-growth and pro-business agenda, but before any concrete results can be achieved the Commission's proposals must be adopted. The Commission cannot do this alone, and everyone must play their role In terms of architecture, the most important project is the review of the ESAs. A special focus is also essential on sustainable finance and fintech, which are two major future challenges in this area.

1.2. Defining priorities

An industry representative considered that although some projects have been achieved, there is 'too much on the European plate' to finish the CMU in the originally allotted timeframe. The CMU covers a variety of different topics with different levels of complexity. The specific elements on which progress needs to be made first and what needs to be accomplished to form a sound basis for further progress to be made on the CMU during the next Commission should be clearly identified and prioritised. The consistency of regulations is an element of the utmost importance, the speaker believed. There have been many regulatory activities and initiatives over the last seven or eight years which address different individual subjects, but these are not always consistent with each other, and thus they do not form a solid basis from which to move forward.

A public representative considered that the two main problems preventing reductions in the fragmentation of EU capital markets are taxation and insolvency law. If Europe wishes to deepen its capital markets and develop cross-border investment, it should focus on these two areas. Taxation is a very important issue for the PEPP in particular, because pension products have taxation implications. More specifically regarding the PEPP, the speaker considered that a balance needs to be found in the proposal between products linked to the capital markets and a state guaranteed minimum standard product, which may not be competitive if financial markets are developing properly. It is important to find this balance, because the PEPP is aimed at a population which usually cannot afford direct access to financial markets.

The problem however is that taxation and insolvency law issues touch national competencies. Taxation is a key issue of national sovereignty. The EU Parliament has nevertheless delivered proposals for a consolidated corporate tax base. Insolvency law is the other most crucial element for the CMU. It is still not clear whether the legal system works at present and if a complaint is to be solved in a proper timeframe. However, these are sizable projects. For example, tackling insolvency law at the EU level is a 10-year project.

Another industry representative noted that the CMU project is a collection of some 35 40 distinct policy initiatives aiming to tackle difficult and complex problems. Most of them are meeting significant opposition at one level or another. One way of optimizing the project could be to merge the discussions on the CMU and on sustainable finance, which are inextricably linked. Sustainable finance is a necessary outcome in order to limit short term decision-making and encourage sustainable growth and financial stability. Achieving this goal will require large, diverse and effective capital markets. CMU is therefore a prerequisite for sustainable finance. The current lack of harmonisation and differences across national fiscal rules and regulations however negatively impact EU financial markets over the long term and the outcomes they may deliver to the real economy. If this is not fixed by the CMU, this may mean that despite our 'high hopes' we will have ended up with 'little to nothing'.

Europe must be one financial market in order to compete in the world. Europe has the potential to be the second biggest growth market after the US, but this is only if it is operated in an integrated way. This will take time but if Europe wants to be part of the global economy, it must pursue this goal and reduce market fragmentation.

A policymaker emphasized that the CMU is conceived of as a toolbox. There are some major legislative initiatives, but also non legislative initiatives, initiatives led by Member States and also certain industry led projects, which come from the bottom up. The difficult and complex objective of the CMU will be achieved by combining all these different categories of measures.

1.3. Timeframe issues

The Chair considered that the CMU project originally lacked ambition and a longer term vision of where Europe's capital markets should go. Two major errors were made. First, the CMU was insufficiently connected with the emerging digital world and in connecting e commerce with capital markets. Second, and more certainly, the CMU would have been more effective if there had been a high level agreement between the Council, Parliament and Commission on the timing of the project. A tripartite agreement on the precise timescale for CMU would have created more pressure on the system to deliver.

An industry representative agreed with what had been said previously regarding insolvency law. Addressing insolvency law is essential to tackling fragmentation in the EU but this is also a difficult task which takes time. It shows that managing appropriately the CMU portfolio of actions is a key issue, because the EU needs to run in parallel this project which might take years and others which can be achieved in a much shorter timeframe. Europe needs a clear plan with clear timings attached to each of the items of the CMU in order to move forward.

Another issue in this respect from a securities market perspective is the EPTF (European Post-Trade Forum) initiated by the Commission. It has come up with a number of assessments and recommendations but these have been on the table for 15 months. And at the same time fintech and industry initiatives are developing and uncertainties related to Brexit have to be considered. Moving ahead, a proper action plan needs to be established taking these different 'moving targets' into account.

A public representative agreed that pressure is needed from the European level and setting a timeframe is the main way Europe has to exert pressure. However, keeping the timeframe cannot be an objective in itself, the quality of the proposals must come first, and it is not easy to define an appropriate timeframe. At present, the main priority of the Council and Parliament is the next EU financial framework, which will establish budgets beyond 2020 and it has nothing to do with the CMU. The Council and the Parliament will keep a strong focus on this, because it relates to financial resources over the years to come. Following this, the first priority will be a review of the ESAs.

2. Challenges to the integration objectives of the CMU

2.1. Brexit challenges

A public representative felt that Brexit will be 'a slight blow' to the CMU. It is important to be realistic about Brexit; it will take place and therefore a deal must be reached and Europe must prepare itself. Losing the most liquid and largest capital market in Europe is a challenge which the EU must address. An official however did not believe that Brexit is a major issue with regard to liquidity, because some Member States will benefit from Brexit.

An industry representative felt that Brexit is ultimately 'a distraction'. It is essential to remember the desired outcomes of the CMU. Bigger capital markets provide better outcomes for the end users of markets. The EU27 is a location that is already very successful for global market infrastructure, and the Commission has ambitions for the EU27 to be a global leader in sustainable finance. For this to happen, Europe must participate in global markets.

The UK exiting is 'sand in the machine', but it should not mean complete interference. It is important to support and trust in European institutions. Europe must overcome this fragmentation or it will not be able to get the necessary consistency to achieve the CMU, and this is a bigger challenge than Brexit. Additionally, seeking consistency at the global level, rather than just at the European level will be very helpful.

Another industry representative agreed that Brexit will likely be perceived as a slowdown factor, though it should actually be the opposite. It should encourage Europe to speed up the implementation of the CMU initiatives in order to achieve a competitive framework and an appropriate level of integration for the EU27. There are several strong elements in the EU27 on which to base the development of a competitive CMU environment including a robust market infrastructure which has been further strengthened by EU regulation.

A policymaker regretted the UK's decision to leave the Union, but agreed that Brexit makes it even more necessary to develop capital markets in the EU27. The CMU makes even more sense if Europe cannot count on liquidity from London It is essential in particular to promote and develop capital markets where they do not exist and where their development is limited. This was stressed in a communication that the Commission published a few weeks after the Brexit referendum on the subject of the CMU and remains the position of the Commission.

2.2. The balance between EU level market integration objectives and local development

An official considered that finding the appropriate balance between centralisation and local development is essential. The EU cannot move forward without developing local markets proportionally to allow smaller markets to benefit from the CMU process. There is always controversy between the periphery and the core countries, which is a source of trouble in Europe. Some of the slow progress on certain projects can be attributed to the fears of peripheral Member States with less developed economies, that new European proposals will centralise powers and activities in the core and increase divergence between the core and the periphery. That is why there is such strong opposition from some of the smaller Member States, particularly with regard to the ESAs review.

A policymaker agreed that the question of the European perspective versus local and regional developments is very important. For example, it is clearly impossible for Europe to impose a cross-border dimension on SMEs that would be unwilling or incapable of developing cross-border. Any measures or initiatives proposed by Europe should be clearly defined from that perspective and not impose unnecessary constraints or objectives.

In respect of fragmentation, it is often felt that the European authorities regulate and impose too much. However, in some cases legislation is necessary precisely to prevent and overcome fragmentation. One example is the cross-border distribution of funds, which is not developing according to market operators because some Member States have introduced additional or different requirements notably in respect of product marketing; only EU legislation can eliminate such barriers. While legislators often face criticism that they produce too many proposals, legislation is only ever proposed by the Commission after careful assessment, in total good faith and to help businesses. Legislative proposals are not punishment; they are instead about enabling. The question of balance between the European level and the local and regional levels is however something that should be borne in mind in this context.

The Chair highlighted the example of several countries from the Nordic region where capital raising for small companies is going very well. There are a cluster of factors supporting this, which include taxation, the encouragement of small investors to invest in the market and knowledge of technology. These elements are not driven by European legislation; rather, they are local. Much can be learned from the success of certain markets in Europe, and this knowledge can be cross fertilised to other parts of the European Union.

A public representative emphasized that although the CMU is an answer to key challenges for the EU economy including Brexit and that cross-border activities need to be developed, this does not mean that all should be done in a centralised way. Capital markets should not be seen as a centralisation of financial markets The same is true for banks. Merging large banks across different Member States might not be the right way forward. This might be allowed by the oversight and surveillance structure but would not be possible when taking into account competition law. A balanced approach is needed in this regard.

Another important aspect to be considered, the public representative felt, is that the European economy is more bank financed than other economically developed regions. Europe needs both bank finance and capital market finance, although the latter needs to be further developed. European entrepreneurs have a different way of thinking to those in other economic areas, and this has to be taken into account. The richness of Europe is that it has a variety of approaches. This is true also with regard to funding, and these different approaches should be given their chance in the market, even in terms of legislation and regulation.

3. Conclusion

The Chair concluded that Europe believes in and wants the Capital Markets Union. Brexit does not change that. Clearly, part of the CMU project will spill over into the next Commission, and the Commission will have to think hard with the other institutions and Member States on its programme in this area and put forward a new set of orientations. Europe is probably behind schedule to a certain extent in this area and some actions will take longer than expected, but, beyond Brexit or any other roadblocks, if and when the CMU moves forward Europe will be very successful. It is a question of developing deep and liquid capital markets as part of a global capital market. This should be achieved while respecting the proportionality and subsidiarity principles of the Treaties.

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Priorities for developing sustainable finance

1. The main challenges faced by financial intermediaries and investors in the sustainability transition

An industry representative stated that the topic of sustainable finance has moved from the niche to the mainstream in two years, but is still not without its pitfalls. Max Weber defined the ethics of good intentions and those of good outcomes, and its application here means some are concerned that good intentions could lead notably to over regulation and economy planning.

The panellists were impressed by the work of the HLEG, since sustainable finance although it has not been mobilised to the extent it might be, is now mainstream. A policy-maker states that a step change is being made in seeing the financial markets as actors. Most people now agree that adaptations are needed to continue living on a planet with 10 billion people and are convinced that climate change is a matter to tackle urgently. For many years the Commission has been working to handle the environment and the economy on equal footings. Each needs the other, hand in hand.

A lot of the policy framework is dedicated to ensuring a sustainable future is in place. What is needed is to close the gap and that is where this Action Plan is essential. It is very concise, with everyone involved agreeing that the main problem to address is to form a robust, credible information system to guide the process.

A public representative suggested that the proposed taxonomy would be useful, because it can bring together the good intentions and measures out there, in the form of workable standards. It must be recognised, however, that not everything can be quantified and qualitative judgments are still needed. The financial sector needs forward looking analysis and also to consider tail risks not just on the environment and climate. It needs, in addition, to leverage social factors such as governance, as the recent Facebook scandal has proved. What is needed is a situation where investors feel it is their duty to take such factors into account, even if they are not part of this taxonomy.

The route to closing this gap will be difficult and must avoid greenwashing, although there is more seriousness detected in the market now. Participants should not be too generous in what is declared green or not on the basis of taxonomy. Environmental policies cannot leave big carbon footprints unattended if they do not fit easily into one category or another. Moving quickly on this taxonomy will make a material change to the market and guide capital flows towards more sustainability. Equally important is to promote environmental risk assessment at the corporate level.

An industry representative concluded that many things are in motion in sustainable finance. The European Commission is actively working with the Parliament on the implementation of the Action Plan, and the industry itself is moving. The big question is how to close the investment gap. The Commission estimates that it needs to invest an additional €180 billion a year into renewable energy and energy efficient housing, so this is also a big opportunity for the financial sector to be engaged and step up its planning and investment. Examples of the race to the top can already be seen. There are laws on disclosure and due diligence in France and other good examples from the Netherlands. There is a coalition of countries that can set and lead this race to the top.

A public representative said that the Action Plan has to convey the message that changes will happen and be here to stay, though they will take time and at present the ETS is barely functioning and the carbon price is nearly zero.

2. The features of the EU sustainable finance framework

The panellists considered the next steps and areas of focus from the European Commission's Action Plan, which was launched publicly on March 22nd. A policy-maker explained that the Commission intends to follow most, if not all, the recommendations of the High Level Expert Group (HLEG) on Sustainable Finance, but first needs to establish a sequence of actions.

In this respect taxonomy is a priority for which for a number of sectors, such as the energy efficiency of buildings, parameters have already been defined, but other areas need more work. Consequently, a second high level group gathering technical experts is needed to produce adequate recommendations to serve as a foundation for the rest of the work. Their first focus will be on climate, which is where the body of evidence is most developed and preparatory work has been done, notably by the EIB. This project should not require legislative action in the short term. They will then progress to other fields, including biodiversity and the circular economy.

The Commission will seek rapid progress on investors' duties and also intends to act quickly on its low carbon benchmarks, with a legislative initiative proposed to begin before the summer, with the hope of adoption before the Parliament ends.

The European Parliament has been equally active, producing an ambitious initiative report on sustainable finance, which has received broad support. The members of this body are excited that sustainable finance is now in the mainstream and being granted greater status.

A public representative stated that financial incentives need to be in place for a change to occur. The HLEG and the Commission are considering what incentives and technical devices might be created, and an industry participant advised them not to apply in Europe the Basel IV recommendations regarding project finance. They would reduce the speaker's bank's activity in sustainable finance, as returns on equity would be only around 1% or 2%. The European authorities would have to implement Basel IV alongside specificities of the way long term European projects are financed. The problem is that Basel tries to calibrate the marginal risk so that it is equivalent on both sides of the Atlantic, although the American banks are not engaged in this activity like the Europeans.

A policy-maker drew a distinction between long term and sustainable finance, since not all long term projects are sustainable. The goal of the European Commission remains compliance with international standards. This creates the chance that international partners will comply too and so create an altogether better world. Probably part of industry's complaint relates more to the interpretation of the accounting and prudential rules than the Basel standards themselves.

Environmental accounting is one of the demands included in the Action Plan, and is a means to look at environmental performance. This is a separate issue from IFRS 9. The Commission is looking at all sides of the issue, but the Action Plan is unlikely to be able to equate 'long term' with 'sustainable' when incentivising finance.

3. The roles of public decision makers and market forces in the transition to a sustainable economy

An industry representative highlighted that banks are becoming increasingly involved in green sector lending and financing this transition. The representative confirmed that the EU Action Plan is stimulating their firm to carry out more sustainable lending. This issue is one of the most important challenges for humanity, and this bank is responding to developing new tools such as the green bond market.

Another way to promote sustainable investment is to incorporate sustainability advisers in discussions with customers about their investments. When customers approach banks with proposals for asset financing, by working with the customer the bank can influence their projects and more closely align them to sustainability objectives and limit their environmental impact, but this will mean a long process of transition. Like all transition periods, it perhaps needs accelerating.

An industry representative summarised that politicians are concerned that the private sector might be paying lip service to transition more than changing corporate actions, whereas the corporate side is concerned that the politicians are over regulating rather than facilitating and stimulating. Representatives from each camp were asked what they could do to assuage the concerns of the other.

A public representative believed that the political side could show its intended direction, so that the private sector is better able to prepare. He invited Parliament and the Commission to be as clear as possible about their next steps, as this will help to remove any suspicions. It is also very important that supervisors should play an active role, as not everything can be done through regulation; all parties need to work together. This will bring about a flexibility to adapt more quickly than through a legislative process.

An industry representative suggested that the time of greenwashing is ending. The banking industry is not paying lip service at all anymore. Increasing numbers of its customers seek finance for sustainable investments. However, the economy will have to change deeply to respond to retail investors' appetite if these types of products are to increase any further.

EU green finance framework

1. Success factors of the EU sustainable finance action plan and next steps

1.1. The EU taxonomy

A regulator suggested that there is a consensus that the taxonomy is the foundation for everything else in this area. Given its importance, the Commission is bringing in expertise, from the EIB and elsewhere, to help develop this taxonomy as well as to look at other areas such as the development of a green bond standard, a methodology for low carbon benchmarks and metrics for corporate disclosure.

The approach of the Commission is to build up a taxonomy framework by which more expert decisions will come along later. When the Commission adopts this framework, it will need to acknowledge that there is a need for flexibility to allow for the incorporation of forthcoming innovations and for standards to be redefined and adapted.

1.2. A progressive and sequential approach

A regulator pointed out that the Commission is adopting a sequential approach to the taxonomy as it cannot do everything at once. The Commission's expert group will deliver first on climate change mitigation and then on climate change adaptation and other environmental activities. The Commission is also preparing a legislative package for May 2018 on fiduciary duty, investor disclosure and benchmarks. The challenge will then be to articulate the taxonomy with those policies.

The Commission intends to look at the investment chain, starting with suitability assessments. Then will come a dialogue with investors to establish whether they have preferences for investing in instruments that take environmental factors into account. Asset managers and investment advisors should have a duty to take those preferences into account and then to show how they have taken them into account. Finally, once there are certain instruments that are proposed to investors, those instruments need to be assessed against low carbon benchmarks.

1.3. Awareness of policy interdependence

A regulator explained that financial services policies and financial regulation policies are not being considered in isolation but as part of a wider policy picture. Different countries are at different stages of their energy mix transitions and the taxonomy therefore needs to be mindful of this interconnection and to maintain a certain amount of flexibility to follow the development of the technical landscape.

Another regulator stated that the energy and climate change policies have been brought together under a consistent framework. A very ambitious legislative package has been put forward, which is looking at renewables legislation, public buildings requirements, electricity market transitions and governance. All of these changes in the regulations on energy and on climate are being made concurrently with changes in other regulations. It is therefore important to be mindful of the interlinkages.

1.4. The EU budget

A regulator noted that consideration will be given to the EU budget in terms of public incentives to guide the market. Parliament has requested that the next multi-annual financial framework should devote 30% of its spending in favour of ecological transition.

1.5. Carbon benchmarking, pricing and tax

A public representative stated that the next step will be to re enter the debate about a carbon tax, which will lead to more efficiency. Accurate carbon pricing in investment decisions will be a driver for investment strategy. Low carbon benchmarks, carbon taxes and carbon pricing need to be introduced in concert as the individual measures alone will not be enough.

1.6. A "Sustainable Infrastructure for Europe" is not currently being considered

An industry representative noted that a "Sustainable Infrastructure for Europe" is not within the scope of the present action plan as the High Level Expert Group does not believe that there is any need for yet another structure to be put on top of existing structures. Instead, the Commission has decided to improve upon what it deems to be the most impactful aspects in improving transparency and the investment pipeline.

2. Main reactions to the action plan

2.1. The action plan is clear and ambitious

An industry representative expressed support for the action plan, stating that it is clear and ambitious and that it addresses the whole market across the investment chain as well as the whole capital market rather than not just the green part of the market. This is imperative in meeting the EU's goals and ambitions as well as infrastructure needs, the global Sustainable Development Goals and the Paris Agreement.

Another industry representative highlighted three features of the ambition-setting of the action plan: first its aim to establish a classification system; second that it is focused on investments; and lastly that it should work under certain conditions. The third of these is the most crucial and raises two aspects that need to be fulfilled: that it should be clear without being too simple; and also that the taxonomy system should address target conflicts and interdependencies.

2.2. The drive towards greater transparency was welcomed

The drive towards greater transparency in the market was welcomed by a number of industry representatives. Better information allows for better capital allocation decisions. Transparency both in terms of companies providing investors with information on how they are managing sustainability risks as well as transparency on the part of asset managers to their investors in terms of how they are integrating sustainability factors in the way they make decisions, is incredibly important. It was also welcomed that the action plan explicitly picks up on the Task Force on Climate-related Financial Disclosures (TCFD).

2.3. The decision to address mitigation aspects in priority was welcomed

An industry representative expressed support for the decision within the action plan to address in priority mitigation aspects before adaption aspects, especially since investments with a focus on adaption are quite difficult because they do not generate any cash flow. Developing a solution for this can trigger the acceleration of investment prospects.

2.4. The taxonomy is not a 'silver bullet'

An industry representative cautioned however that the taxonomy should not be seen as a 'silver bullet'. While the taxonomy will be helpful, it should not hold up other actions that are to be taken. The taxonomy will help define what is deemed to be 'green' but the more important issue is making companies agree to transition, once an investor has decided which companies to invest in. All these companies need to recognise what the risks are and to take appropriate measures.

2.5. The sequencing needs to be reconsidered

An industry representative suggested looking at the sequencing, noting that, until there are sound standards and data coming out of the corporates, any further steps towards labelling and benchmarking will be questionable. Asset managers will be worried about being required to label financial products without being confident in the corporate data that sits below it.

2.6. Consideration needs to be given to a possible antagonism in the asset management industry between investment managers and the role of ESG (environmental, social and governance) teams

An industry representative warned that attention must be paid to the possible bifurcation within the asset management industry between the role of portfolio managers and analysts on the one hand and the role of the ESG (environmental, social and governance) teams on the other. This has already come up in other areas such as remuneration where companies will believe that they have support for their proposals from the investors but will then be contradicted by ESG teams. It is essential that the ESG capabilities within asset management should become embedded within the mainstream of the investment process both for portfolio managers and analysts.

2.7. The report of the High Level Expert Group would be wrong to pre-suppose market failure

A regulator contended that there is no evidence for the supposition in the report of the High Level Expert Group that there is widespread market failure and that people are unable to get the tenors and the financing that they want.

2.8. Regulatory standards should not be used to achieve a political goal

It was stated by a regulator that Mark Carney, declared that it would be a grave mistake to change regulatory standards to achieve the objective of climate protection, although this is exactly what the High Level Expert Group report recommends.

In addition, the introduction of anything like a green supporting factor or of an environmental element in prudential rules means deviating from the Basel single international standard, and adding an additional regulatory layer to what European banks are already facing. This is of particular concern as competitiveness with the United States needs to be borne in mind.

The regulator continued that different countries have different ideas of what is considered 'green'. Some countries, for example, consider nuclear energy and wood-burning to be green. Changing regulatory standards and introducing fiduciary duties to address these widespread views and to achieve a political goal is akin to a planned economy and, ultimately, a 'very bad idea'. There, questions arise as to whether investment managers or supervisors will be able to judge which environmental technologies will exist in the next few decades. Further questions asked were whether investments to, for example, China or Africa will cease because of their CO_2 emissions. Such decisions could result in developing economies being cut off from European investment.

An alternative approach is to implement an industrial policy that protects the environment which the banks can follow up on, as opposed to forcing banks to pre judge which technologies will exist in the future and to finance them even though the policy outcome is still unknown.

A policy-maker outlined the Commission's two-step approach in its action plan to avoid the 'mixing up' of tools: first, the taxonomy to understand what 'green' is; and, second, understanding whether lending to 'green' is less risky. Only once those two things are understood can there be a favourable prudential calibration for green investment and green lending.

2.9. The role of the public sector in developing common standards

A public representative acknowledged that prudential objectives should not be conflated with other objectives and that monetary policy and financial market regulation, which is mainly dedicated to financial market stability, should not be used for other purposes. However, banks have a say about which industries they want to finance and should not have to wait for a market participant to come up with an acceptable proposal in relation to 'green' investments. Market-led trends can be disastrous and there is therefore a role for regulations and incentives to move things in the right direction. The ESAs (European supervisory authorities) have a significant part to play in this regard.

An industry representative notes that, after a few decades of 'green' investing, the asset management industry has still failed to develop an industry standard, largely because asset managers find themselves caught between differing client views on what is green or ethical. There is therefore a role for the public sector to play in developing common standards and terminology.

An industry representative stressed the importance of fund managers obtaining the best available information on ESG factors across companies and of factoring these into the investment decision making process in order to make the best long-term investment decisions. It is worth remembering that while some clients are very clear about what they would like to invest in and not to invest in, the vast majority just want to know that their money is being well taken care of and that the ESG issues are being taken into account.

A policy-maker questioned whether the market can be expected to move towards the climate goals on its own. It is believed that there needs to be a partnership between the public and private sectors. The Commission is creating a framework in which the industry will play a crucial role.

2.10. The role of the industry

Active participation of the industry is required. A policy-maker calls for greater ambition in eliciting this participation, which should be galvanised by the success of the voluntary increase of the share of climate change projects in the EFSI's investments from 20% to 40%.

A regulator explained that the Commission's initiative with the European Mortgage Federation exemplifies co operation between the public and private sectors, whereby lenders have recognised the benefits in lending more to mortgagees who want to improve the energy efficiency of their home, as it makes for a better quality asset and a more credit-worthy one. Eventually, energy efficiency building standards will become hard legislation but, in the meantime, co-operation is required to help the transition along.

3. Broader challenges in achieving climate targets

3.1. The current situation

A regulator pointed out that as of 2018, Europe is well placed in terms of achieving its targets. It has cut CO_2 emissions over the last 20 years and has almost achieved the intermediate targets on the road to its 2020 targets. It is ahead in terms of cutting greenhouse gas emissions and is almost there with renewables and energy efficiency.

3.2. There is a substantial investment gap

A regulator warned that there is a substantial investment gap with no clearly-defined pathway towards the 2030 targets. The most substantial gap is in relation to the building stock and the housing stock. Of the requisite €180 billion per year that DG FISMA refers to in its reports, three-quarters goes to renewable energy efficiency in buildings where the renewal rate in Europe is less than 2%. DG FISMA is considering the capacity of the financial market to participate in the renovation of the building stock.

To fill the investment gap, there needs to be a structured and efficient dialogue between public and private investment. Legislative incentives can also be useful. The massive investment required in renewing the housing stock is critical, not least because the housing in question is often social housing or housing where the owners do not have the funds for renewal.

3.3. The work of the European Investment Bank

An official underlined that the EIB (European Investment Bank) has a strong interest in not just the work of the High Level Expert Group and the action plan but more generally in the whole question of sustainable finance and green finance. A minimum of 25% of the EIB's lending goes to significant climate financing, which totalled over €19 billion last year. The EIB is also fully committed to the support that it is giving to the EFSI (European Fund for Strategic Investments), which now has an enhanced commitment towards climate finance and green finance.

A regulator stated that the EIB is also a pioneer of green bonds, having issued, in 2017, what is generally considered to be the first green bond, the Climate Awareness Bond. Last week, the EIB announced its intention to develop sustainable awareness bonds that will be targeting other parts of the SDGs (Sustainable Development Goals) that are not specifically related to climate.

3.4. The EFSI is not perfect

A public representative stated that the EFSI is not perfect and that it will not be able to address all the investment gaps. Many other public policy initiatives should contribute including the Stability and Growth Pact, if there is to be success. However, it needs to be recognised that the EFSI has worked and that it has made a difference. Follow-up proposals from the Commission on the EFSI are eagerly awaited.

3.5. Expertise needs to be built up

There is concern over whether sufficient resources and expertise either exist or are being developed in both the NCAs (national competent authorities) and the ESAs. The Commission recognises this concern and is currently in touch with the ESAs about what type of resources they need and how much is needed.

Developing fund cross-border distribution

1. Expected impacts of the Commission's proposal on fund cross-border distribution

1.1. Objectives of the proposal

The Chair noted that the European Commission had recently made a proposal (a package comprised of a regulation and a directive) to improve the cross-border distribution of funds in the EU, in response to concerns raised by operators over the passport system in the UCITS and AIFMD directives.

Notwithstanding the clear success of UCITS and the increasingly high level of success of AIFMD, the rate of cross-border penetration between EU Member States remains low. Several barriers prevent these passporting opportunities from being fully exploited, notably differences in marketing requirements across Member States.

1.2. Expected impacts and possible limitations

The panellists welcomed the Commission's proposal, agreed with its objectives and noted the constructive engagement with the industry.

Some speakers however felt that it is not going far enough with regard to tackling regulatory barriers (such as notification requirements and marketing measures), which increase the cost, complexity and risk of fund cross-border distribution. An industry representative stressed that these issues need to be addressed in order to achieve a truly pan European distribution of funds and improve distribution in the smaller Member States in particular, where these additional costs make it difficult to support the marketing of funds in a profitable way. This would also help European funds, which are often too small, to grow. Another industry speaker agreed that developing cross-border distribution would help the EU fund industry to grow and become more competitive, which would have a positive impact on European savings and the European economy.

A regulator commended the Commission for balancing appropriately the needs and interests of fund managers and investors in the proposal. A thematic study on the functioning of the fund marketing passport published by the French AMF, however concluded that the elements hampering proper cross-border distribution are not so much notification and marketing requirements or fees but rather other issues associated with local cultures and distribution channels. These include: (i) local saving practices and appetites for risk which translate into specific marketing approaches that are needed for non domestic funds to compete; (ii) local tax incentive frameworks, which create compliance costs for non domestic funds seeking local tax favourable treatment, and; (iii) home biases from domestic distribution networks and integrated banking distribution networks.

Another industry speaker also felt that the reform could go further with regard to supporting the development of outcome-oriented solutions, which are a growing investment method. Driven predominantly by the low interest rate environment, most clients now ask firms to provide particular outcomes for them rather than seeking advice on which fund to purchase. Here, asset allocation and investment advice become increasingly important, which is supported by MiFID II and PRIIPs (Packaged Retail and Insurance based Investment Products). In order to deliver these outcomes to investors, firms must have the broadest possible set of underlying funds. These funds will have to be cross-border, because solutions in one country will be suboptimal relative to cross-border approaches.

1.3. Legislative approach

An industry representative, while agreeing with the analysis of the barriers remaining to be lifted, considered they mainly relate to very technical issues, which need to be tackled at Level 2 or 3 rather than with the highly political co legislative approach of Level 1.

A regulator underlined that defining the correct level of regulation is important and added that clarity is essential in level 1 regulation. At Level 1, co legislators must provide clear rules which obviate any need for further discussions at lower levels.

Another regulator noted that ESMA has worked on supervisory convergence across the EU28 for many years, but there are limits to what it can achieve, so the Commission's attempt to address some of these barriers legislatively is very welcome. Many of the problems in this field relate to a lack of administrative efficiency.

2. Notification and data processing

2.1. Notification issues and the possible role of ESMA in this regard

An industry representative emphazized that although domestic administrative requirements for local paying agents and domiciliary agents, which are pointless and very costly are due to be eliminated by the Commission's proposal, several complex notification issues have somehow not made it into the proposal. Certain countries for example require businesses to notify them of every distribution agreement and weekly of net new money or assets under management (AUM). Setting up the systems to ensure that this is done on a repeatable basis and with no errors across a large group of countries is extremely expensive and complex.

Some panellists suggested that cross-border notification processes could be further improved, using ESMA as a central hub through which notifications could be channelled and dispatched. A regulator suggested that whether ESMA becomes a notification hub is a question of efficiency. Routing notifications through ESMA, as opposed to operating bilaterally, will ensure that the same information flows across Europe and that market participants only create one form of information. This would also help ESMA to play the role foreseen in the Commission's proposal as information and data hub for the cross-border fund sector.

Another regulator mentioned that in the trialogue around the Prospectus Regulation, the Parliament has required ESMA to develop a notification portal to manage all notifications in relation to prospectus passports, and ESMA is currently developing this IT tool and an RTS around it. If such a function is being developed for securities and prospectuses, the investment in IT being made by ESMA could also be extended to funds. An industry representative stressed that from a practical perspective having a single notification process through ESMA would also make it easier to handle for asset managers.

A regulator however considered that the Commission's proposals for facilitating file modifications are sufficient for solving existing notification issues. Currently cross-border distribution initially goes through a simple regulator to regulator electronic notification procedure, which works well, however, modifications have to be sent individually to each supervisory authority concerned. Under the new proposals, firms will only have to send notifications of modifications to their home regulator, which will then go through the same regulator to regulator electronic notification procedure as original notifications. An industry representative agreed that the existing process works well and that regulators should not seek to fix what is not broken. Moreover ESMA may not have the manpower to handle additional processes at this point. If anything, ESMA could play a coordinating role across national authorities in order to foster greater cooperation, rather than acting as a hub.

An industry speaker suggested that a common approach for de notification or de registration is also needed, which is not the case at present.

2.2. Improving data management processes

Some speakers considered that ESMA could play a useful role as an information and data hub for professionals and the public, as proposed by the Commission.

A regulator added that in any case ensuring consistency in the data requested between AIFMD, UCITS and Money Market Funds (MMFs) is essential in order to avoid double and triple reporting and regulatory fragmentation.

An industry player believed that ESMA could play a useful role in the reporting space by consolidating the data and giving it back to the industry. Firms provide a substantial amount of information and receive little in return. This information would be very helpful in terms of risk management and could enable firms to spot gaps and identify trends or provide relevant products and services to investors.

3. Marketing requirements and supervisory fees

3.1. Pre-marketing requirements

A regulator explained that since the introduction of AIFMD in 2013 there have been many requests to exclude the seeding phase of AIFs from marketing requirements in order to facilitate the testing of new funds. National pre-marketing regimes have been created in several Member States but these differ from one another. Harmonizing these rules by a European initiative is a positive step forward.

Several speakers on the panel were in favour of extending the proposed EU pre-marketing regime, currently limited to AIFs to UCITS because UCITS are often distributed to institutional investors before they are then distributed to the retail market and finding seed investors is also important in this case.

A regulator noted that this would require introducing the definition of marketing in the UCITS Directive. There is also a question of scope. AIFMD only targets professional investors and not high net worth individuals, whereas the pre-marketing rules of EuSEF and EuVECA also cover the latter investors, creating an unlevel playing field in this area. What should be considered as marketing also needs to be further clarified (at Level 3 rather than Level 1). Some specific situations that require clarification have been identified by the AMF, e.g. when a management company responds to a call for tender launched by an institutional investor to create a UCITS or AIF targeted to its needs.

Another regulator considered that the issues associated with pre-marketing can be addressed very easily by deleting the reference to draft documents in the text. If reference is only made in texts dealing with marketing to the 'final documents', perhaps the problem of excessive requirements for pre-marketing will be solved without having to introduce new measures. Some other speakers agreed that it is important for asset managers to be able to show draft or preliminary legal documents to seed investors in the pre-marketing phase.

An industry representative was concerned by the obligation of continued marketing stated in the proposal. What this involves needs clarifying, because it may limit the distribution of funds in smaller countries, where asset managers will not be ready to commit to continuing to market funds in perpetuity.

3.2. Marketing documents

An industry representative emphasized that the language of marketing documents is a major issue. 15,000 fact sheets are produced by the speaker's firm every month. Marketing documents including the Key Investor Information Documents (KIIDs) are required to be in the local language (unless other languages are authorized by the local authorities), and some of them are very complex to translate. This requirement was set in the Markets in Financial Instruments Regulation (MiFIR) and is a bad precedent.

Several panellists also considered that changes should be made in the marketing requirements to allow documents to be provided in 'a modern way' in all countries and not only in paper. This would save significant costs and would also facilitate the provision of information to investors (notably the younger ones) and the interaction between manufacturers, distributors and investors. Most countries have moved to web based documents, but some countries in Europe still have rules in place which are appropriate only for paper advertisements, which is very problematic. The industry speaker also noted that the industry widely uses web-based content, videos, blogs, chats, social media etc., which are incompatible with a requirement for pre-approval and therefore suggested to eliminate any pre-approval provisions regarding them. Allowing this would also facilitate the provision of information to the European and national authorities.

An industry representative suggested that ESMA could drive further convergence in terms of marketing standards, principles and practices in this perspective.

3.3. NCA fees

An industry representative did not understand why fees should be paid to national regulators when funds are passported and exported. This is a form of customs duty within the single market.

A regulator answered that host National Competent Authorities (NCAs) have a legitimate interest in verifying the marketing materials of funds distributed in their jurisdiction. There should be a fee to cover the cost of conducting this activity. If this fee is transparent and proportionate, it will not be a customs duty.

A regulator recalled that similar discussions were conducted two years ago in the context of the Prospectus Regulation. There is a need for consistency in how the cross-border distribution of funds and the cross-border offer of securities are treated.

4. Taxation issues

An industry representative regretted that tax reporting is absent from the Commission's proposals. The industry does not want harmonised taxes; it wants to know what to file for funds to be available in a country on a tax efficient basis for clients. Filing costs are addressed by the proposal, but these are trivial. Currently, the industry spends thousands of euros on lawyers trawling through local legal and tax documents. Some Member States have sophisticated withholding tax systems for example that are difficult to manage for firms that are not aware of them. One of the proposal's biggest strengths is to propose solutions to make information accessible in a harmonised and easily retrievable way. This principle could be expanded to tax-related information to allow firms to make sensible decisions on whether cross-border distribution is appropriate for them.

Some other speakers considered that taxation issues are difficult to address at the EU level. There are on-going discussions but regulators have a limited capacity to address these questions.

Another industry representative however agreed that clarity would be a useful first step.

5. Impacts expected from the ESAs review

A regulator highlighted two important aspects of the review of the ESAs which would impact fund cross-border distribution if they are adopted. First, there is a proposal to move competencies on EuSEFs, EuVECAs and ELTIFs to ESMA. The speaker believed that there is not a strong case for this since these vehicles are generally managed by the same companies managing AIFs and UCITS, which may lead to double supervision. Secondly, the proposed changes in governance would mean that ESMA has more powers to ensure that rules are being followed in accordance with the Single Rulebook. This will only work if supervisory convergence is dealt with by an executive board with independent directors.

Another regulator was not in favour of the direction in which the ESA review proposal is moving, because there are no convincing arguments for fundamentally changing the current system. There are no market failures, crises, irregularities, flaws or shortcomings that justify a fundamental restructuring of the system. On the contrary, with the ESA review there is a risk that the NCAs will abdicate some of their responsibilities, resulting in supervisors moving further away from supervised entities. With the ESA review there is also a risk of making the system more time consuming, more burdensome or more complicated and costlier, which should be avoided. There are however convincing arguments for giving greater powers to the ESAs in some other areas: for example, on CSDs, on the negotiation and drafting of memoranda of understanding (MoUs) in the context of Brexit, following the successful centralisation of AIFMD MoUs. Additionally, deadlines such as those related to MiFID II could be managed centrally by ESMA rather than by individual Member States.

A third regulator considered that there are benefits in centralising within ESMA certain elements of the supervision of cross-border EU players. ESMA has already been given enhanced powers in respect of EuSEF and EuVECA funds in the authorisation process in order to improve consistency in the implementation of rules and the current proposal is just taking this a step further. The regulator also believed that ESMA's current powers on supervisory convergence must be strengthened, with improved decision-making and governance structures and additional responsibilities and tools.

The proposed changes regarding opinions on delegation / outsourcing would not be fundamentally different to what ESMA is already doing in other areas and are about achieving commonality and avoiding regulatory arbitrage. The Commission's proposal to use opinions for such types of decisions is actually quite a light touch power. This is already being done across MiFID for pre trade transparency waivers or short selling, for instance. ESMA has demonstrated that these opinions can be produced within 24 hours. This shows that ESMA has the capacity to drive further convergence in respect of delegation and outsourcing, without making the decision process lengthier, more difficult and costlier.

6. Exporting of EU funds outside the EU

An industry representative stressed that the single market in cross-border funds works well in comparison to the exporting of EU based funds outside the EU. At present only 10% of the registrations of Luxembourg and Irish funds take place outside the EU: the Commission could help the industry by reducing the barriers to selling EU funds outside the Union. It could also help the industry to become more competitive. Indeed in the process of exporting funds, outside the EU, one substantial element is the cost of producing or managing the fund. The speaker called for a pro business approach from the EU institutions in a similar way to what has been done last year by the US administration and for a slowing down of the production of new rules.

Index investing

1. Taking advantage of the growth of index investing

1.1. Potential contribution to the CMU and the development of EU capital markets

The Chair cited Warren Buffett's remarks from 1993 that 'When dumb money acknowledges its limitations, it ceases to be dumb. By periodically investing in an index fund, the know nothing investor can actually outperform most investment professionals.' Buffett's statement is still true today, the Chair believed. After the financial crisis following which there was some loss of credibility of actively managed funds, index investment helped to reinforce investor confidence.

The advantages of index investing are wide-ranging and significant, the Chair emphasized. The cost benefits are important, particularly for the small-size investor. Research also proves that many index funds outperform actively managed funds and allow for dividend payout or reinvestment. Index investment funds have developed at an extraordinary speed, with an average growth rate of 20% per year over the last 4-5 years. In total, these funds now account for more than 10% of the total fund market in the EU, having started from a low base.

An industry representative stressed that the low costs and relative simplicity of index products mean that more investors can access markets, providing European capital markets with additional funding sources. Another industry speaker added that index investing, via ETFs (exchange-traded funds) or other structures, increases market efficiency in terms of facilitating access and increasing potential returns. Index investing indeed provides a diversified, low-cost means of achieving asset allocation potentially creating a virtuous cycle that leads to more capital infusions. Capital flows into index products also tend to be long-term and to provide long term capital to firms as long as they stay in the index.

An investor representative agreed that index investing helps the average small-size investor, and can potentially answer the call of the European Commission in its report on the distribution of investment products for simple products that help retail investors to diversify their portfolios. Retail investors should be encouraged to use index funds such as ETFs to diversify and minimise investment complexity.

The importance of "investor stewardship" in this context was also stressed by an industry representative. If active investors do not like particular stocks, they can sell them. Index investors cannot sell them, so the way to increase long-term sustainable earnings for clients is for asset managers to engage with companies, ask questions about their long-term strategies and assess their ability to implement them.

1.2. Increasing transparency

Following the work already conducted on the risks associated more broadly with open-ended funds, ETFs are now being more specifically assessed by regulators at the international level regarding issues such as conflicts of interest, disclosure, costs, and investment strategies.

A regulator considered that MiFID II and PRIIPs may support the development of index investment, increase the volume of distribution of these products and also provide more transparency on fund trading volumes. These legislations indeed set obligations for distributors to reflect the interests of investors, while removing payments (e.g. inducements) that might have distorted the distribution of different investment products.

An industry representative agreed that these transparency provisions should 'give index a tailwind'. Assessments show that robo-advisors are largely using ETFs, whereas traditional advisors, who until recently were 'on commission' are not. With the MiFID suitability rules and transparency obligations, that situation should change. The 'prudent person' concept (requiring investment advisers to only make investments for their clients that a «prudent person» would make) which was adopted in IORP and is also cited in the Commission's Retail Financial Services report should also have an impact. This should lead to weighing up more closely the different asset-allocation components including costs. In this context the expected growth of European pension assets with the PEPP should be another tailwind for index investing, alongside other investment funds and long term products.

A regulator added that improved transparency would allow retail investors to better understand what they are buying (e.g. the S&P 500 index) and the drivers of return on their investment, thus increasing their confidence. Improved transparency and suitability testing obligations are also necessary at the distribution and advisory level. Recent FCA action in the UK against advisors who had not moved people into lower-cost products with the same strategy is a strong and interesting point, the regulator believed.

1.3. Building awareness about the features of index investment products

An industry representative suggested that one solution for developing index investing is to create more awareness about these products in the retail market. One way of doing this would be to allow direct investment into equity markets in the PEPP through index funds. Another important factor is to obtain the same level of attention on the part of advisors and intermediaries to different investment and savings products including index funds (as well as other UCITS, AIFs, direct equity and savings accounts).

A regulator noted that there is a strong commitment of the public authorities both at the EU and global levels to public education. The aim is to increase the confidence of retail investors by providing them with simple products and clear information. If a positive dynamic is created that way, people will move assets out of deposit accounts into higher-return investments. This movement should be facilitated by the growth of robo-advisors, notably for millennials, but the attitude of investors depending on a traditional advisor will also change with the provision of simple products.

A member of the audience suggested that a possible idea for governments to encourage the use of index funds could be to provide every child with a government grant to invest in equity-linked index products which they could cash when they are 18. This idea has been presented in the US in the form of a 'baby bond'.

An industry representative suggested that facilitating cross-border investing would also support the development of index funds. Developing fund cross-border distribution in Europe however remains challenging, a regulator believed. The current data on cross-border investment fund distribution in the EU indeed overstates the degree of integration of the European marketplace, because it is based upon notifications. The reality is that there is not a well-developed pan-European market at present.

1.4. Lessons that can be learned from the US

An industry representative explained that index fund markets are developing at different paces. There is notably a price disparity between the EU and US markets. The weighted average cost for ETFs in the US is around 23 basis points versus 35 basis points in Europe. For mutual funds it is 59 basis points compared to 135 basis points in Europe. A great deal of this difference between ETFs and mutual funds is tied to differences in distribution approaches.

In the US, the big driver for the development of index funds in the retail market has been a push in education and demonstrating that index funds can have a positive impact on returns. The trend was led in the US by wealth managers, banks and independent advisors, and predominantly in the early days by fee-based advisors. Later adopters were the brokerage community that was still on commission. The main change however came after the 2008 credit crisis, when many large firms decided that they wanted more control on how wealth managers or advisors allocate money for their clients, creating model approaches to investment allocation using index constructs and imposing suitability and investment-process controls on brokers. In the US, index products and ETFs have been the biggest beneficiaries of that trend and have produced the significant growth that has been observed in recent years. In Europe however, there is a more captive distribution and index-like products will not penetrate in the same way until this changes. A regulator agreed that a clear distribution model for the EU fund sector still needs to be determined.

An investor representative added that there is a difference between Europe and the US not only in the share of index funds in the overall fund market but also in retail participation in index funds. This gap can be bridged by better information, which the MiFID-based rules should facilitate with rules regarding cost transparency, distribution and independent advice.

2. Potential challenges and vulnerabilities associated with the growth of index investing

The Chair emphasized that the nature and risk profiles of index funds have changed since their inception, raising questions in terms of product complexity and impact on the market.

2.1. Increasing variety and complexity of index products

A regulator pointed out that some emerging index products are significantly more complicated than traditional market-capitalisation index funds and difficult to understand even for professional investors. Some of them use multiple and complicated indexes, with complicated portfolio constructions. Smart beta strategies aiming to combine the benefits of passive and active investing strategies, with an element of active decision-making rebalancing the elements of an index in response to events, raise questions for example.

An official stressed that there has been an incredible amount of innovation in the index fund area over the last 5 years, with the growth of inverse and leveraged ETFs in particular in addition to complex smart beta strategies. No significant vulnerabilities have arisen so far from this increasing variety and complexity of index funds, but this remains to be further assessed, particularly in stressed market conditions. The relatively benign market conditions in recent years have indeed not allowed drawing definitive conclusions in this regard.

An industry representative agreed that the risks posed by these new index product constructs are worth investigating, particularly those related to inverse and leveraged ETFs built with derivatives, which can raise issues in periods of market stress. Following the 2008 crisis, many investors moved back to physically-based index products. It is however also important to think about the positive aspects of derivative-based products which can be used to good effect by some investors who cannot open an options account, trade on margin or buy a future. Nevertheless leveraged ETF products should not be accessible to everyone. Another element to consider is that ETFs have existed in the market for many years without causing particular trouble (equity products have been in the market since 1993 and fixed income products since 2002). In addition, although ETFs tend to be a point of focus in the assessment of systematic risks because they are publicly traded, they only represent a small part of the overall market: less than 2% of the equity market and less than 1% of fixed income.

2.2. Possible need for additional disclosure and a classification of index products

The panellists agreed that better disclosure of the risks posed by index products and of the related constraints for investors is needed. Investors should in particular be appropriately warned that the strategies that are used by certain ETF structures, for example those which are highly leveraged, are highly risky, so that they might potentially lose all their investment.

An industry representative suggested that European and international regulators should go further in the classification of the different types of exchange-traded products in order to distinguish between traditional ETFs, which are mostly UCITS, levered and inverse ETFs which are fundamentally different, and also other exchange-traded products that are not funds (e.g. exchange traded notes) and which have different exposures, including to the sponsor of the product. The aim is to prevent end investors from buying risky ETFs believing that they are vanilla products and without knowing what they involve.

Another industry representative was more favourable to improving investor disclosure and information at the point-of-sale. Although classification may be a good idea, harm may come from the gaming around the classification and how it evolves in the market, thus resulting in more confusion.

In addition, although it is difficult to anticipate what the next blockbuster product in the market might be, it is likely that more active strategies will appear within ETF constructs, moving out of pure indexing. The 'next jump' in the ETF market will probably come from a use of these products in portfolios alongside active constructs and alternative investments. Explaining the effective use of different types of products is becoming increasingly important in this context. One example is smart beta, which is a large, ill-defined segment of the market. Smart beta strategies seek to follow indexes, while also taking into account factors such as volatility, liquidity, quality, value, size and momentum.

A regulator agreed that categorisations are a good solution in theory but are problematic in practice because, once put into place, they are immediately gamed in order to get market advantage or because the features of the products are attractive for a broader range of investors than initially defined. It is difficult to overcome that problem. For example UCITS were designed as retail products and AIFMD products as non-retail but the reality is quite different. There are large levels of institutional investment in UCITS products, as well as a high level of retail investment in AIFs, so this does not work as a categorisation.

2.3. Challenges raised by the use of Artificial Intelligence (AI)

AI is an interesting tool in the index investment area, an industry speaker believed, because it can be used to achieve more granularity in portfolio constructs with more specific assessments. An example is a company whose core business has nothing to do with electric cars, but which has some activities that can contribute to the disposal of rechargeable batteries, which is a key component to any electric-car future. This can be identified by reviewing regulatory filings and here AI and natural or machine-language learning can be very useful.

A regulator however stressed that the potential use of AI raises 'black box issues'. Supervisors have to be able to understand on a day-to-day basis exactly what has been done in the fund, which may be increasingly difficult with AI. This is a potential issue both for investors and for supervisors in terms of testing the integrity of the market. One way of dealing with this, based on the 'ETF and other UCITS ESMA guidelines', is to require indexes to be capable of being replicated. Indexes are currently being replicated independently in the industry in order to test the pricing of ETFs versus the pricing of the components in the underlying index. As strategies get more and more complex, it may become increasingly complicated for supervisors to test compliance and ensure replicability. This is an area that supervisors need to keep under close scrutiny.

2.4. Possible issues created by the outsourcing to index providers

Answering a question from the Chair regarding possible issues created by the outsourcing to index providers, a regulator considered that the EU Benchmarks Regulation which will be fully implemented in 2020 will hopefully deal effectively with the potential conflicts of interest this may lead to. This area should be kept under review, because a process of outsourcing is inevitable and if providers to whom indexes are outsourced are not directly regulated the question arises as to whether that may next lead to the degradation of the regulatory framework.

Although outsourcing has caused no particular problems so far, this is an issue that needs continuous monitoring. Regulators need to talk to index providers as well as to people who choose them, about due-diligence processes in particular.

2.5. The possible impact of index investing on market efficiency

The industry representatives on the panel considered that the opposition between active and passive investment is overstressed. Index investment is not really 'passive' because it takes time and energy to run effectively. In addition there is no clear cut difference between active and passive; in reality, there is a continuum of different strategies from index to active through beta and through various approaches to alpha, relative and absolute. Investors do not choose between index and active; they use both in their portfolios. It is mainly a question of efficient access to the best investment strategy.

A regulator considered that in principle, when buying the market through an index, the investor is free-riding on other people's research, analysis and intelligence. That reduces costs, but at the same time there may be a negative impact on price discovery in the market. While this is theoretically true, the regulator believed, there are many other influences which mean that the impact of index investment on price discovery might be marginal and not one that should drive public policy. In addition, if index investing has a significant market impact, this will increase opportunities for the active investor. It might be a self-correcting mechanism, where, if the price-discovery mechanism deteriorates, profit opportunities will rise for active managers, and the price-discovery mechanism should recover as a result. An industry representative agreed with this self-correcting mechanism and stressed that such movements have been observed before in the market, making the question of the negative impact of index investing on price discovery mostly hypothetical. At present there is price parity for bonds of the same issuers that are in and out of indexes for example.

Another industry representative disagreed with the idea of free riding, noting that a great deal of intellectual capital goes into the development of different types of indexes which allow investment across the entire investible universe. Regarding the potential impact on market efficiency, the speaker emphasized that index investing is only a small percentage of capital allocation, 20% of total global equities if separate accounts and all pooled funds in ETFs are included, or 7% if looking solely at funds. However, price discovery is made by the buying and selling of shares of the whole investor universe. When analysing the US market, for every share traded from an index strategy, 22 are from an active strategy. Active investment is mostly what is driving price discovery. It would take a large growth in index to counter the 1:22 ratio. If index grew to that scale, there would be short-term fluctuations in prices, benefitting active fund managers because it creates an opportunity to outperform.

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Developing equity investment and financing in the EU

1. Current status of equity markets in the EU and impediments to their further development

1.1. EU equity market trends and main challenges and opportunities

The Chair stated that it is well known that European companies rely more than their US counterparts on debt (and particularly bank debt) rather than equity to finance their investments and working capital needs. This is an issue in mature economies because in such a case repayments may not await the proceeds of investment or may not be compatible with the uncertainty which goes along with new projects. Own funds account for 121% of GDP in the US, but only 78% in the Euro area and this gap is widening. Developing equity financing is thus key for the growth of European economies particularly to fund innovative projects.

An industry representative considered that Europe is still recovering from the financial crisis which affected access to capital markets from SMEs in particular. However Europe is at the beginning of a recovery cycle with some positive signals ahead. As shown by recent IPOs, there are a large number of start-ups in almost every EU country, which attract non European investors e.g. from the US or China. Large caps are doing well also and venture capital ecosystems are helping SMEs to grow into scale ups.

A regulator however felt that the development of equity markets in the EU is more a structural than a cyclical problem; this needs to be recognised if progress is to be made. Capital markets in the EU are probably only about one-third as deep as those in the US and, when you zoom into some of the smaller firm segments, the gap and the differences appear even bigger, with a ratio of around 1 to 7. SMEs are not the main worry as they are not expected to access capital markets, and bigger firms do not have major problems in accessing capital. It is the middle area that causes the worry.

An industry participant believed that US mid cap companies, in particular innovative ones, are able to access capital markets more easily than European ones.

This is problematic in Europe, another speaker agreed, as innovative and technology-based companies often need a high amount of money at the beginning of the project, which can only be financed by equity, since these companies usually do not have sufficient cash flows at that stage to pay back loans. Another issue is the fragmentation of equity markets in Europe. Local ecosystems play a key role in financing the growth of smaller companies, but this market fragmentation adds complexity for foreign investors, who have to shop around in different EU countries with different rules.

A market observer stressed two further issues that have short term implications for EU equity markets. First, Europe is facing an increase in interest rates, which will increase volatility. Over the medium term the growth rate in the EU is expected to go back to its normal trend, slightly below 1.5%, which will reduce growth and funding opportunities for mid-sized firms, making equity financing even more necessary. Brexit is a second issue to consider due to the current concentration of the EU equity market in London. The City represents 25% of the total IPO value today and one in every five conducted.

1.2. Barriers at the investor level

An industry representative emphasized that retail investors in the EU do not privilege investment in smaller companies, and prefer traditional large caps. Unicorns are lacking also.

An investor representative added that equity culture is still limited in the retail segment. Surveys show that retail investors are asking for an easier access to equity markets. They also request a greater harmonisation of financial reporting, including on ESG, because many of them are interested in issues such as sustainability, clean energy, air and water and want to choose the countries in which they invest. Another issue is the access to the AGMs which is difficult and sometimes impossible, involving extensive paperwork and in some cases fees asked by brokerage firms just to register for this shareholder right. This hinders shareholder engagement and good corporate governance.

Barriers to equity investment were also mentioned at the institutional investor level.

A market observer pointed out barriers that hinder the investment of insurance companies in equity and distort asset allocation. Consequently, there has been a major decrease in the equity investments of insurance companies over the last 20 years. Equity and other risky assets now account for less than 5% of their assets, compared to 10% to 15% in risky assets two decades ago.

A first issue is the Solvency II regulatory capital framework. It excessively favours sovereign bond investments, which require no regulatory capital charge, whereas investing in equity requires high capital charges (between 25 and 49%), which heavily weigh on the rating of insurance companies. A second obstacle is the IFRS financial-asset accounting standard. This new standard imposes systematically valuing equities at their market value and permanently reporting related profits or losses, although they are virtual since these assets are not traded but held by the company. Such an accounting approach has artificial on-going tax implications. It also leads to artificial and volatile mismatches between assets and liabilities.

An industry speaker added that the business model of insurance companies and the way liabilities and guarantees are structured have an impact on the amounts invested in equity by insurers. Once the liabilities are structured in a way that allows providing clients with the promised return, the tendency is to favour fixed rated assets. This has led to a shift in the asset allocation of European insurers particularly in Germany, towards real estate and alternative funds. The share of equity has not increased despite a booming equity market over the last 10 years and low interest rates.

2. On-going initiatives to further develop EU equity markets

2.1. The Capital Markets Union is a welcome initiative but needs optimizing

The Chair stressed that many initiatives have been launched in the context of the CMU agenda, such as a review of European venture capital funds regulation (EuVECA) and adjustments to Solvency II to enhance insurers' roles in the long term financing of the economy. There is also a recent Commission proposal to smooth out the fiscal bias that favours debt financing. The Chair questioned the panellists on whether the actions underway are sufficient to remove the main obstacles to further development of EU equity markets or if additional incentives are needed.

The panellists were generally supportive of the CMU initiative and of its ambition. The upcoming proposals regarding the listing of small companies are welcomed in particular. Some limitations in the way the project is implemented were however identified, as well as issues associated with specific initiatives.

A market observer believed that the proposals made by the Commission were all appropriate but a clearer set of priorities is needed. Brexit creates an additional challenge that requires speeding up the effects of the CMU and defining a new strategy for the EU27. One area that could be quickly acted upon is developing equity investment by pension funds and insurance companies which requires addressing the different barriers mentioned above. One industry representative also saw encouraging signs with the move from defined benefits to defined contributions, which should favour higher equity allocation. Secondly European initiatives such as the pan-European pension product (PEPP) should also favour a stronger allocation to equity going forward. Strengthening banks is a third priority because banks are needed to support listing processes and to provide liquidity in the secondary markets. This requires in particular tackling non performing loans issues, in particular with the creation of a secondary market, as has been proposed by the Commission.

One regulator was not sure that that the CMU has 'hit the nail on the head', particularly in the equity space. Progress has been limited so far. One way to improve the project would be to engage more with issuers in order to better understand the challenges they face and provide them with the tools they need to succeed in the capital markets. At present policymakers do not appear to have a good enough understanding of how the ecosystem works and what policies are needed.

Several speakers also considered that more could be done to create a pan-European equity market.

An industry representative believed that further 'defragmenting the EU market' was essential. This is true in the trading area but also in the post-trading space such as CSDs. Fiscal processes also need to be further harmonised. The current fragmentation indeed reduces the attractiveness of EU markets for foreign investors who are faced with many different rules, raising complexity.

A regulator felt that more should be done to facilitate access to the equity market, notably regarding legal aspects which are very costly for SMEs. The divergences in company laws and asset ownership rules across EU Member States should be reconsidered in particular. At present it is difficult for investors to understand how different systems work and how to exercise their rights. This is however a difficult area because it requires changing many existing laws and regulations.

Bringing companies from different Member States to a pan-European market is easier than developing cross-border listing, the regulator believed. An additional idea could be to create EU service centres to help companies go to market. An investor representative agreed that investing and listing across EU Member States should be easier, lifting the current cross-border barriers, but considered that the UK should also be part of that approach.

An industry player added that MiFID II requirements concerning research and analysis also need reconsidering as they have negative impacts on mid caps. That needs to be closely monitored to understand how to create the right environment and new business model for sufficient research and analysis to be available.

2.2. SME growth market and prospectus requirements need further specification

SME growth markets constitute one area that is not well specified, a regulator felt, and as a result it is difficult to adjust the requirements. A more distinctive regime is needed. An industry representative agreed that SME Growth Markets, which are an interesting concept, need to be further specified and calibrated. It is unclear what the implications are for investors and issuers and how bond issuance may be included.

In a regulator's view, the Prospectus regulation is 'a lost opportunity'. The Commission has proposed some simplification, but regulators so far have not implemented them completely. This is a major issue for small caps, as the cost of legal advice to prepare documentation and auditing services consumes part of the money that might be raised by going to the market.

An industry representative supported the idea of a Growth Prospectus for SMEs, but considered that a great deal of testing in the market and further calibration was needed to make it effective. Relatively more is being asked with this new Prospectus from SMEs than from large caps, which makes little sense. An investor representative however found the Growth Prospectus too limited. References made to websites and financial statements will allow producing shorter documents but that should not limit the description of risks, particularly those of start-ups entering the capital markets. Indeed smaller companies tend to be those that may provide the highest return but also the riskiest ones, so investors need appropriate information. The effects of prospectus rules, PRIIPs and MiFID II requirements need to be monitored over time.

3. Additional actions proposed

3.1. Developing long term investment

An industry representative considered that fostering long term investment is part of the solution for developing equity markets. Long-term investors, such as promotional and development banks, indeed have long term liabilities that allow them to invest in equity markets and have an investment strategy based on an assessment of long term risks and returns.

In addition to the regulatory measures mentioned above, the speaker considered that initiatives such as the Juncker plan can promote investment in riskier assets and thus help to develop equity markets. Benefitting from the guarantee of the European Fund for Strategic Investments (EFSI), long-term investors are able to take on more risks and crowd in private investors to the market as well. This kind of instrument can therefore help to address some market gaps and failures, and also develop new equity market segments. The speaker believed that social infrastructure in particular is a type of asset that presents potential for equity funding, as is shown by a report published earlier in 2018 (Report of the High-Level Task Force on "Investing in Social Infrastructure in Europe" chaired by Romano Prodi and Christian Sautter[1]). Indeed, there are huge needs for social infrastructure investment and a major backlog of projects in social housing, hospitals and schools. Public budget constraints mean that these projects can only be financed if there are private investors. Including a window dedicated to social infrastructure in the instruments promoted by the new "InvestEU Fund" in the next multiannual financial framework would be a good way to incentivise investment in such projects. An investor representative emphasized that a problem with investing in social structures, however, is that they are often within funds which add costs.

3.2. Developing retail investment in the equity market

Several speakers were in favour of encouraging retail investment in the equity market.

A market observer suggested that the high savings rates in the EU could be taken advantage of to further develop equity markets. The issue however is that European retail savers are generally risk-averse. At present those who invest in equities mainly do so through funds and packaged products. Tax exemptions could be used to encourage more retail investment in equities with common mechanisms agreed at the EU27 level.

A regulator agreed that more could be done with regard to fiscal incentives. In Italy for example, the state has created tax exempt individual savings plans, with a holding period of five years, and a mandated investment of 70% in small and medium caps. This type of mechanism should be further developed across the EU.

An investor representative believed that the low interest rate environment provides an opportunity for developing retail investment, as people are looking for a better return on investment than savings products. An issue however is that their advisers usually suggest investment into funds or other packaged products instead of shares, which limits the exposure of retail investors to equity markets. A more balanced approach in that regard would help to develop a better equity culture. Equity retail products also need to be very simple, transparent and replicable, so that investors can see where their money is invested and in which equity.

3.3. Market-led initiatives

An industry player emphasized that stock exchanges in particular have a critical role to play in developing the listing of small companies: e.g. in educating CEOs of mid cap companies and supporting investors pre IPO when they are looking for exit strategies. A key issue is that not all growth funds consider IPOs a valid way to exit, because of valuation, complexity, cost, etc. It is the exchange's role to make them accessible and simple, so that firms can make the right decision.

Not all companies behave in the same way, so the speaker's firm has created two different programmes: one for innovative companies, i.e. digital companies but also green tech and clean tech ones and another for family owned businesses that are considering listing to accelerate their growth. A specific approach and education is needed for each sector. The key for the next two to three years however is finding ways to foster appropriate research and analysis.

1. http://www.eltia.eu/images/Boosting_investment_in_Social_Infrastructure_in_Europe.pdf

Regional and SME ecosystems in the context of the CMU

Introduction

A policy-maker opened the meeting by introducing the panellists and structuring the discussion questions.

1. The importance of financing issues for EU SMEs and their main uncovered financing needs

1.1. Access to finance: the current situation for EU SMEs

An official pointed out that financial systems in the EU are too bank-based. European SMEs are financed through banks, with little stock-market and corporate-bond financing or for start-ups through Venture Capital (VC). Institutional investors play a limited role, even more so in the new Member States. There equity and bond financing are lower than in Western Europe, institutional investors are smaller, and VC is underdeveloped. The dominance of banks was a problem in the post-crisis period, as they were reluctant to lend, and this was a factor in the weakness of corporate investment. New Member States and the Euro area crisis countries suffered as banks reduced their exposure. In addition, between early 2003 and late 2008, the exposure of Western Europe banks to Eastern Europe increased from 150 billion to 570 billion and, post-crisis, it fell to 340 billion.

This was not just supply-driven; weak demand also played a role. Research found that supply shocks were important initially and demand later.

An official advised that the EU's Survey on the Access to Finance of Enterprises (SAFE) found that supply factors are not a constraint and SMEs' access to finance is less of a problem than during the crisis. Only 7% of EU SMEs mentioned access to finance as the most important problem. There are improvements in the Euro area crisis countries and the EU new Member States. In Spain and Italy, in 2013, 22% of SMEs saw access to finance as the most important problem; now, it is 8%. In Bulgaria and Romania, it fell from 15% to 5%. Availability of staff, finding customers, competition and regulation are now all more important.

Furthermore, in countries including the new EU Member States, private investment is low. Higher investment rates would be expected than in Western Europe but investment in Poland is 18% of GDP compared with 21% for the Euro area 15.

However, the financial system being bank-based is a problem. Although the monetary stimulus has driven market interest rates to record lows and resulted in a search for yields which has made financing abundant, access to finance may become a problem when investment picks up.

An official stated that there is an increasing concern in Europe regarding financing and equity for SMEs and it is a political priority even in larger countries such as France. Political mobilisation is essential. In addition to the fact that equity is not a new problem, credit is an issue for the general economy and SMEs whenever they cannot source finance elsewhere.

However, the sizes of corporate-bond and equity markets differ across Europe. Corporate bonds are 68% of GDP in the UK but 9% in Germany. Stock-market capitalisation is 121% of GDP in UK, and 31% in Italy. It is difficult to see how regulation results in such differences. They are more likely to reflect different institutions and history.

The CMU is trying to bridge this gap. Studies show that the situation is widespread, with problems for listed and unlisted equities and few SME IPOs in Europe.

1.2. The particular needs of new Member States

An industry representative commented that SMEs in EU emerging markets are smaller in size compared to the EU15, which is normal for a developing situation. Another obstacle to market finance is the willingness of companies to ask for financing, no matter the source, due to corporate governance issues. It is not about hiding something, but not having a sufficiently well-developed corporate culture or not using professional services to put the company in order. For many companies, going to a bank is not attractive and VC or markets are even worse, because of the corporate governance. One solution is to give SMEs managerial tools and the representatives institution is working with SAP in putting together a cloud service for mid-cap companies. This will give a better assessment of these companies' risks with warning signals, enabling faster financing decisions. Companies that are served by proper systems find it easier to go to markets or negotiate with VC players, as systems can help provide discipline.

Finally, an industry representative noted that the problems are similar; the main difference in eastern countries is the scale. Corporate governance is also at a lower level than in other parts of Europe. Helping companies, whether through financial instruments, private equity or a less traditional type of financing, is done on a smaller scale, such as a micro-pilot, especially for companies in sectors where traditional banking is not attractive. That will not change in the future, so it is important to be inventive. Improving corporate governance and providing opportunities to interact with banks or private investors to improve how businesses are run will drive opportunities.

1.3. General reasons for the lack of market funding of SMEs in Europe

An industry representative highlighted the missing equity financing ecosystems. The most recent EIB study shows a strong preference for SMEs to fund activities through bank debt. 80% prefer it despite knowing that it is more expensive than equity. It is of strategic importance to find an answer to that. Central infrastructure has to have the means and market models to convince people to use this market to raise capital. Currently, bank funding does not do this. It is important to find an answer in order to scale up market finance. An ecosystem cannot be built by one market finance infrastructure only. It requires specific incentives. In this respect there are imbalances where equity investment is treated differently from debt for tax. This is not attractive to investors.

An official advised that exchanges must become more SME-friendly. Culture is also an issue and is an area where MiFID can increase the confidence on market finance. The same problem exists when it comes to the intervention of private equity in general or VC in particular, and is true for traditional businesses as it is for start-ups. It is important that companies think about opening to capital and beginning the growth process before it is done for them.

An official noted that in addition the local availability of equity is an issue. In a context where the market for start-ups is increasing - notably France has been the first market for VC recently, although the level is low compared to the US - seed money is an issue, as angels are undeveloped, and this is a good way to bring equity into a start-up. Later on the funding curve stable investors and cross-border big tickets are also necessary for the CMU to develop, as these funds bring equity after the start-up stage, during growth notably to face up the J-curve effect which occurs on the first several years when funds experience negative returns from investee companies.

An official advised that this must be looked at more broadly. Funding for SMEs depends on the amount available for other sectors. In a country where the government is financed through banks, as in the western Balkans, banks are less likely to lend to SMEs.

A participant asked about SME financing statistics. An official notes that Eastern Europe has additional factors, such as the nature of financial assets and liabilities. There is investment from west to Eastern Europe, but little the other way. Culture also plays a role. The US has a culture of starting a company and growing it quickly. The top 20 US companies are different to 30 years ago, where Europe is more similar.

1.4. Lack of market funding of SMEs in new Member States

An official advised that notably in the EU new Member States private capital markets are a recent phenomenon. In the 1990s and 2000s, Western European banks entered these countries, leading to the rapid development of a bank-based financial system. Other forms of private funding remain underdeveloped. Corporate-bond-to-GDP ratios and stock-market capitalisation are low. Government bonds are the only capital market that is relatively well-developed and not in all countries. That does not mean that regulation does not matter. Capital markets in the new Member States are small relative to GDP and in absolute size. The stock-market capitalisation of all these states together is 2% of the EU aggregate. For corporate bonds, it is 1%. Hungary's corporate-bond-market capitalisation is less than €3 billion compared to €800 billion in France. Regulation differences may segregate countries' capital markets but making regulation uniform helps integrate them, allowing for expansion. The Baltics are integrating capital markets to boost financial market capabilities and support banks by allowing the sale of covered bonds secured by mortgages from across the three countries, which is currently not possible.

An official noted that integrating capital markets is more difficult with separate currencies and not all EU countries are in the eurozone. The EU new Member States, with underdeveloped non-bank capital sources, have the biggest issues. Each country needs its own strategy, based on the real sector, which differs from country to country. Government bonds are a starting point, and a well-developed bond market may attract foreign financing. Developing corporate Bond markets may need more time, as large corporates will go offshore anyway.

Developing private bond markets, covered bonds and securitised SME or household debt is key for listing locally. Developing a domestic investor base through pension funds and insurance companies is key. The experience of emerging-market countries shows the importance of foreign investors. Many problems that the CMU seeks to address are urgent for the EU new Member States. The size and nature of capital markets make implementing the CMU challenging, but perhaps more rewarding than for the well-developed countries.

2. Financial instruments and regulatory actions to support SMEs

2.1. Financial instruments at European level

Signs of improvement exist, relative to the situation of recent years. The European Commission and partners such as National Promotional Banks and Institutions (NBPIs) and other public authorities have made a dedicated effort. In the last year 200,000 SMEs were supported, but if that disappears tomorrow, they will not find private finance. Bank or market-based finance, including securitisation or ABS, is not at pre-crisis levels.

An official noted that the Juncker Investment Plan for Europe has used less than €5 billion and, with risk-sharing and co-investment, achieved €100 billion of finance for SMEs, allowing for the support of over 600,000 SMEs. Continuity of these activities must be assured. It is not only about numbers but about impact and creating ecosystems. In Bulgaria, Structural Fund investment was used with local partners to build an ecosystem. The same is now happening in Greece and elsewhere. Toolsets must be refined and dialogue with partners is key to getting the right framework. Instead of a galaxy of competing financial instruments, it is about pooling of resources for common objectives and this needs the right regulatory framework. The CMU is key to creating a conducive framework for market-based finance. Ultimately, financial instruments are about trust. A baseline is established over time and must continue to show meaningful impacts.

2.2. Actions at national level to help SMEs

An industry representative advised that the national complements the EU level. France has a diversified public-finance group dedicated to funding SMEs with private equity. It represents investors specialised in investing in small and mid-caps after IPO. This requires entities dedicated to public funding and capital. France has an efficient spectrum of public measures which are close to EIB and EIF tools. There is a question of insuring against market failure at different levels of the financing curve. Europe actively promotes the VC industry for innovation and tech, but investors can be cautious. The public authority has to avoid crashes or bubbles. National promotional banks have a responsibility to offer a stable environment for SMEs to grow without funding difficulties. Problems often arise after IPO as companies, especially hi-tech ones, may not have stable investors. European authorities could provide public support to show private investors that listing is not the end of the company's story and the NPBIs could be part of that.

2.3. Doing more with less public money

An official advised that financial instruments are useful for making an impact on the economy and should only be used where there are market failures. Needs are increasing in areas that have not yet benefited from the support of financial instruments, such as the social field. Financial instruments should increasingly be used in areas that are traditionally grant-based, such as agriculture and bio-economy. There is more to do around climate change, migration, security and defence. These needs must be served by an EU budget though it is likely to decrease. This means doing more with less and using public resources effectively, in order to catalyse private investments by creating an alignment of interests where the private sector sees advantages and policy goals are served. Financial instruments only work if parties' interests are aligned, risk is shared, and co-investments can make more out of scarce resources.

3. Obstacles to further development of the role of market finance in the financing needs of EU SMEs

3.1. Obstacles to attracting institutional investors to SME financing

An official advised that insurance companies are generally long-term investors and do not usually buy stocks to trade them. They can be global and local investors, which is important for SMEs. Insurance has a large amount of possible investment. In Europe, around 4% of insurers' assets are invested in equities. France has around 10%. Even moving a couple of percent towards equity would be a big change. Public authorities are an asset in fostering the development of the market, but private-sector equity must be available. There are challenges, for which Solvency II is a useful framework that was supported by many countries, but there are still issues and tension for insurers. The review of Solvency II is an opportunity to decide how it is accounted for in the prudential assessment of insurance companies. This should bring more equity to companies.

3.2. Venture Capital and SMEs

An official noted that the measure of equity that companies get per capita is €313 in Israel and €280 in the US. Sweden is the highest in Europe at €160; it is €49 in the UK and €23 in Germany. There is a pervasive market failure in equity through all stages of the VC field. The amounts flowing into the asset class in Europe are back to pre-crisis levels, at around €18 billion, which is roughly 20% of the US. The scale-up area of VC is concerning, where companies reach breakeven and become global leaders, so need bigger tickets. For every €1 put into this stage in Europe, the US puts in €21 and this translates into real results. The number of innovation leaders in 2017 with a market valuation of €1 billion is 16 in Europe, 91 in the US and 44 in Asia. Spotify was here, but it went to America. Good exits happen, but often in the US and China.

A policy-maker asked about the unbalanced VC market geographically in Europe. An industry representative advises that the EU is fragmented and central and Eastern Europe lacks scale though markets like volumes and depth, so consolidation is essential.

An official advised that the reasons for obstacles are complex, with no panacea reply. It is an issue of risk-taking by market players, some of whom do not have the required culture. Market fragmentation is a factor, as smaller markets are not cross-border, but equity investors require exposure to the whole of Europe. Different taxation systems, rules and standards are not helpful.

A participant in the floor asked about European representatives at Basel agreeing to increase risk weighting for VC. A policy-maker notes that regulators set capital charges commensurate to risk. It is understandable that regulators are cautious after a crisis. However, an industry representative considers that it will work in the US and probably the UK, but the EU is currently unattractive to private money.

Changes toward the CMU take time and are complicated. The direction of travel is the right one, but now is not the time to sit back. A better regulatory framework is required, as appropriate structures do not exist in many Member States to do VC. There is a need for appropriate skills. VC experts must have the right skillsets as this is a priority for investee companies.

Another requirement identified by 400 European VC funds is the supply side, namely more money and international investors in Europe willing to go into the asset class of pension and sovereign wealth funds and insurance companies. This needs an attractive proposition, with performing funds managed to generate returns.

New actors come into the market, sometimes from outside Europe. Corporates are also interested in investing in VC notably in the context of Techs, but have a different culture to the usual players. However, the size of national and European actors is a problem as the capacity of private actors to invest at a level higher than €10 million or €50 million is not there. This has pervasive effects on investment at public and private level. Long term structural evolution towards promoting bigger private actors in Europe is needed. NBPIs can play a part and and public authorities can promote a pan-European vehicle, with the Juncker Plan showing the direction.

An official stated that much has improved recently. Pre-crisis equity supply has returned but is low. New tools such as the Pan-European Venture Capital Fund allow investment in well-performing funds of funds that attract private money for various stages of development. Leverage gives more firepower to public money. However, building ecosystems must continue in countries that lag and, apart from a few exceptions, that is everybody, so more must be done. The level of ambition for equity finance in Europe must rise to create a viable asset class for companies that want to grow, and have the potential to innovate potential and create jobs in Europe.

Brexit will have an impact, as companies will have the alternatives of New York or London and neither will be in the EU. Spotify is an example of a Swedish company, financed in Europe, that crossed the Atlantic to seek growth. Stock-exchanges in Europe should help to scale up after VC. An industry representative advises that Spotify is symptomatic of Europe's inability to offer attractive conditions flows from an ecosystem which is unfavourable for stock trading. In this perspective in certain countries stock exchanges help screen and support initiatives for VC. In these countries where downstream the financing curve there are market-maker schemes and research to avoid the problem of nothing happening following listing, there is interest in the result of the funding process and it is important for exchanges to be involved.

However, requirements for the regulatory side of VC and enhancing the ecosystem, perhaps with tax incentives, would help. The goal is well-functioning, positive role models from VCs and companies that use funding initiatives.

4. The importance of developing market finance ecosystems that assist SME and are attractive to the younger generation

An official noted that ensuring that fund managers add value by working closely with investee companies, offering services, communications and network access, and giving a perspective on growth is built into the selection process and is a key assessment element. Fund managers who do this consistently have better chances of building funds. They have credibility and can syndicate and access deal flow. This is important when teaming up with universities or accelerators as a conduit for developing spinoffs. Smart money brings selectivity in the choice of manager and companies but is an area where one fund is taken for every 100 screened and each fund invests in a couple of hundred companies screened.

An industry representative noted the benefits of also assisting small private investors to invest in SMEs on the stock market, which fosters in the medium and long-term, trading culture. The younger generation looks to alternatives like crowdfunding, tokens and cryptocurrencies and not traditional systems. One answer is to convince young people to use larger funds and the possibilities that Europe offers. This is a challenge for regulators. The risk is of losing SMEs and the culture of traditional, safe, secure and well established organisations. A sandbox approach to regulation should be considered to encourage certain SME classes.

Impact of bank prudential rules (FRTB, NSFR)

1. Impacts on financial firms, capital markets and the CMU

1.1. The impact of over regulation on financial firms

An industry speaker described several studies conducted by PwC, highlighting in particular one carried out in April 2018 for AFME. Here, PwC undertook an ex post data driven study of how banks respond to regulations. The main body of post crisis regulation has been known for some time and it has been influencing banks' strategy, decision making and their choice of businesses and products. Via statistical analysis, the study accounted for other potential drivers of changes such as commercial performance, macroeconomics, wider financial sector trends, technological changes.

There were several key findings. First, there has been a significant asset deleveraging in capital markets activities since the crisis. Aggregate capital markets assets fell by 38% – and even more in rates, repos, credit, commodities and equities. Interestingly, this trend of deleveraging is global; it is not limited to firms or regions. Secondly, regulatory drivers have been the biggest contributors to balance sheet shrinkage. The aggregate annual regulatory cost to capital markets activities is estimated at $37 billion – or 39% of banks' total expenses in 2016. The data demonstrate an empirical connection between regulations, the size of regulated banks' balance sheet capacity and the transmission impacts on the intermediation activities of clients and markets.

1.2. The importance of Quantitative Impact Studies (QISs) to assess the impacts of regulation

An industry speaker noted that the data suggest caution about reforms still under consideration or yet to be implemented. In respect of the last QIS, banks had only 4 6 weeks' time to carry out the necessary work, and most banks had to do this on a manual basis. These factors affected the quality of the last QIS. Such QISs are very important. Banks must have enough time to conduct this work properly, because only then will it be possible to identify the impact of FRTB and any other regulation.

A policy-maker agreed that there are issue with the quality of the last QIS. There was a smaller number of QISs and they were rushed. The industry should have produced another iteration of the QIS. If this had occurred, the FRTB calibration would not have had to be opened. At the end of the day, this process may end up costing more time than would otherwise have been necessary for this process.

An industry speaker suggested that additional ex post QISs should be undertaken and completed with ex ante analysis, to enable a better calibration of complex prudential regulations to carried out.

2. The design, calibration and implementation of Basel III standards

2.1. The importance of consistent and timely implementation

An industry representative felt the most important aspect of Basel III is ensuring consistency in both the timeliness and the application of international standards. However, it is also very important that these standards should be appropriately calibrated. Post crisis reforms were necessary to restore confidence in market resilience, make markets safer and address 'too big to fail'. Another industry representative agrees with this, noting that a consistent, predictable and well calibrated set of international standards is the preferred outcome for all market participants and regulators for the standards to come.

A regulator turned to the issue of the impact of Basel III on Asian capital markets. It is important to remember that commercial banks play a dominant role in Asia. Therefore, NSFR and FRTB will have relatively minor impacts on individual Asian banks. However, the industry in Asia must have regard to the effects of Basel III on the underwriting and market making capacity of global financial institutions, including those in Europe, because these institutions play significant roles in the Asian financial capital markets.

An industry representative stressed how implementation delays cause dislocations in certain markets. The industry requires a dynamic implementation which is timely and also contains a feedback loop, hopefully facilitated by an international body. Only a dynamic implementation will allow the industry to adapt Basel III to the right size over time.

An industry representative suggested that the only other issue in respect of implementation should relate to the consistency of supervision. Under the SSM, it is easier to audit issues such as the consistency of risk weighting in the banking and trading books to identify gaps and use this as a basis to carry out internal assessments. This will enable the industry to address regional inconsistencies not through punitive and risk insensitive rules but rather through enhancements to supervisory practices that promote the consistency sought by all market participants and supervisors.

2.2. The development of a feedback loop in the process of standards setting

Another industry representative felt that the essential question on this subject is around how to create an appropriate feedback loop.

This representative felt that the haircut floor for Securities Financing Transactions in the Basel III finalisation package is reflective of the failures of the process by which it was developed: there was no impact assessment, not enough consultation and no advanced warning that it was about to be finalised. The impact is outsize and the design must be re evaluated. The Basel Committee and national authorities must consider the comments they are receiving on this issue as constructively as they considered feedback on FRTB.

Since the last Eurofi panel on this subject, the industry has stumbled into a very effective way to calibrate its proposals. Indeed, the concerns raised during the European implementation of Basel III caused the Basel Committee to examine what they had finalised in January 2016. With some reflection, they realised it was not well designed, not well calibrated and potentially could have had very significant adverse economic impacts.

Finally, it is a matter of perspective as to whether you consider the uneasiness observed during national implementation as a failure of the international standards setting process or a helpful feedback mechanism for international standards setters to use to recalibrate and reset the international standard. With FRTB, the Basel Committee took account of the concerns raised by industry during the European implementation. The decision to undertake a new consultation is incredibly constructive. The consultation incorporates many of the primary concerns identified by the industry, which is a credit to the Basel system.

An industry representative noted that, when the Committee finalises a standard, there is always a throwaway line in their report indicating that the Committee will continue to review the standard to ensure there are no unintended consequences. If the Basel Committee makes good on that commitment, they will remain a highly relevant body. Consequently, the process would benefit from a more formalised and more receptive pathway through which concern can be raised about the national implementation process. This process is the acid test for whether an international standard has landed in the right place.

2.3. The democratic deficit within the BCBS

A policy-maker felt there is an issue relative to the democratic legitimacy of the Basel Committee. In the US, Basel standards are directly implemented by the supervisors. In the EU, however, legislation must be passed by the co legislators to implement these standards. Ultimately, it is European legislators who make legislation for Europe. They take into account the recommendations of the Basel Committee, but these remain the recommendations of an unelected international body.

The Basel Committee is not elected by anybody. The value of its recommendations consists in the fact that, first, they are made by people who normally know what they are doing and, second, they will be broadly implemented everywhere. Their recommendations aim to create a level playing field, which is good for business and financial stability worldwide.

A Central Bank official felt that democratic legitimacy is an important issue in respect of the Basel Committee. The people who sit on the Basel Committee are sent there by democratically elected people, but that is not good enough. The main reason is the global nature of the standards. There is no basis for democratic legitimacy in respect of a global standard, so the Committee must find a way to manage.

One useful contribution to improving its legitimacy is transparency. In this perspective the Basel Committee has decided to issue an executive summary of the last meeting. Furthermore, the Committee is debating whether to issue advanced notice of the topics of its next meetings. If you only provide transparency about the last meeting and do not provide an outlook for what you will consider next, there can be no further democratic legitimacy. Indeed, publishing its work programme as well as a summary of its minutes would enable people to see what the Basel Committee is considering in the future and provide input for it.

An industry speaker stressed the importance of transparency. There is doubt over what regulators are planning to do in the next few years, and there is also a need for regulators to seek transparency on what particular measures mean for the market before producing regulations. It is important to continue further assessments of the effects of regulations on products, instruments and asset classes. If this is done in a proper way, the industry will produce regulations that are acceptable for most banks.

A policy-maker emphasised that the initiative taken by the Basel Committee to reach out to the European Parliament is very much appreciated by MEPs. The co legislators' role is at the very end of the process. At the moment, very little information about these issues is made available to the co legislators prior to them being asked to consider it. By reaching out earlier and explaining to MEPs what is happening, the process of passing legislation will become easier.

A regulator noted that the Basel Committee was not famous in Japan until recently, because in Japan Basel standards were known as 'BIS regulations'. The Japanese industry disliked these 'BIS regulations', because it was believed that these regulations were harmful to financial intermediations in the economy. However, this trend has changed dramatically during the course of Basel III. The Japanese industry thought that Basel III might not be agreed to by the Committee, and considered that it would not be an optimal solution because it could harm the global activities of Japanese financial institutions. Against this backdrop, towards the end of the finalisation of Basel III, the Japanese general public became very much internationalised and, by the end of the process, they expressed few complaints regarding the finalisation of Basel III.

A Central Bank official described how Basel III had similarly not been popular in Germany. Though it was famous, not everybody fully understood the detail of it. There was no real discussion of NSFR and FRTB, but everybody seemed to have an opinion about them. However, once Basel III was completed in December, this has diminished. The German banks have now agreed to fulfil Basel III, and the debate has gone away. In Germany at least, despite there have been more than a dozen meetings with German banks to involve them in this process, this has not helped the popularity of Basel III.

2.4. EU policy priorities suggested in relation to forthcoming BCBS standards

The industry representative felt that the framework for covered bonds in Basel III must be considered further. A well-functioning covered bond market is an essential aspect of financing the real economy in Europe. Last month, there was a joint proposal for a harmonised European covered bond framework which the representative endorsed. From this sound basis in respect of covered bonds, it is important for the Basel Committee to consider this issue. The Basel III framework featured a definition of covered bonds, but it is now time to fine tune how things are working in different markets. To give one example, in the current FRTB proposal covered bonds are stressed with 400 basis points in the credit risk stress of the FRTB. This is four times as high as the worst stress observed during the financial crisis, which would also apply to the best-functioning covered bond markets in Europe. If such a stress is imposed on FRTB, it will 'kill' a substantial amount of market activity in covered bonds, which will damage the real economy.

A policy-maker noted that the European Commission has made a proposal on Basel III, which is fairly compliant to the Committee's proposals. Should the outcome be different from the Commission's proposals, this would be because European legislators make amendments to the proposals. Moreover, the Commission has made a number of amendments to the original proposals, because there are several issues that must be reconsidered, particularly as regards NSFR.

First, there are parts of the standard which run counter to the international supervisory community's objective of moving clearing towards central counterparty platforms. These should be removed and re evaluated in order to reach the intended goal without any unintended consequences. Secondly, a number of features in NSFR do not make it easier to develop market based finance, which is one of Europe's aims. Finally, there are several problematic technical issues, such as the treatment of repos and reverse repos and the potential impact on liquidity.

FRTB is very important for the EU. Its late arrival is a pity, but this is an important reform. Europe must ascertain how to manage the recalibration of FRTB properly in its legislative process now underway. This question is still pending with the co legislators, but Europe is heading towards a legislative solution where it would keep the structure of FRTB as a piece of legislation and then insert the new calibration. Without this, the legislative process would have to restart from scratch – which guarantees that Europe will miss the implementation deadline.

3. Divergences in implementation in the United States and Europe

3.1. The implementation of Basel III standards in the United States

An official explained that the US Department of the Treasury supports the Basel III package and its implementation. However, it is important to note that the Federal Reserve is entrusted with the promulgation of the standard. Doubt over US support for Basel III results from a misunderstanding over the language used in the US Treasury's recommendations on the US banking system. These recommendations suggest that FRTB and NSFR should be calibrated before implementation.

However, too much has been read into this. The US Treasury supported its colleagues from the Federal Reserve when an agreement was reached last year, and the Secretary of the Treasury made statements in support of the completion of the Basel package. The US Treasury also supported the QIS on FRTB. The US Department of the Treasury and the United States Government are committed to continued engagement in international forums, including the Basel Committee and the FSB. The United States will not depart from previously agreed international standards, with the caveat that international standards must be promulgated by the Federal Reserve pursuant to the statutory authority given to them by Congress.

An industry representative stressed that most of the current regulatory effort in the US concerns a variety of US only regulations, including CCAR, the US G SIB buffer, and SLR. There is no issue relative to commitment to international standards within the US; however, the new Administration and the new regulators should reassess these US specific regulations.

An official explained how the US recognises that the world has a global financial system. It seeks a level playing-field in terms of the regulation of US domiciled banks. The US industry seeks the consistent application of the Basel standards for competition and financial stability reasons. The US will focus on financial stability during implementation, but it is important to do this smartly. There is a need to regulate according to size and complexity, which is why the US is seeking targeted relief for some of the smaller US banks. There is no need to gold plate the regulation of G SIBs. Recently, the Federal Reserve issued a proposal on potential recalibration of the leverage ratio, which is a promising direction.

A policy-maker emphasised that the European Commission has no reason to doubt the United States' commitment to implement the Basel standards. Of course, every country has its difficulties. There are always specificities to a country's industry which are important to that country. However, the value of the Basel Committee is its global reach. That does not mean countries cannot deviate somewhat here and there, but if they deviate too much the process loses its global aspect.

3.2. Divergence from Basel III standards in Europe

A regulator noted that the current European draft rules on NSFR and FRTB deviate from BCBS standards in the treatment of government bonds and reverse repo transactions. While expressing sympathy with this, the regulator stressed the importance of a full, timely and consistent implementation of these reforms in all major jurisdictions. The deviation from an international standard may be tiny in terms of capital impact, but it can significantly affect business strategy, risk management practice and give rise to regulatory arbitrage.

An industry representative described how the industry does not want Europe to deviate from the Basel agreement, though not everything has been correctly calibrated. It is very positive that the Basel Committee has realised this and is now trying to undertake recalibration. It is important that none of this recalibration should be forgotten, however. Killing a well-functioning market is akin to hunting a species to extinction. It is impossible to bring a market back to life once it is gone. Therefore, this recalibration must be done properly. It is important for the Commission to be aware of the industry's concern.

Returning to the subject of covered bonds, the industry representative noted that the EU's CRR2 proposal featured a stress, the level of which was half of the Basel Committee's one. Because Basel rules are implemented in all European banks, it is also important to take account of specificities and recalibration even when creating reporting standards.

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Insurance groups in the context of the CMU

1. No major changes have occurred in the portfolios of insurance companies since the introduction of Solvency II

A participant noted that excess savings in the north of the Eurozone and insufficient in the south creates problems and increases the fragility of the Eurozone. Another problem is that the insurance business has large amounts of sovereign debt in insurance companies' portfolios. The risk is supposed to be zero but is really high, as shown with the Greek debt. The risk exists for much sovereign debt in the Eurozone, so it is incoherent to see the charge on public debt compared to that on the private sector.

A participant advised that the priority for Europe is to fund research and innovation, but the war is being lost to the Chinese and the US in terms of innovation, research and artificial intelligence. It has to be funded. There is money in insurance companies that has to be used to fund these parts of the economy. The problem is a conflict of interest. It is convenient for government to make a deficit and to fund it at near-zero rates. It is a political problem, and the private sector has to deal with it seriously for the future of the economy.

A regulator noted that however, the insurance sector is an important institutional investor in Europe, with more than €10 trillion investments. Comments suggesting that the insurance sector needs to invest more in the real economy imply a lack of investment, however, commentators maintain that the insurance sector has in fact heavily invested in the European economy.

However, perhaps due to past restrictions on investments or asset-liability-management strategies and different risk appetites, European insurance investment has focused on government and corporate bonds.

The CMU includes a number of elements with the intention of diversifying the EU's funding sources from a purely banking privilege channel. A pan European pension plan has been proposed by the Commission to foster long-term investments. The question is whether insurers can contribute, given their portfolios and liabilities, considering securitisation and other non-liquid investments.

A regulator informed them that, ahead of debates about the CMU and Solvency II, there was a profound change in the regulation of insurers' investment activities. Past constraints on investment under Solvency I were abolished. Solvency II has a new principle of Prudent Person Principle investment, where insurers decide on investment policies taking into account quality, liquidity, security and profitability to make a risk-reward analysis. This is the paradigm of Solvency II. Though, the devil is in the detail when calibrating the capital charges required for different investments and it can be difficult to plan the appropriate regulatory treatment. However, Solvency II allows insurance groups to fine-tune their risk approach for investments, which many do through internal models.

A regulator explained that no tectonic changes have occurred in the portfolios of insurance companies since the introduction of Solvency II. There has been movement, particularly in corporate bonds, with an increasing duration of portfolios. Groups are steadily investing more in infrastructure, particularly qualified infrastructure. There is also stable investment on equities. However, an industry representative considered that the calibration of equity had been detrimental to investment in equity.

2. The involvement of insurance companies in financing EU economies since the launch of the CMU

2.1. Setting the conditions and incentives for funds to flow to asset classes that are less favoured in the EU by insurance investments

A policy-maker agreed that insurers play a large role in funding the economy. The Capital markets Union is about diversifying sources of funding and channelling funds to where they are most needed in the EU. The question is whether those trillions of euros are going to where they are most needed, and it seems that more could go to equity or long-term investment.

An industry representative felt that the CMU has been designed piecemeal with many goals and initiatives but is missing institutional investors. Creating or growing a market requires looking at supply and demand, but if institutional investors' needs do not seem to be at the forefront, then it will not attract them.

A public representative advised that the European Parliament supports an ambitious CMU incorporating the insurance sector. Progress on the CMU is not satisfactory, but the goals attached to it may not be achieved by the CMU alone, so that a holistic approach is needed. New financial market regulations cannot solve shortcomings at the national level or induce a healthy and sustainable economic environment. Fruitful investment environments require efforts beyond the legislative package of CMU related measures. In addition to the regulation regarding the insurance sector there has also been the creation of the ELTIF and a revision of the EuVECA (Venture Capital) regulation. This may be perceived as piecemeal, but what is more important is that the pieces should fit together.

The Commission has been focusing on the required conditions and incentives for funds to flow to asset classes that are less favoured by insurance investments. Legislators have alleviated obstacles to insurers' contribution to growth and the financing of the economy, for instance, with the long-term guarantee package in Solvency II in the implementation phase of the directive, including the early revision of the delegated acts, infrastructure-finance equities and securitisation.

A regulator felt that the insurance sector has a role and is playing it, due to the excess savings it collects and the need to match the duration of their long-term liabilities. Prudential regulation aims to ensure financial stability, consumer protection and confidence, and the soundness of firms. These objectives are consistent with long-term investment because the driver must be a sound supervisory and regulatory environment that avoids negative externalities and prevents potential crises. Sources of inconsistencies such as regulatory arbitrage or mis-calibration should also be reviewed. Solvency II contains features supportive of long-term investment; particularly the Prudential Person Principle, and Pillar II measures. All this gives firms freedom in setting out investment strategies.

A regulator highlighted in this respect many specific developments, such as treatment for infrastructure investment. Europe has a dedicated infrastructure asset class for the first time, with granular treatment of investments. It is encouraging that in the EU the Solvency II calibrations for dedicated infrastructure capital charges have led to ongoing work on infrastructure as an asset class at an international level.

Proposals are also with the European Commission regarding the treatment of unrated debt and unlisted equity by assessing risks in these different investments. The recalibration of investments in securitisation will hopefully follow the securitisation proposals in January 2019. Studies on the drivers of investment in equity in Europe and drivers of insurer and pension fund investment in equity are progressing.

Accounting treatment is important for insurers. Accounting issues regarding long-term investment are being reviewed according to the broader sustainability theme, which encompasses long-term and sustainable investment.

2.2. Possible fundamental misconceptions of Solvency II and International Financial Reporting Standards (IFRS)

• Addressing regulatory pro-cyclicality

An industry representative agreed that Solvency II is not perfect but marks significant progress. The recalibration of infrastructure and securitisation is welcomed by the industry. However, the key question is whether Solvency II, which works well in benign capital-markets, is fit for less benign scenarios i.e. it would be disproportionately pro-cyclical in difficult times. This question goes beyond calibrations and the 2018 review.

Indeed, such a possible pro-cyclicality is linked to long-term investments because the usual regulatory response to avoid pro-cyclicality is additional capital and buffers, the cost of which is eventually borne by the projects and corporates being financed. In addition, potential regulatory pro-cyclicality raises a question over the consistency of the regulatory framework with the business model of insurance companies which are long-term investors holding assets to maturity, suggesting that the framework reflects artificial volatility that is not consistent with the actual risk profile of insurers.

A regulator noted in this respect that features including the one-year Value At Risk (VAR) and the balance sheet reflecting economic value are often mentioned by commenters a disincentive to some long term investments. However, evidence and analysis show the long-term balance-sheet stability of the investment, including in equities and that prudential regulation might not be the most important driver.

The concern is ensuring future-proofing from a macro-prudential perspective and assessing the triggering of pro-cyclical behaviour in a crisis. There are volatility adjustment mechanisms and macro-prudential features within Solvency II. However, if it is pro-cyclical, it should be fixed within the regulatory framework to free up capital for deployment in equities or real-income investments. That will mean that investment decisions are driven by underlying economics and not regulation.

• Rating agencies have constraints that also limit investment options

The question is about maintaining an appropriate equity allocation to ensure a good rating with the ratings agency. If there is no room to increase the risk-asset ratio, it can be rebalanced, but no more can be added without risking losing the investment-grade rating.

• Regulatory investment opportunity-costs

An industry representative explained that insurers will naturally invest long term, so it is not about adding incentives but removing disincentives. He stressed however that the issue is not about recalibrating certain asset classes but that of a regulatory-driven bubble. He stated in this respect that financial repression is the elephant in the room. Government bonds make up half of investments and have a zero-capital charge, which distorts the calibration ladder. These are not niche asset classes but insurers' main asset classes.

A regulator agreed with many of the points made. It is true that it is a political decision and that sovereign debt is treated in the standard formula with zero calibration, but it is already considered in internal models. This expectation is clear. Internal models around Europe already show risk charges on sovereign debt. It is part of the discussions and the equation in the ORSAs and analysis in Pillar 2. An unbiased calibration of risks is also the basis of a discussion for Pillar 1 and the standard formula.

• Liability-valuation constraints weigh on investment

He added that adjusting certain calibrations will not either address the massive impact of inappropriate liability valuations resulting from the ultimate forward rate (UFR) curve imposed by Solvency II to discount them, which ignores their actual market value. Indeed, investment is heavily driven by liabilities. If a portfolio contains interest rate guarantees, investing depends on matching that closely, as well as matching the movement of the interest-rate curve.

• Accounting standards fail to take into account insurance specificities

IFRS standards for accounting assets (IFRS 9) are also challenging for insurance business models, since they propose unsatisfactory options which are locking investment gains, or running them through P&L with accompanying volatility.

Furthermore, another industry representative noted that there are many things that do not work in IFRS 17 (IFRS standards for accounting insurance companies' liabilities), including the unit of value, which is against the spirit of mutualisation. Reinsurance recognition is badly done in IFRS 17 and does not work. He expressed the view that that European institutions should carve out IFRS 17 in 2018. This would constitute a first step for Europe taking its accounting policy back into its own hands. Since instantaneous, volatile, point-in-time valuations of assets do not work, it would show that European accounting is serious and not about rubberstamping IFRS work.

A policy-maker noted that additional costs stem from differences between Solvency II and IFRS 17, on the level of granularity of IFRS 17 information and whether the level of detail in Solvency II is sufficient to meet the IFRS 17 requirements. The issue is being monitored in the endorsement process and an analysis has been commissioned into the differences. An external study is expected at the end of April, so it is being taken into account. IFRS 9 and the accounting treatment of equity investments and whether potential investments are necessary are also being reviewed. The market is being listened to and its issues taken on board. Some can be fixed, but others cannot. For some, there needs to be regulatory stability. It is good to keep to a certain timeline rather than doing things too quickly.

3. The timetabling and sequencing of forthcoming legislative changes at EU and international level

3.1. The timetable for a legislative review

What makes a difference to investments is whether an asset or equity will create value over time, and this is critical. A secondary consideration is how it fits in with the P&L and solvency ratio and there are no easy answers.

There is no quick fix for Solvency II or IFRS, as it is a complex situation. In addition, markets are currently not normal, with implications for prices. An industry representative explained in addition that the forthcoming timetable has created a situation where International Common Standards (ICS) 2.0, which is similar to Solvency II but not identical, will most likely be endorsed in 2019. That will contain mandatory reporting, so probably of a softer type. A Solvency II review is due in 2018 and another in 2020-21. Endorsement of the new IFRS rules is also due in 2019.

An industry representative felt that, at least, the 2020 review should look at what has been endorsed in 2019 at national and IFRS levels, and whether simplification is possible, such as using IFRS balance sheets within a Solvency II context.

3.2. Key success factors for an appropriate definition of insurance regulations and standards in the global context

Recalibration of infrastructure assets and proposals under the call for advice on unrated debt and unlisted equities will be taken over by the Commission, with Europe and the international supervision community working together under a mandate. It is important not to overstate the role of prudential regulation. It is not a static issue and topics should be reassessed for areas of potential inconsistencies. The PEPP proposed an important initiative to work alongside information to customers and a prudential framework. There are also tax issues. There must be awareness that recalibration of an asset class adds complexity to the framework. It requires analysis and balance between removing obstacles and the criteria to be applied. Solvency II is a sophisticated, complex framework for a potentially limited outcome in capital charge.

Another panellist advised that regulations on insurance products that give options to people are desirable. For instance, in France non-life policies can be taken out at any time and given to another insurer. But this results in less stable, less predictable liabilities and consequently in shorter investments.

There should be caution over cherry-picking certain investment options and asset classes for softer regulatory treatment. It is better to make a holistic assessment and return to principles of market consistency and evaluation. This is the aim of the initiative report on stocktaking and challenges, in which a cumulate impact assessment is set out as a major demand. This is appropriate and helpful for the overall aim.

A regulator noted that the long-term guarantee package is instrumental in addressing potential shortcomings and will be reviewed in 2020. That will be prepared with the annual survey of EIOPA on the use of the measures. Indeed, work on annual reports point outs most useful measures and whether they are used.

A public representative informed them that regarding regulatory improvements it is important to be coherent. Facilitating financing by insurance companies should not be offset by counteractions elsewhere. Two prominent examples are the premature revision of the UFR curve as part of the Solvency II interest-rate curve, as well as the overly extensive standard formula review, which proposes to cover sub-models such as interest-rate risk. These actions are not coherent with political agreement on the legislation or the goal of supporting the CMU's overall agenda. These amendments risk harming the balance that was achieved in the Solvency II framework, which was to enable long-term financing while fostering stability. In addition, nothing is as detrimental to a good investment climate as uncertainty. Stability covers economic, political and legislative stability. The agreed timetable for revising legislation should be followed as the legislation is made for a long-term purpose and for long-term business models.

A public representative noted that anticipating future legislative changes is difficult but crucial. When deciding on regulatory requirements, it is important to take into consideration regulators' future plans. This includes envisaged changes in international standard setting for insurance. Insurance companies face additional compliance burdens with international requirements, yet globally active companies have the capacity to contribute substantially to the financing of the EU in terms of size and economies of scale. It is important to promote policy goals at the international level. In addition, pending legislation offers opportunities to re-evaluate the contribution of insurance companies to the financing of the European economy.

In terms of an articulation of the European timetable and priorities with international sequencing, especially with respect to the longstanding and long-term project regarding ICS, the agreement that was endorsed last year in Kuala Lumpur by the IAIS is pragmatic in its commitment to moving forward in a realistic manner. The international standard will not be binding before 2024 but will be used in an interim period of five years as a benchmark and to foster a supervisory dialogue. That is desirable from a European perspective and there will be time to finalise it. The IAIS evaluation method is not Solvency II but will be close and familiar to European firms. Europe has room to move forward with its priorities. Changes led by international standards are not anticipated in the short term; so there is time to accommodate this work.

FOSTERING FURTHER INTEGRATION OF EU FINANCIAL MARKETS

Review of the operation of the ESAs

The three European supervisory authorities (ESMA, EBA, EIOPA) aim to sustainably strengthen the stability and efficiency of the European financial system in response to the financial crisis which exposed significant failures in financial supervision. Their responsibilities include defining common practices and standards for the regulation and supervision of banking, market and insurance activities, and ensuring the consistent application of these measures within the single market. They launched their activities on January 1, 2011.

The Chair noted that the Commission's proposal for reviewing the ESAs cannot be ignored. Since then, 8 years have elapsed and it is timely to assess the efficiency of these entities and their future in the context of the implementation of the Banking Union, the Capital Market Union and the Brexit, which require common approach at the EU and Eurozone levels.

The context notably links to Brexit, as it risks the EU moving away from a major financial centre and other centres to a multitier financial centre. At the same time, proportionality and ring-fencing policies of Member States threaten the internal market. Strong ESAs and consistent implementation of the single rulebooks are therefore critical. Legislators, assisted by the Commission, are dedicated to ensuring that the single rulebook is fit for purpose. Energy and effort is lost if implementation is not consistent. Consistent implementation and supervisory convergence within secondary legislation are why the review is so crucial.

1. The priorities to improve the consistent implementation of the single rulebooks and equivalence arrangements with third countries

1.1. The positive role that the ESAs has played in fostering the creation and implementation of common rules for financial services in the EU is widely recognised

A regulator stated that the rulebook's content is a success story. ESMA, for instance is a success and has been able to reach unexpected results through quality (external) staff and the involvement of the National Competent Authorities (NCA). Gold-plating is strongly reduced regarding ESMA's tasks, which is a positive development.

One of the most revolutionary aspects of the ESAs was the possibility of launching the Regulatory Technical Standards (RTS) without implementation through national parliaments. It was a revolution decided during the Belgian Presidency in 2010. Now there is no more discussion about it.

Another official noted that the ESAs are children of the crisis and so only seven or eight years old. A question is whether it is prudent to wait for the next crisis to allow them to grow or take the opportunity of positive aspects like the CMU, or external factors like Brexit, to build supervisory capacity within Europe. The single rulebook has taken tremendous work and, while there were still things to be done, the situation for financial markets has improved.

The industry complains about the length of the European regulatory process, particularly MiFID II, which raised concerns about a possible MiFID III, as well as Solvency or CRR. Trust is lacking between Member States and EU institutions, as well as, for financial markets, among national supervisors or authorities. Explaining the European process is key to finding compromises, as with MiFID II and high-frequency trading.

1.2. No integrated markets without integrated supervision

All the panellists agreed that supervision convergence is at the core of what is still to be achieved. A policy-maker commended the work done on the single rulebook and the achievements since the crisis years. The ESAs have done a great job in making the rules concrete and designing common technical standards, however, consistent application still lags. Consistency is essential to eliminate cross-border barriers and create a level playing field, which is critical to support the Capital Markets Union project and prepare for Brexit. It is about creating a virtuous circle, where integrated markets need integrated supervision, and integrated supervision drives integration of markets.

A key motivation for the Commission proposal is improving conditions for ESAs to drive the consistency of rules in the financial sector within the EU and for third countries, which is important in today's context. This must be done without putting into question the role of national supervisors, as there needs to be symbiosis between them.

A regulator explained that they value good-quality supervision. The financial crisis had eroded to some extent the trust in national supervisors resulting in the Banking Union and ESA structure. The ESAs were not granted direct supervisory tasks, except ESMA for rating agencies and trade repositories taking into account their cross-border characteristics. It is a question of what the EU wants to achieve, be that integrated financial markets, minimising risks spreading between countries or deterring cross-border consumer detriment. High quality supervision is required for integrated markets to function and that means more powers should be granted to the ESAs. These must have a value-add, otherwise, if something is done better nationally, so be it. The issue of a level-playing-field should be the responsibility of the ESAs.

1.3. Is a fundamental modification of the governance structure needed?

A public representative agreed on the importance of the consistent implementation of the single rulebooks and supervisory convergence but convergence should not result in evening out all differences but should focus on addressing existing deficiencies in supervisory practices. The extent to which it exists is due to the Commission and co-legislators, however, the system of implementation requires change. It is not successful enough, but this alone does not justify an overhaul of the ESAs' governance structures. Small adjustments to the existing governance structure would work as well. The speaker did not share the underlying idea of the legislative proposal that there is a general mistrust vis-à-vis the national supervisors. Building on the expertise and experience of national supervisors in the revised ESA system is essential, as is guaranteeing that national supervisors will have ownership in the common project of successful European supervision.

An official noted that jurisdictions with federal supervision rely on supervisory authorities. A single rulebook that is understandable by everyone requires strong ESAs. A huge amount of work has been done but the ESAs dedicated a great deal of the first years of their existence to writing and delegating RTS. That means that they need a greater degree of independence. Concentrating governance on a board of supervisors with the power to focus on key issues, helped by an executive board, made up of a European workforce is core to this proposal.

Improving the functioning of the ESAs is a step by step approach based on experience. It is necessary to avoid conflict of interests and rely on people appointed for their competence and European interest for improving supervisory convergence. Member States should also concentrate their regulatory activities on political issues at the level one of the process and accept that supervisors address issues linked to technicalities at level two or three. In this perspective, ESAs should have a real, interactive and appropriate dialogue with the industry. It would be counterproductive to protect them from it. Sufficiently independent and strong-minded people are needed, who are able to meet with the industry in an adult way, to find solutions within the political lines set up in Level 1 legislation.

1.4. Increasing the decision making, arbitration and investigation powers of the ESAs

A policy-maker advised that it is critical to improve existing convergence tools and create new ones in order to achieve more supervisory convergence. In this perspective it is essential to increase the decision making, arbitration and investigation powers of the ESAs in different areas such as: breaches of Union laws, the settlement of cross-border disagreements and the consistent implementation of EU requirements (e.g. possibility for them to conduct independent reviews).

Independent governance is key but cannot be done without appropriate funding. Difficult decisions on the ESAs' annual work programmes and budget must be made, so that the budget is flexible and controlled, with sustainable costs. The ultimate way to achieve supervisory convergence is direct supervision. It is important to acknowledge views that the balance is not right and seek suggestions that maintain the goals of consistency, better governance and sustainable funding.

A regulator agreed that promoting supervisory convergence is important, and the ESAs should have sufficient tools to intervene in cross-border problems. The current tools are not adequate and require enhancement. If problems occur in individual jurisdictions, the ESAs should have powers to intervene.

A regulator agreed that peer review works to the extent that supervisory deficiencies can be named and shamed. There is no place for weak gatekeepers at the national level, especially when they are in charge of an ecosystem with a European passport. If one of the national gatekeepers is not strong and is not professional, there will be a spill-over effect. In terms of supervisory convergence, there is no problem with the so-called strategic supervisory plan, as such plans are already in use in some Members States. The mission statement of many NCAs is however broader at the domestic level than at the European level. There are supervisory tasks in insurance, consumer protection and contract law, which means that MiFID consumer protection is only part of the whole product supervision.

Peer review can take place if a problem arises with NCA supervision. An executive board is not necessarily required for that purpose. A review committee chaired by ESMA staff with NCA staff would improve the quality of supervisory convergence.

1.5. Entrusting the ESAs with the responsibility for monitoring the regulatory and supervisory practices of third countries

A public representative noted that the European Parliament has long aimed for a coherent approach for third countries. This is even more relevant because of Brexit and is a duty that has to be directed to the European Commission and the co-legislators. Continuous monitoring of third country equivalence has a significant loophole to be closed. Entrusting the ESAs with monitoring is wise and should be done.

The Commission's approach to the delegation of tasks to third countries could be improved both inside and outside the EU. The free movement of capital and services should not be restricted, as globalisation brings benefits to the economies. Precision is needed around what is to be achieved and the necessary instruments. Avoiding empty shell companies and a bureaucracy of authorisation papers will not get to the root of the problem. It is better to foster onsite inspections with a major role for ESAs, while extending peer reviews involving third-country issues and supervisors, in connection with the equivalence process. Much is still to be done around the ESAs' regulation of third countries. ESAs should be granted substantial but practicable contra-possibilities on third-country equivalence.

2. Increasing the direct supervisory powers of the ESAs on cross-border activities where there are strong synergies at the EU level

2.1. The need to differentiate more explicitly the objectives and roles of the three ESAs

A public representative stated that the ESAs were created at the time of the financial crisis, in an atmosphere of urgency and pressure. All three authorities were equipped with the same level of competences and tasks. Revising the ESAs is an opportunity to take account of distinguishing elements between the financial sectors. There is no automaticity in having the Banking Union as a blueprint for a CMU or an Insurance Union. All sectors have specificities and business models, and supervision should mirror those. Proposing three separate regulations is positive. Supervisors' demands and sector specificities must remain proportionate.

Another official noted that If the ESA review is to be fruitful, it might be interesting to have two debates. The CMU does not mean a copy and paste of SSM. Regarding the ESMA tasks, there are no national champions and banks are not directly prudentially supervised. It is about supervising thousands of products and about rules of conduct. A real federal system means supervision without any gold-plating at a European level, with close interaction between ESMA and the NCAs, which means strong supervisory convergence. Real peer review is critical.

2.2. Increasing the role of ESMA for wholesale securities markets is not an issue but National Competent Authorities are best placed to supervise the compliance of retail products with the applicable legislation

A regulator explained that one should consider the right level of supervision at the right level. In this respect the main distinction to be made are between wholesale (B2B) and retail (B2C) markets.

ESMA cannot supervise everything. There is no problem with wholesale activities or critical benchmarks, data providers. We can also envisage to extend the supervisory powers of ESMA - and more generally the ESAs – to provide them with the ability to set reporting standards related to EU legislations in order to facilitate data consistency and sharing also to centralise at ESA level the development and maintenance of related databases and IT systems. However, CCPs are another issue, legally and politically.

Another regulator also considered that supervisory powers could be granted where there are few cross-border players, such as critical benchmarks, data providers or the collection of trade-reporting data. Where value can be added by doing things centrally, it should be done, so ESMA could be granted these. There is not much value-add in giving ESMA a role on retail products. The EBA's role with the ECB is different, as are EIOPA and ESMA and so slightly different stances are required.

While it might be difficult for the global banking industry to admit, most of the time, the financing of the real economy at local level remains a national issue in the framework of unified, harmonised regulation. A regulator gave the example of specialist issuers' prospectuses. It is not meaningful to think that ESMA could be in charge of ad hoc prospectus supervision and that issuers would go to the local NCA for day-to-day supervision of regulated information. It would be surprising. In terms of advertising relating to financial products, national authorities supervise and approve large numbers of adverts every year in a variety of languages, with the majority approved, usually within days. It is smooth and efficient and would be difficult for ESMA to have that capacity. Specialist issuers are spinoffs and start-ups in biotech, pharma and real estate and are not usually interested in having a passport, because the investors are retail, not institutional. In sum transferring supervisory powers over retail products to ESAs would ignore the existence of local ecosystems and risks leading to less efficient supervision.

The added value of the ecosystem is an interaction between ESMA for regulation of third countries. Following Brexit, ESMA might be a partner for the SEC or for the FCA. That is a traditional coordinating role performed by the European Commission or by an agency like ESMA or EIOPA. The retail market is a world away from institutional aspects.

2.3. Maintaining supervision at the domestic level is necessary for consumer protection which rely on domestic rules

The Chair noted that peer review is a lengthy process and asked if there was an argument to move the governance to ensure that ESAs can do cross-border work where consumer protection is hampered in cases that are not breaches of law.

A regulator answered that it will be a problem if ESAs are unable to fulfil the task of consumer protection at a European level. However, their mission statement is limited. Some of this is tackled domestically, as around 60% of tasks are linked to consumer protection where there is no plan to extend European legislation to the insurance sector or have new aspects related to consumer protection in contracts. The leitmotif is not Europe versus countries, or ESMA versus NCAs, it is ensuring the most appropriate supervision at the right level. ESMA is for wholesale or B2B and NCAs are best-placed for B2C. The extension proposed by the Commission is amazing. In English, it is an eclectic list; in French, c'est un inventaire à la Prévert. There will be difficulties in approving a prospectus in Paris and taking it back to countries for day-to-day supervision.

2.4. Asking EIOPA to ensure the comparability of internal models used across EU insurance companies would be a major step forward

The Commission's proposal addresses a critical level playing field issues. EIOPA is proposed to have a coordinating role in the internal model approval process. This is not a popular topic, but would be a major step forward The ECB's supervisory focus on internal models via the Targeted Review of significant institutions' Internal Models (TRIM)[1] highlights the validation of models, whether they are being used appropriately and consistently. There is a great deal to be improved.

The challenges of the modelling are in no way a privilege of the banking sector. Indeed there could also be arbitrage and different approaches in the insurance sector. Almost 40 cross-border insurance groups in the EU use internal models, so one can question whether it is right that these give different results. Companies cannot be compared with each other when capital requirements differ. It would be a major problem if banks had reduced capital requirements through incorrect models. This should also be tackled with insurance groups. The easiest way forward, as in all issues between ESAs and national supervisory authorities, is to work together on EIOPA procedures or similar regarding the approval process.

In such a context, EIOPA should have a coordinating role in approving internal models. They should also have some powers in this supervisory process. Of course, that requires adequate resources to fund salaries for high-level expertise with considerable experience in the market. Without these powers, there can be no level playing field between countries, as some insurance companies will benefit while others lose. That is not the desired result of integrated markets.

3. Conclusion

The Chair closed the meeting and summarised the position that, the ESAs having been set up during the crisis, it might be the right time to ensure that the system is ready for the next crisis and for Brexit. There is room for improvement and it is hoped the review will be successful and be adopted under the current EU Commission and Parliament and not be postponed any longer.

1. The targeted review of internal models, or TRIM, is a project to assess whether the internal models currently used by banks comply with regulatory requirements, and whether their results are reliable and comparable. One major objective of TRIM is to reduce inconsistencies and unwarranted variability when banks use internal models to calculate their risk-weighted assets. TRIM also seeks to ensure consistent supervisory practices. TRIM on-site investigations started in 2017.

How to foster EU banking integration?

1. Despite major institutional achievements, the existing regulatory framework still favours a fragmentation of banking markets in the EU

In the 10 years since the financial consolidation in the European banking sector has been very limited, contrary to the United States. In reality, in each EU Member State, lending to the economy remains largely domestic. At the same time, the market share of US banks in European investment banking is now nearly 50%, while EU banks' share in only 38%, down from 43% shortly after the crisis.

1.1. Why has there been little cross-border integration?

A Central Bank official stated that the financial crisis has only been over for a few years and that recovery remains ongoing, although much progress has been made. The economies are moving in the right direction, which is very good news for everyone, but this has only happened rather recently. Political uncertainties remain in Europe, such as in the case of Brexit. Most importantly, the Banking Union is not yet complete. In the supervision area, the SSM (Single Supervisory Mechanism) is fully at work and is already a success although the resolution part still needs further work. The deposit insurance scheme – the third leg of the Banking Union – is still a work in progress. Thus, despite coming a long way in recovering from the crisis, the economies still have a way to go.

An industry representative suggested that the regulations, including Basel III and the various iterations of the CRD (Capital Requirements Directive), are organised in such a way as to prevent consolidation in practice because cross-border lending triggers additional capital requirements and is therefore more costly than domestic lending. As an example, he explained that a New York bank lending to a Californian corporate does not increase its systemicity score nor does it create any specific need for additional capital. However, when a Belgian subsidiary of a French bank lends money to a Belgian corporate, it triggers an additional need for capital for the parent group. Thus, in terms of capital, it costs a bit more to lend in Belgium than to lend in France.

While acknowledging that this may not have been the intention of the regulation, the representative underlined that the Banking Union as a single constituency for the purpose of the G-SIB (global systemically important bank) score is not recognised by Europe. Such a decisive action would only require an amendment to a single sentence in the CRD IV. The speaker expressed dismay at the seeming reluctance to carry out such an amendment and noted that the current CRR (Capital Requirement Regulation) / CRD discussion provides an opportunity to make that change and this, notably, would not take any power away from local supervisors.

The industry speaker also noted that the solo requirements, especially in terms of liquidity, are preventing liquidity from moving within the same banking group and within the Banking Union. While the single market is built on the pillars of free movement of people, goods and capital, it does not seem to be based upon the free movement of liquidity in banking, which creates an issue in an "Banking Union area".

In sum, according to this industry representative, European policy makers have expressed their wish for industry consolidation but there is no attractive business case to create pan European banking groups. The existing EU regulatory framework still favours fragmentation of banking markets in the EU. In practice, banks are not operating in a single banking market but as a sum of separate entities by country, because international regulations, intended to apply at consolidated level, have been transposed at solo level. Without adjustments to this framework, cross-border consolidation will not happen except for limited and selective acquisitions related to specialized businesses.

1.2. Consequences of non-integration

The market share of the five biggest banks in Europe in terms of total domestic assets on the balance sheet is 20%, whereas it is 40% in the US. This is a worrying trend because the market share also stood at 20% in 2008 and so nothing has changed. Since then, the volumes of credit have increased somewhat, despite the crisis, which means that the production of new loans and credit is as fragmented as the outstanding amount.

The world is globalising very quickly and corporates tend to be more international. Hence, the big corporates and even the large mid-sized corporates need services and loans abroad that small domestic banks, while very useful for the local economy, cannot provide. Instead, those large corporates will need bigger international banks not only for such loans but also for forex strategies, options, interest rate risk management and so on. They need to access the financial markets and they need to issue bonds, and it will be the big international banks, not the savings banks that will help them in issuing bonds.

In such a context, if Europe is not able to build a certain number of big international banks, it will be putting its economy at the risk of being a second tier economy, the Eurozone will continue to lose its financial sovereignty and will be vulnerable again at the time of the next crisis, despite all efforts put into swift building of the Banking Union.

2. Fostering more integration in the EU banking market and addressing the obstacles that currently hinder it

2.1. Benefits of cross-border consolidation

The speakers agreed on the need for the EU economy to benefit from large and diversified banks to finance it through competitive lending across the monetary union and through providing pan Eurozone access to capital market products. Consolidation in the banking sector has many benefits: cheaper and better products will be available to consumers due to increased competition; Member States will be enjoy a better level of private risk sharing, which is an important objective of the process; central banks will benefit from more financial stability due, inter alia, to a reduced sovereign bank nexus; and the EMU (Economic and Monetary Union) will benefit in terms of the monetary transmission channel. Although it is not a risk free endeavour, consolidation is worth striving for in Europe.

2.2. Solutions for fostering cross-border consolidation

A Central Bank official stressed the importance of solving some of the legacy issues that are holding the economies back in terms of the conditions in the banking sector, including those for NPLs (non performing loans). In addition, the ongoing regulatory processes need to be completed. Basel came to an agreement in December last year, which now provides much requested regulatory certainty and, for the first time, there is a Basel accord on the lessons from the crisis with new initiatives and plans. However, Basel is not legislation but an international standard and therefore still needs to be transformed into European legislation.

Further economic growth will help create more convergence, and consolidation will come with the completion of the Banking Union. A Central Bank official believed that, since many initiatives in the regulatory arena are still being implemented, it is important to finish what has already been started rather than adding to the changing regulation. In particular, very little progress has been made on the deposit insurance side and it is very important that the remaining elements of the Banking Union are finalised in order for it to sufficiently control the risks that would come about with major cross-border mergers and acquisitions.

An industry speaker dismissed the relevance of the deposit insurance scheme in this regard, citing the free movement of capital in Germany, which is a country with at least three different deposit guarantee schemes. The speaker believes the issue of deposit protection is easily solvable with the minimum of liquidity backstop between the different deposit guarantee schemes.

Instead, the industry speaker believed that this is a question of will. The SSM controls all the major banks including, by definition, all the banks with cross-border activities and there is also the Single Resolution Board and the Single Resolution Fund towards which the speaker's organisation contributes more than €500 million per year with very little in return in terms of free movement and free organic development of its activities in the area. To put an end to this situation, Europe needs to regard the Eurozone as a single constituency so that the creation of the SSM, SRM and SRF can deliver its intended benefits.

A Central Bank official acknowledged that banks should be focused on risk weights, capital requirements and whether something can be done at more or less cost but added that there are a number of developments that are just as important for the strategies of banks in Europe and just as important as changes in capital requirements due to Basel or Banking Union issues. For example, the banks can play a role in striving towards a capital markets union in Europe. In addition, the development of fintech is important to the banks' strategies. From a regulatory or supervisory perspective he highlighted the importance to achieve an EU agreement on the third pillar of the Banking Union (EDIS).

2.3. Transforming subsidiaries into branches

The speakers agreed that many regulators and supervisors are less at ease with branches than subsidiaries because of the control and the information that is available on a subsidiary vis-à-vis a branch.

A Central Bank official acknowledged that transforming subsidiaries into branches could lead to a facilitation of cross-border activities once the regulatory and supervisory framework is in place.

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Addressing the obstacles to further integration of EU banking markets

1. No business case encouraging the creation of pan-European integrated banking groups in the context of the current fragmentation of the EU regulatory and supervisor framework

1.1. Since the financial crisis, consolidation in the European banking sector has been limited

An industry representative explained that there has been some consolidation not only in corporate and investment banking but also in retail banking (e.g. Unicredit acquired HVB, BNP Paribas acquired Fortis and BNL). But this consolidation has been limited compared to the United States where the five biggest banks hold over 40% of domestic assets, compared to 20% in the EU.

In addition, over the last nine years, in terms of market shares, some banks have disappeared from the leagues and the European banks have lost some ground – five or six points – to the profit of US banks. In 2009, four of the five top banks in terms of revenue were from the US; now all five are US banks. The revenue of the major US banks has increased whereas the revenue of European banks has decreased or been stable, such as in the case of HSBC and BNP Paribas.

1.2. The current EU regulatory framework creates barriers to carry out significant cross-border acquisitions

The institution is not willing to take such action now, since there is no business case for it. This is, first, due to lasting very low interest rates, meaning low margins. Second and more importantly, the EU regulatory framework is pushing against it. Indeed it is not considering trans-national banking groups structured around subsidiaries at the consolidated level, but as a sum of separate subsidiaries. The management of liquidity and capital is not possible at group level because the CRD, CRR and BRRD adopt a solo approach for the definition of capital and liquidity requirements (LCR, NSFR, MREL, leverage…). Ultimately, liquidity and capital are trapped.

The G-SIB (global systemically important bank) score is an additional issue. Banks are being penalised when delivering a loan outside their home country because this increases their G-SIB buffer. This was not the case during the crisis, where there was no G-SIB buffer.

An official sympathised with the case of removing regulatory obstacles to cross-border integration and noted that the European Parliament is hoping to deal with some of the 'less unreasonable' methodologies for calculating the G SIB surcharge and the national discretional waiver on cross-border exposures.

A public decision maker stated that regulatory requirements for cross-border exposures of the same banking group should be waived within the euro area as long as some prudential safeguards are in place, of course. In particular, the possibility of accepting waivers on large exposure limits should be in the hands of the supervisors and not in the hands of the national legislators. Currently, it is up to the Member States to actually apply the large exposure waiver and not all of them do. Several countries have used this national option – available to them until 2028! – to apply their own national policy on this waiver. This overrides the SSM stance and makes the playing field for euro area banks less level. In turn, this affects the usability of waivers on liquidity requirements. Large exposure limits constrain the movement of funds, putting a limit on the amount of liquidity that cross-border banking groups can move around freely. Banks therefore have less reason to apply for liquidity waivers in the first place. In a broader context, this also reduces the incentive to engage in cross-border mergers. Moreover, the European legislation should permit cross-border solvency waivers under certain supervisory conditions, which is not the case so far.

1.3. Divergent policy areas

A regulator noted that certain divergent policy areas such as tax codes, legal systems and insolvency law may also discourage the creation of a pan-European banking group, but that these are outside the scope of the financial regulations. Another regulator stated that a business case for cross-border mergers does not currently exist and that such business cases needed to come from the industry rather than from supervisory or resolution authorities.

1.4. The case for fragmentation and supervisor neutrality

An official underlined that financial integration across borders may contribute to strengthening the common currency area. For example, it is seen to facilitate absorption of regional shocks and to contribute to transnational private risk sharing. The European banking union can play its part in fostering financial integration. Much has been done in that regard, as evidenced by the SSM (Single

Supervisory Mechanism) and the Single Resolution Board (SRB). Another important step was the establishment of a new class of non-preferred senior debt, which further harmonised the creditor hierarchy in Europe and makes available a new instrument which can reliably be bailed in. Both support a harmonised resolution of failing cross-border banking groups within the Banking Union.

However he also believed that existing fragmentation should not be entirely condemned. In particular, a recent Eurostat survey amongst corporates highlights various economic reasons in favour of banking sector fragmentation. The question of whether cross-border consolidation has a positive or a negative effect on financial stability is an open one with many arguments on both sides. Supervisors should therefore not necessarily promote cross-border consolidation, but rather take a neutral stance, at least for the time being. A careful case-by-case approach is required according to the circumstances, risks and business models involved, which vary amongst different companies and countries because they entail different risks.

A public representative agreed with the need for neutrality amongst supervisors but added that, in the current context where a number of European banks do not earn the cost of their capital, it would be prudent to have a supervisor with an industrial vision to permit/ encourage market' initiatives. . Some people are conflating the impetus to remove risk and the impetus to promote cross-border mergers, which could give rise to a disturbing nuance to the neutrality of the supervisors.

1.5. Lack of trust between Member States

There was a loss of trust during the financial crisis and trust remains in short supply. As the Banking Union framework is still in its infancy there remains an issue of trust between the former home and host within the Banking Union. There is also an issue of trust between the countries within the Banking Union and those within Europe but not in the Banking Union. A far more efficient framework is required and the Banking Union needs to be completed to help address these trust issues, including the completion of EDIS (European Deposit Insurance Scheme). A public representative noted that common trust is required in order to share more sovereignty. Once issues around trust have been addressed, it would then be for banks to identify the business case for investment.

As the Banking Union is not yet complete, there is not yet an equal level of protection of deposits and an alignment on decision-making on liability. It is therefore not surprising that host countries are somewhat reluctant to remove the large exposure waiver. More harmonisation on insolvency resolution company law is required because otherwise, the mechanism remains entity-specific, which creates obstacles.

At the European level, 'too big to fail' is still an issue as it was both before and during the crisis. A public representative stressed that this is a tricky and nuanced issue because economies of scale can be present in banking; the question is to what level and degree.

The chair noted that a genuine banking union not only needs the three pillars, but it also has to be a real union, without regulatory fragmentation and ring-fencing of national markets. Currently, liquidity and capital do not flow freely in our banking union.

2. Realistic steps to foster more integration in the EU banking market and address the obstacles that currently hinder further integration

2.1. Moving forward in a balanced way between risk reduction, risk sharing and regulatory harmonisation

The reduction of risk should be undertaken in a balanced manner between risk reduction and sharing. Currently, only one of these two sides is being focused upon; the more they move in parallel, the more effective both sides will become. In addition there needs to be a balance between risk sharing and reduction, and regulatory harmonisation. Ultimately, insolvency is fundamental.

A balance must also be struck within the risk reduction dimension, particular with regards to MREL and NPLs. In terms of MREL, there is some confusion between risk and resolvability. A public representative explained that risk is measured on the asset side and is covered by capital whereas resolvability is another concept on the liability side such that the subordination level should be related to resolvability. Member States in the European Council, however, are mixing up these two concepts and putting everything together, which does not take into account the density of risk weighted assets.

In terms of NPLs, the European Parliament is intending to fast-track the Commission's legislative proposal on the prudential backstop. A public representative stressed that things should be done in order to get the proper outcome rather than just for ideological reasons, which can have counterproductive consequences. Currently, not all risks are addressed at the same level, which may also produce unintended and unexpected resistance to moving ahead on the Banking Union. Caution is required. The crisis was a result of many different kinds of risks and, if Europe does not show that it is able to address all the types of risks in a balanced way, confidence will be affected.

2.2. Completing the Banking Union, eliminating national options and reducing risks

A regulator stressed that much has already been completed with the Banking Union, the single rulebook and the wider European institutional framework. Banks that are 'too big to fail' at the national level may not be too big to fail at the European level. The SSM and the SRB contribute to address the home and host issues as well as the trust concept. Moreover, there is no distinction anymore between home and host supervisors for significant institutions operating within the banking union: all national competent authorities are indeed around the table of the Supervisory Board of the SSM and their vote is as important as the vote of the country where the bank in question is listed or registered. He believed that now is the time to complete the Banking Union by implementing the third pillar, which is the deposit guarantee scheme.

In the meantime much still needs to be done. First, regulatory certainty needs to be achieved, including in terms of the implementation of the new Basel III rules. Second, there needs to be consistent treatment of domestic and cross-border groups and, hence, further harmonisation of the regulatory framework, including eliminating unwarranted Member State options and discretions. Third, uncertainty around bank assets needs to be further reduced, which will make cross-border mergers more attractive: the work on legacy assets and on the reduction of NPLs (non-performing loans) needs to be continued. In this respect, the Commission's legislative proposal on the introduction of statutory prudential backstops to tackle potential under-provisioning for new loans that turn non-performing is welcome. The ECB and the Commission have closely collaborated on the legislative proposal and the Addendum, which are complementary initiatives and will together support the needed efforts to tackle NPLs in the future.

2.3. Further developing the EU crisis management and facilitating the free circulation of liquidity and capital within EU transnational banking groups

The crisis management framework of the banking union has, all in all, performed adequately: the few cases of bank failures were addressed smoothly, without disruptions or contagion. The Single Resolution Board is currently working on resolution plans that should provide reassurance that bail-in, as a basic principle, will work and that subsidiary losses can be upstreamed or capital downstreamed in order to remove the perception that it will still be the national authorities that are at risk if something goes wrong.

The SRB is also setting binding consolidated MREL targets for the largest and most complex groups and trying to be very reasonable in that regard. Additionally, the SRB is looking into the quality of MREL. Making banks resolvable would significantly contribute to restore trust between domestic supervisors. Legacy issues and notably Non- performing loans also need to be addressed as do the issues that arise between different cultures or different legal systems, including insolvency law and so forth.

Nonetheless the EU crisis management framework still needs further improvement. For example, national winding-up proceedings, which are not harmonised at European level, may be more favourable for some creditors (senior bondholders, non-covered depositors) than European resolution. This divergence of national insolvency laws is a major obstacle towards a fully-fledged Banking Union. In the current system, the counterfactual of no-creditor-worse off (NCWO) might produce different results in different countries depending on the national insolvency regime and thus negatively impact on the orderly wind-down of a bank. Therefore harmonising national insolvency laws should be further encouraged.

An official highlighted the importance of supporting the SSM and the SRB, adding that the ESM (European Stability Mechanism) may also need to be upgraded in order to strengthen its shock absorbency, which would lead to better financing conditions in Europe.

An industry representative noted that setting up the SSM and the SRB was an important step, but more progress must be made. A level playing field with other big banks in the United States or in China will not be possible unless European banks are on equal terms with them. Trapped capital and liquidity do not exist in the United States. One of the reasons which explain that the US banks have recovered more quickly than the EU ones is the importance in the US of private risk sharing through the banking channel. In this respect allowing the free flow of liquidity and capital within banking groups is essential and should be a key priority for EU public decision makers.

An official agreed that cross-border liquidity and solvency waivers are indeed required within the SSM, without which there would be no real Banking Union. The large exposure waiver needs to be unlocked because liquidity cannot flow freely without such a decision of the relevant national legislators. “What’s the point in being a cross-border banking group if you cannot reap all the benefits that brings?” And finally, there should be cross-border waivers on capital. Introducing such waivers would be another important step towards a truly European banking market and a true banking union.

A regulator noted that measures taken in the United States to remove obstacles to cross-state banking have done a great deal for the capitalisation of American banks. Not moving forward in Europe would essentially mean European banks competing with larger banks with their hands tied. A public representative cautioned against this comparison with the United States, stating that Europe is not a federal entity and that the United States established a common deposit with a bigger budget than what is seen in Europe.

According to an official, cross-border capital waiver presents another step towards a completed European banking union and might also work against fragmentation of cross-border banking groups. But as long as neither insolvency law nor resolution law nor company law are harmonised within the EU or even within the SSM, the introduction of a cross-border waiver entails unpredictable risks, especially in crisis situations.

2.4. Transforming subsidiaries into branches is a possible solution

A regulator expressed scepticism about the notion of branchification solving all the issues, but noted that it may be among the possible solutions.

An industry speaker explained that their institution’s branches in Germany are providing some comfort to national authorities because, in case of failure, the system for the German depositors would be the same as the system in the institution’s home country. Though the institution will not transform all its subsidiaries located in the Banking Union into branches overnight, this provision of comfort is to be noted.

A regulator confirmed that there will be no issue with branchification from the perspective of the SSM as long as a head office is present somewhere within the 19 Euro area countries.

However a public representative noted that the home and host issue is a tricky one that we have to be very careful about. He stressed the importance of assurances that subsidiaries will always have sufficient capital and liquidity buffers at all times.

Addressing fragmentation issues in the Banking Union

This session discussed the reasons why banking markets are so fragmented in the Eurozone despite the implementation of the Single Supervisory Mechanism and the Single Resolution mechanism and the possible way-forward.

1. Further integration of EU banking markets is hindered by the domestic bias in the EU banking regulatory framework and the heterogeneity of retail markets and insolvency laws

1.1. EU banks have reduced their risks but cross-border integration remains an issue

An official stressed that much progress has been made in a limited amount of time with the achievement of a common banking rulebook and the establishment of the Single supervisory Mechanism (SSM) and the Single Resolution Board (SRB). Banks are safer: CET1 has gone from 7% in 2008 to 14%. Non-Performing Loans are going down. Leverage ratios are going up. Looking at resilience measures from LCR to NSFR, everything is moving in the right direction and banks in Europe have achieved a great deal.

However, cross-border integration remains an issue. Cross-border business is actually declining across Europe, despite all the efforts that have been made in this regard. In its financial integration report, published in November 2017, the ECB produced an interesting chart which demonstrates that since the start of the crisis the banking sector has made a negative contribution to risk sharing, which means it has amplified shocks instead of diminishing them. Increased risk sharing contributes to risk reduction. With greater possibilities of diversifying across jurisdictions, the banking sector is more able to smooth idiosyncratic shocks and there is less risk that the European safety net will have to be employed. More should be done in this area, and more could be done without any need for legislation.

1.2. Further integration of EU banking markets is hindered by the domestic bias in the EU banking regulatory framework (solo approach)

The industry representatives explained that the solo approach of the EU regulatory framework and the large exposure framework in particular maintains a domestic focus in the way prudential requirements (capital, liquidity, leverage) are imposed on banking subsidiaries across the Eurozone. Liquidity excesses in one subsidiary of an EU banking group cannot be used to compensate for possible shortages in other ones and lending liquidity excess from a subsidiary to a parent company of a transnational EU banking group is also subject to the large exposure framework.

An industry representative compared banking with the music industry, noting how the music industry's product remains the same across sellers, which means that the focus for businesses is only on delivery of the product and how its products can be delivered cross-border notably digitally in a harmonised way. In the banking industry, banks cannot be differentiated due to the specificities of their products (deposits are the same or similar everywhere). So the way you deliver a banking product is the most important. But Europe lacks efficiency in the banking sector because if banks have one factory for one kind of product they cannot serve the entirety of Europe.

Moreover on the supervisory side, capital, liquidity and MRELs are locked in to the different centres where the group is located. Integration enables groups to collect MREL at the group level but then they have to be distributed in each of the subsidiaries. There has been much discussion over the necessary guarantees for such a system. At the same time, It is impossible that banking groups would not support one of its subsidiaries which would fail in a particular country. There is an on-going debate about this guarantee, but this issue should be addressed collectively at the level of the SSM and not on a solo basis.

An official agreed that Europe lacks an efficient way of allocating capital and liquidity. The European Central Bank has done all it can in terms of waivers and so on. In response to an example given by another panellist, the regulator noted that supranational bodies might be better placed to take certain kinds of regulatory decisions over NCAs. The ECB undertook a small, informal survey on the subject of cross-border business, but the industry informed the ECB that the main issue was not the ECB and the SSM.

A Central Bank official recognized the importance of allowing single entities to have free movement of its capital and liquidity. However, for example regarding liquidity there are also national aspects to consider because emergency liquidity assistance is a national provision, even in the Euro area. Even in larger Euro area countries, risk ends up in the balance sheets of national central banks. For countries outside the euro area it is obviously important to keep liquidity at the national level. There banks with liquidity problems go to the National Central Bank and not to the ECB.

1.3. The integration of banking markets is also impaired by the heterogeneity of retail markets and insolvency laws

An industry representative felt that one aspect which is hard to address is the huge amount of heterogeneity between retail markets across the Euro area sector. This has cultural, historical and legal causes, but it prevents a considerable amount of integration. For instance, it is very difficult to operate a single IT system to provide a retail product across different Euro area markets. Additionally, there are very different processes and procedures to get a mortgage enforced in different Member States. It is important to be realistic. There will not be a significant amount of integration of retail markets, if integration means the homogenisation of products. Integrating retail markets is difficult because it will require the harmonisation of products and insolvency laws.

An official highlighted the importance of insolvency in the EU banking crisis management framework. Much time has been spent on resolution and perhaps not enough on what happens during liquidation. The liquidation of banks does differ across different countries and the underlying regimes, however. It is essential to identify the elements in insolvency fragmentation which require further harmonisation. Resolution authorities should seek to feel more confident about what happens in liquidation and reduce the prospects of litigation claims.

2. Measures proposed for optimising the Banking Union

2.1. Facilitating cross-border business by allowing transnational banking groups to operate as a group from an operational, regulatory and supervisory perspective and not as a sum of separate subsidiaries

Another industry representative suggested that the most important aspect of integration is to remove domestic capital and liquidity barriers. As is developed in the Eurofi paper, the main problem is about providing host countries with greater security through the use of resolution mechanisms. The first solution to integration is to transform subsidiaries into branches. The second solution is to increase formal coordination between host countries and the SRB. Thirdly, barriers to liquidity and capital should be removed and the SSM should be given more power.

An industry representative suggested that the next short term step should be to eliminate national discretions and solo requirements. European banks must continue to think about how to operate as consolidated groups rather than having individual entities within national borders. It is important to understand the concerns of national governments, both in terms of hosts and larger countries, in relation to local financial instabilities. In a well-functioning Banking Union, these issues should be the responsibility of supranational entities.

An official stated that the only way to integrate retail banking in the European Union is to allow cross-border groups to have an efficient internal capital market, which means allowing the free movement of liquidity and capital within the group. Without this retail markets will never be integrated in Europe, he added. It is important for Europe to tackle the issues already on the table, such as how to define capital add ons, requirements for liquidity and requirements for loss absorbing capacity. Thiq debate on waivers can be very depressing, because it is very unclear why an Italian bank should be able to waive requirements for an Italian subsidiary and not for a subsidiary 25 kilometres north in Austria. It will not require a lot of political capital to address these issues, he added.

2.2. Combining financial integration and financial stability

A regulator stated that the core obstacle to progress is the perception that there can be arbitrage between financial stability at the national level and the integration of the groups at a cross-border level. It is important to provide more guarantees that integration will in fact promote financial stability instead of jeopardising it. Instead of continuing debates on principles, it is more important to move towards the concrete steps to building confidence in the fact that cross-border is an asset for internal financial stability.

There must be a sense of urgency about this question. Europe has a window of opportunity to advance the Banking Union; it is important not to miss this. Instead of continuing the debates on principles, it is more important is to move towards the concrete steps to building confidence in the fact that cross-border is an asset for internal financial stability. Europe must find a concrete and negotiated way to advance EDIS. Europe must also advance concretely on group support. The Eurofi paper appropriately tackles this issue. Group support should contribute to assuaging the concerns of host countries. Europe must convince host countries that they are not losing the potential to manage financial stability.

An official asserted that that greater trust in resolution practice is one of the most important practical points in the debate on fragmentation. The industry must ascertain how group resolution works in practice in the Banking Union. It is questionable around whether there is sufficient free flow of capital and liquidity within groups to fully implement single point of entry strategies. This requires a dialogue between the industry and authorities about how to move capital and liquidity to where it is needed in a group. Legislative changes might be necessary, but the most important issue is to establish a concept of resolution which works in practice. An industry representative agreed, noting that this is addressed in Eurofi's paper. He added that there remain many questions on how host countries will be involved in resolution plans, and this issue is a very important one.

2.3. Transforming subsidiaries into branches

Several industry representatives stated that Europe could move towards more structural branches. The paper published by Eurofi on this subject is accurate, but the essential first condition of any solution is to de link sovereigns from banks according to one of them (see next paragraph). However there is one issue to be resolved. To take one example, if the speaker's institution were to establish a branch in Belgium and then moved €80 billion savings into the home DGS scheme, the regulator would have a heart attack. Europe needs to address this issue. EDIS may be necessary, because otherwise it would be difficult for major institutions to operate cross-border under this legal regime.

A Central Bank official highlighted another substantial structural issue which is the asymmetry between big and small countries, and the asymmetry between home and host countries. There are some countries which basically dominate foreign subsidiaries. If Europe allows them to convert into branches, the system will essentially be left with no capital. The only proper guarantee for these countries is for the rules to be enforced in an asymmetric way. Another point also noted was that smaller entities know they are more likely to bear the cost of liquidation because they would be deemed not systemic by the SRB and therefore not resolvable.

An industry representative totally disagreed with this comment implying that branch structures would be left without capital, which would mean that host countries 'draw the short straw'. He noted that in his experience it is impossible to sell any of a firm's activities unless they are substantially capitalised. Capital must be allocated to assets being disposed of, otherwise firms will be unable to sell them. This is an important issue. When resolution plans are drawn up, regulators look at them with suspicion and query what will happen in liquidation cases. While sometimes there are problems in the case of liquidation, normally what happens is that firms sell activities, and this is always done with adequate capital.

An official stressed that now, host countries are at the table where the decisions are taken about branches, at least in the Banking Union. There are still actions that can be done here. Supervisors must take into account the concerns of host countries in order to allow branch networks to expand and for subsidiaries to be more integrated. There is still progress to be made in waivers. However, the real condition to advance is convincing host countries that this provides additional tools for financial stability. For instance, there could be cases where a branch or subsidiary could be considered systemic for a particular country but not systemic for the whole system. The host country's concerns must be reasonably addressed. Europe must have an ex ante arrangement about supervision, regulation and what happens to state support during liquidation. Clarity on this extremely precise point is necessary to be able to move forward in this area.

2.4. Further reducing the link between banks and sovereigns

An industry representative felt that the sovereign bank link still persists. There is a direct link between the rating of sovereigns and the ratings of the banks incorporated in those sovereigns. As an example, the Spanish sovereign was recently upgraded by e agencies and there was an almost immediate across the board upgrade of the Spanish banking sector. As long as this link remains, legal location matters.

De linking banks and sovereigns should be fixed. Completing the Banking Union is important in this respect. As long as DGSs remain purely national, the vicious circle cannot be completely broken, and Member States and financial institutions will continue to be exposed to financial instability. Both depositors and national authorities clearly understand that although supervision is European, national treasuries remain the backstop for national deposit insurance schemes. Retail depositors must feel the same level of protection irrespective of their location.

A Central Bank official noted that the industry continues to seek to break the link between sovereigns and banks, explaining that this will prove impossible because there will always be exposures from the sovereign (the voters through their deposits) to the liabilities side and to the sovereign from the assets side of banks' balance sheets. Even in a mutualisation scenario the link between banks and sovereigns remains. One of the weaknesses of the Banking Union is that it does not discipline weak sovereigns, and their weakness ends up in the balance sheets of the banks. This is a reason why the movement of liquidity and capital is hindered in banking groups. This issue must be addressed in order to provide the trust and confidence for banks to agree to share risk and allow capital to flow freely. Otherwise, every banking business will keep the level of capital which is appropriate for their level of stability in the banking system, because the levels of sovereign and corporate risks in different countries are also different.

Responding to this comment, a regulator explained how the 'Vienna Initiative' enabled European authorities and businesses to reach an agreement on capital and liquidity flows when foreign banks were pulling out of Central and Eastern European countries immediately following the crisis. The agreement allowed banks to commit to provide lending to these countries while also allowing local authorities to commit not to trap excess capital and liquidity. The regulator noted that it would be an important step forward if this framework could be crystallised into a legal framework.

A Central Bank official disagreed, downplaying the role of the 'Vienna Initiative' in this process. Rather, domestic savings increased massively, which generated the savings to be able to repay funding for parent banks. The savings rates in the household and corporate sector in Eastern Europe reflected how countries in this region went from current account deficits to large surpluses. This adjustment was not administrative, but rather an internal adjustment of the economy.

2.5. Risk reduction and risk-sharing

A regulator noted that the debate about the completion of the Banking Union is now focused on risk reduction and risk sharing. However, risk sharing is often viewed in a very narrow definition. Public sector risk sharing consists in deposit guarantee schemes and the safety net, while private risk sharing does not factor in the discussion as much as it should. Increased risk sharing contributes to risk reduction. With greater possibilities of diversifying across jurisdictions, the banking sector is more able to smooth idiosyncratic shocks and there is less risk that the European safety net will have to be employed.

An official underlined that Member States should have the confidence to mutualise risks on backstops and similar issues, which are connected with risk reduction and risk sharing. It is possible to contribute to both. Europe should be very practical here. It is important to finalise the banking package to ensure there is sufficient MREL and subordinated buffers in the system. These buffers only meet the objective of trust if people are sure they can be bailed in. Past cases have shown that this means these buffers must be subordinated.

The NPL part of this is also important. Legacy NPLs are less distressing, because they are at least identified and known. Equally important for the future of the system is having a more uniform approach for the treatment of NPLs. Risk reduction will improve the banking sector and it will also help to build more trust in the public sector, which can consider additional steps in terms of risk mutualisation.

A Central Bank official noted that one original weakness of the Economic and Monetary Union is its lack of convergence on fiscal policy and economic structures. Ultimately the question of fragmentation in the Banking Union revolves around how Europe distributes its savings. When there is a shock, there are always moments when the private sector is not willing to distribute. This demonstrates the importance of the risk reduction/risk sharing mechanism, which has not been solved.

An industry representative stressed that this idea of a distribution mechanism is very important. Savings are collected in various countries, and banks allocate these to assets. The question is about whether banks are doing this freely. Overall, banks are depositing too much capital with the ECB for a variety of reasons. This capital should be used elsewhere in the system rather than circulating liquidity via the ECB.

3. Considering fragmentation in the Banking Union in comparison with the US

A regulator suggested that the US has been very effective at quickly managing excess capacity in the banking sector. In one and a half years, 500 banks exited the banking sector in the US. This happened very smoothly, using the purchase and assumption process. This has led to the reduction of excess capacity and to a very fast recovery of profitability. In Europe, however, there is still a substantial amount of excess capacity in the system which drags down profitability.

An official noted that, when making comparisons with the US, it is important to remember that in the US the biggest four banks hold 50% of the assets, whereas in the Euro area the four biggest banks hold 25% of the assets. This aggregation of assets enables the use of very different platforms; it is also much easier to allocate from north to south and east to west.

A regulator summarised a paper which compares the US response to the crisis in Puerto Rico and Nevada with the EU response to the crises in Ireland and Greece. The paper shows that these crises are very similar. In one case, this was driven by the sovereign getting into difficulties; in the other case, the banking sector generated the problem. In the US, the crisis in the banking sector was solved because the FDIC sold the assets and liabilities of the banks in Nevada and Puerto Rico to banks from other states in the United States. This is how the capacity was reduced during consolidating and restructuring. In the European Union, European money was put into the programmes in Ireland and Spain, but the consolidation that happened was domestic. For some reason, this excess capacity was never removed using a cross-border transfer of assets or through cross-border consolidation.

A Central Bank official felt comparisons with the US are slightly incorrect, because the US is a single sovereign with a centralised budget. If this does not become the case for Europe, Europe will always have a problem with sovereign exposures. While Puerto Rico can default, the Euro area should not encourage countries to default and restructure their debts. On the other hand, however, Europe will create a moral hazard machine if it encourages sovereigns to accumulate risk and tries to spread it to other banking systems.

A Central Bank official reminded the audience that while the US might often be seen as a well functioning system in respect of banking resolution, the same could not be said about its insurance industry due the fragmented supervision in this area in the US.

EDIS and SRF backstop: expected benefits and success factors

The rationale for an EDIS and the arguments against such an EU reform were exposed during this session. There was also a consensus on the need of a backstop for the Single Resolution Fund even if EU Institutions have still to work on the technical modalities, in particular on the lender of last resort issues, in order to achieve a political agreement in the coming weeks.

1. The expected benefits of European Deposit Insurance Scheme

1.1. Achieving a truly single currency

A regulator explained that depositors are not equally protected in all Member States. Full monetary union and a single banking system cannot exist without "single money", which has to be fungible whatever form it takes, independent of its location within the euro area. Therefore the concept of single money" requires deposits to inspire the same degree of confidence regardless of the Member States of the Banking Union where they are located. And EDIS would be an effective tool to promote a uniform level of depositor confidence and help ensure the true singleness of the euro.

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

Through a single fund, EDIS would ensure equal, high quality protection of all depositors across the Banking Union in case of banks' failures. Europe would have more resources than national deposit guarantee funds to cope with large local shocks, which could otherwise overburden national DGSs. Indeed EDIS only works in an insolvency or liquidation scenario when funds from national DGSs are insufficient. EDIS would be used notably when smaller banks are put into liquidation. EDIS is a European DGS and a way to break the loop between sovereign risk and the banks when the state has to intervene and fund the DGS.

If we look across the Atlantic, we can see that the US has a Deposit Insurance Fund which is pre-funded and managed by the FDIC, which has adopted a 2% Designated Reserve Ratio each year since 2010. By comparison, in the EU we have two prefunded facilities to address bank failures: Deposit Guarantee Funds at the national level and the Single Resolution Fund. Implementation of EDIS could ultimately centralise the deposit guarantee funds and would therefore align the EU and US more closely in this regard (even though the EU would still retain two separate pre-funded facilities).

1.2. Increasing Financial stability

An official explained that the Banking Union must be completed without delay if we do not want the EU banking system to be still vulnerable in case of crises and used two arguments:

- The first is size, which is the same as the law of insurance: it works better when it pools more resources. By pooling resources at a central level we will significantly increase the resilience of the financial sector. No national DGS would have sufficient resources to do this.
- The second is that, even if you believe that national DGSs can deal with a systemic crisis by themselves, bank failures do not happen in isolation. Banks are so strongly interconnected that an instrument like EDIS is much better placed to deal with spill-over effects.

A regulator stressed that EDIS could create smoother, more credible and transparent insolvency procedures. There is this concern that national DGSs could trigger massive deposit outflows that could provoke the resolution or insolvency of the bank. The financial disparity across backstops of national DGSs may indeed create adverse incentives, contributing to market fragmentation and competitive distortion. In such a context EDIS should reinforce depositor confidence, reduce market fragmentation and the risks of bank run and increase financial stability across the Banking Union.

An industry participant agreed that EDIS is a discussion about financial stability and market confidence, not about avoiding another crisis. It is saying that financial stability requires depositors who want resources to be available and are willing to incorporate them into the system. The problem is how. People need to be convinced that there is one Europe and one euro, whichever country their bank is in. Such a system will support confidence in the market.

A leader of the industry stressed that contributions to EDIS should be based on institutions' risk profiles. Big institutions do not expect to benefit from EDIS but a EDIS would restore to market confidence. It will give depositors the idea that they can trust the entire system, not just one part of it. To achieve this goal the Eurozone must put in place a process of gradual increase in risk-sharing, that must go hand in hand and in parallel with risk reduction in a reasonable timeframe.

An official reminded the audience that it was always intended that the Banking Union should have three pillars: single supervision, single resolution and a single DGS. Nevertheless discussions are ongoing at the EU Parliament and the EU Council. In its Communication dated 11 October 2017, the Commission considered possible ideas in an attempt to address the diverging views and concerns that emerged during the negotiations and to steer the discussions in the European Parliament and the Council. In particular, EDIS could be introduced by the co-legislator more gradually: In the reinsurance phase, EDIS would provide liquidity to national Deposit Guarantee Schemes (DGS) in case of a bank failure, which would have to be paid back by the national DGS. Liquidity support is the most essential element to ensure that depositors are paid out. In the coinsurance phase, EDIS would also cover losses, without recouping them from the national DGS. This would further reduce the link between banks and their Member States. However, moving to this second phase would be conditional on the progress achieved in reducing the level of NPLs and other legacy assets assessed through an Asset Quality Review (AQR).

1.3. Aligning liability and control

An official perceived EDIS as a small part of a big mosaic serving two goals: the first is to ensure that accidents in the financial sector are less frequent, cost less and are less severe; the second is to provide the financial sector with a level playing field, as much as possible.

EDIS is important to enhance the sector's credibility and within the European Union, but it also has a political dimension. If the responsibility for supervision is elevated to the EU level, the question can be asked as to whether accidents should be paid for at the national level.

A policy-maker also raised the argument about consistency of liability and control. There is a mismatch between European control and national liability. As supervision and resolution are European, their effectiveness will influence the "if and when" a DGS has to pay out to insured depositors or contribute to resolution.

The supervisory powers of the Banking Union are under the lead responsibility of the ECB, so we cannot argue that national DGSs should pick up the bill in any event of failure. Thus there is a mismatch between European control and national liability that that can lead to extra costs and inefficiencies. An EDIS is therefore necessary to eliminate such asymmetry by elevating accountability for a trusted safety net for deposits to the European level.

1.4. Completing the Banking Union is necessary to reduce risks of systemic crises

Unfortunately, the European Union has a history of launching new projects and leaving them incomplete mid-course unfinished. Take the Schengen treaty. It opened up opportunities for people to travel, but Europe forgot to put police in its borders until later finding out that this had created risks. The monetary union has been left unfinished, because there is no de facto economic union. Now the Banking Union has been launched, and there are doubts about whether it will be completed too.

The three pillars of the Banking Union were tabled for all the negotiations taking place at the European institutions. Everybody agreed to them then, but now people are having second thoughts. Consistent in the project is that a Banking Union can unleash more risks. It thus needs instruments capable of managing those risks. Without being part of a Banking Union, all national DGSs might prove effective in dealing with a domestic crisis, but this is a globalised financial system with a globalised banking system. Europe is part of that process.

The objective of having a fully integrated banking and financial system must also include the instruments for managing this supranational system. Instead, some argue for a reliance on national schemes and procedures, backtracking on what had been agreed at beginning. The reason EDIS is now needed is not just for the sake of the completion of the Banking Union; it is because the industry is not immune to the possibility of a major liquidity shock that may affect European or global banking systems. Europe needs to be prepared for such an emergency and it cannot do so using the domestic imbalances of individual countries. The crisis of 2007-08 came from difficulties in controlling capital flows, and the risk management strategies adopted to deal with them. We may continue to live without EDIS, but we will be running greater risks and have insufficient instruments to deal with future crises.

2. Arguments against implementing EDIS

An industry representative did not consider EDIS a necessary prerequisite to completing the Banking Union. The Commission has already attested to the numerous benefits of the DGS Directive. It is fully harmonised and ensures deposit protection, regardless of where those deposits are located in the EU. It already ensures a level playing field between credit institutions and prevents regulatory arbitrage. His main concerns were the followings: EDIS would encourage moral hazard, imply European bail-outs, would not respect banking sector diversity and would prevent the use of alternative measures by national DGSs and IPS.

2.1. Moral hazard

In this industry participant's view, EDIS could have negative impacts on banking markets, the most important one being moral hazard. It would create incentives to direct flows to Member States whose banking sector as a whole has a relatively high risk affinity (including with regard to investments in government bonds) and spread as precisely these risks across the entire euro area. Depositors will invest in high risk assets in risk friendly banks, and this will negatively affect financial stability. In this way relatively 'healthy' banking sectors in Member States with a low level of risk and a high level of debt sustainability would support their competitors in other Member States. EDIS thus leads to cross-subsidization on a massive scale.

2.2. National solidarity yes but no European bail out

Once the DGSD is implemented in all Member States, all depositors will be protected in the same way. However, the credibility of a national DGS depends not only on the amount of paid-in funds, but also on the health of the banking sector in the country concerned. The same is true for the health of the public sector that serves as a backstop to the national deposit guarantee scheme. If the national deposit fund is depleted in case of a large pay-out, the fund would typically get a loan from the relevant national government.

Taking this into account, it is agreed, that depositor confidence in all the Member States should be fostered independently of the geographical location of a bank in the EU. The need of solidarity between the national DGSs in case of distress of one of them is therefore widely accepted. Nevertheless, there are serious doubts whether this solidarity can only be established by a fully centralized bail-out system like EDIS in its full insurance stage. By creating a mutualized fund, EDIS provides an institutional link between national markets that could allow risks emerging in a regional crisis to spread into other Member States. By further increasing interconnectedness, Member States' sovereign risks could become inseparable. These doubts are directly linked with the legal concerns with regard to the principle of subsidiarity and proportionality. Especially for this reason, a number of alternative proposals have been developed that remain below the threshold of centralization.

2.3. No respect of diversity

According to this industry participant, the diversity of banks should foster the resilience of the banking system in Europe. However EDIS takes no account of the specificities of the banking structures in the Member States. EDIS would destroy the options and discretions within the DGSD and erase the IPS - which are protecting the credit institutions as such and are insuring liquidity and solvency of their members - in at least two Member States.

The home host problem has also been mentioned in the Eurofi paper and other forum debates. If that problem can be solved, EDIS might not even be needed, according to this speaker.

2.4. Others views mentioned during the discussion

A regulator responded that EDIS was compatible with keeping the different business banking models and notably IPS. If we have business models with fewer risks, this has to be considered when setting contributions to EDIS. An official added that EDIS would create more competition and a more level playing field. Regarding IPS, she explained that these issues can be addressed appropriately in technical discussions and included in the calculations of bank contributions, as just said. The industry just needs to roll up its sleeves and work out how to move forward on these thorny issues.

A regulator did not believe that EDIS will promote a more uniform banking market in the EU. If will not affect banks' decisions about mergers; this is, in the regulator's view, political wishful thinking.

An industry participant noted that he did not see that EDIS will create a moral hazard or introduce disincentives for imprudent behaviour. SSM and its procedures take care of this moral hazard issue at the local level. There are separate instruments to address problems with individual banks. EDIS would only reduce the risk of a bank run spreading to other countries. This is why it is needed to deal with systemic issues that do not necessarily arise from the misbehaviour of individual banks. Moreover with EDIS the financial integration process in Europe would be fostered and lead to cross-border acquisitions. Without it, pan European banks may reconsider any major cross-border acquisitions.

Another industry representative saw EDIS and the level playing field as completely aligned. Europe has to consider is weak banks and institutions, not only its weak states, as are all related. Now what is happening is that there are many weak banks in strong countries, which are designing their business model with the knowledge that they will be supported by the state in the event of any problems. This is very bad for the market.

3. Pre requisites to move forward

3.1. The need to differentiate between solidarity and enforced solidarity

A regulator emphasized that there is a huge difference between solidarity and enforced solidarity. Populations can protest against subsidising others far from their homes.

That is true among children, families and nation states. He suggests one ask a Bavarian about why they pay billions of euros to northern German states to fund their deficits while, at the same time, they have to pay to put their children through kindergarten when the same northern German states get it for free, and asked what kind of mood that creates. That is an enforced system of solidarity. If that is screwed up it will destroy the European spirit. This is not just cheap political bargaining; it is the very essence of the European spirit. He questions what must be done to make it work.

3.2. Addressing legacy and structural disincentives remain the main priority

There are two key issues on which to focus. The first is that we do not start from a vacuum. There are huge legacy issues that are quite unevenly spread across the EU and cannot be ignored. There is almost €1 trillion of legacy risks on the books. If an enforced system of solidarity is imposed on that, it will be difficult for the political leaders to explain it to the people of Europe. The fight against legacy risk in the books of Europe turns hugely political and is happening now. This is destroying the way forward for EDIS and it becomes more than just managing risk; this is credibility in its most fundamental sense. As well as legacy problems with NPLs, the discussion could turn to government bonds. They are much more of a global challenge. If such issues as impose a system of enforced mutualisation are not tackled, we will blow up the system.

A further point is to add some reality to the visionary statement made about responsibility and liability, thanks to the SRB. The SSM and the SRB are already a reality today. The speaker gave the example of a bank in a larger country brokering deposits from retail customers to a much smaller country within the EU. This demonstrates freedom of capital and of services, and is a perfect application of the European spirit. If it is low risk for the large bank and attractive to depositors earning higher interest rates than they can at home – no matter if high risk or even dubious business models are the basis of their offerings-, these attractions are likely to lead to the national guarantee system being oversubscribed and blowing up. If EDIS exists, the mutualised system will pay. This is the perfect model of arbitrage and an example of how the system cannot manage with just the SSM. There is an important saying that well-intentioned is not the same as well done. That is why he advocates taking the time to do it well, and to not mistake good intentions for good execution.

3.3. Three stumbling blocks to be overcome

An official highlighted three principal reasons not moving ahead.

The first is technical. Some people think it is too quick; others, too slow. Some people think risk sharing comes too late or too early. These issues are not unique to EDIS, and public decision in the European Union will find a compromise if they want to.

The second reason is a mixture of competition interests and costs. Some banks feel that EDIS is too expensive but in the medium term there is no reason why it should cost more than the current system. If these beliefs are based on legitimate reasons and risk profiles, they should be addressed. Others believe the current system is also beneficial to their part of the industry. This is trickier to resolve, as some industry participants do not see improvements to the level playing field as in their interest.

The third reason is the issue of NPLs. If bad assets are not adequately provisioned, it undermines the whole Banking Union. It does not make sense to agree capital adequacy of 15% if those assets are not correctly provisioned. This point has to be addressed, as a matter of the credibility of SSM and the capital framework that has been created.

He concluded that reaching agreement on the technical problems and different views on liquidity, risk sharing and timing is not a complicated issue. The overarching problem is not a matter of trust but having the courage and ability to adhere to an agreed goal. Every effort to improve the functionality of the EU is facing similar issues. Member States must work with Members of Parliament to address the technical details and move forward.

A regulator added that well-intentioned is not the same as well done. If the vision is wrong, it could destroy the European spirit, so time should be taken to do this work well. A Central Bank official comments that EDIS needs some measurable and realistic milestones.

4. Backstop to the Single Resolution Fund

The creation of such a backstop for the Single Resolution Fund was agreed by Member States already in 2013. It needs to be made operational now so as to reinforce the overall credibility of the bank resolution framework within the Banking Union.

4.1. An agreement on the need of a backstop to the Single Resolution Fund

An official assessed whether the target of the Single Resolution Fund - 1% of covered deposits, or €60 billion - by 2023, is sufficient. Some analyses of the current framework and the last financial crisis concluded that around €80 billion would be needed. Increasing ex ante contributions of banks to 1.2 1.3% of covered deposits instead of 1% could be a solution to fulfil this gap. However, the probability of a need exceeding €60 billion is quite low. It might be more appropriate to have a backstop that is the contingent liability of the fund rather than receiving more upfront contributions from the banks, as this is a real cost for them. A backstop is needed for solvency, but not a very large one.

An industry representative noted that it most important to ensure that taxpayers are not the final backstop in the next crisis. Market confidence would be clearly strengthened by setting an institutional backstop to the SRF. The major issue related to this backstop is market confidence. A central bank official explained that there are two ways to effectively increase the SRF: further ex ante payments or an institutional backstop. An industry participant suggested a happy medium could be found, with the fund enlarged a bit but with an institutional backstop too.

A regulator agreed a backstop is very important. The proof of the pudding will be the next crisis. The trickier question is how to organise it, but workable solutions can be found, as long as it is clear that the SRF is used only as a backstop and not an automatic overflow valve for any type of crisis. Another industry representative agreed that it makes sense to provide the SRF with a backstop because, in times of systemic crisis, there may be speculation among market participants against the SRF. Introducing a final backstop is the best way of ensuring it is never used and enough measures have already been introduced to prevent its application in haste. Historical recovery rates in bank insolvencies show that the volume of distressed assets and losses has not exceeded the volume of the SRF. The backstop should be applied only in systemic crises.

The main problem of most crises is liquidity after resolution. Here the amount of money needed considerably exceeds the target of the Fund and this currently a debate about who can provide this liquidity backstop. Some countries are able to use their central bank and some public collateral for this, because a bank should usually be solvent after resolution, but more collateral may be needed by the central banks. A regulator warned that they have to be careful not to turn themselves from being the lender of last resort to the lender of first resort. As well as these concerns, central banks should not fulfil the task of government to resolve banks. This is close to monetary financing, which is prohibited by the treaty.

4.2. The main remaining issues to obtaining an agreement

An industry participant hoped that the coming negotiations will explicitly recognise how the ESM could be used as a source of backstop. This large amount of funds has added to the burden of debt that can only be utilised for specific cases. It is not the best way to enhance confidence in the ability of the system to withstand a systemic shock.

A public representative stressed that any arrangements or system agreed upon should be adhered to and not diluted. Such a mechanism is only to apply in emergencies and it will be unfortunate if it is extended to other areas. Finding the right balance between ex ante and ex post payments is important, whereby the efficient solution must avoid generating additional cost to the economy. A restructuring of the SRF into a European Monetary Fund would be an opportunity to merge together and incorporate different emergency mechanisms easily.

A policy-maker also saw emerging consensus on the SRF backstop. Last year the Commission looked at two options: the credit line from the ESM, or loans and guarantees from Member States. It has now fully settled on the former. A proposal was made in December to streamline the ESM to allow it to fulfil this role. Its size and ability to deliver a backstop swiftly make ESM the best way forward.

Alternative proposals have been submitted by the rapporteur of the Parliament's Committee on Economic and Monetary Affairs and discussed by that Committee of the Parliament. There are different technical options concerning speed and moving from liquidity support to risk sharing, but the positions of the original Commission proposal and those of the rapporteur are not so different, a public representative noted. They are heading in the same direction and will deliver similar benefits. There are many ways to proceed. The obstacles to a way forward are unlikely to impede the political will to find a compromise. We have to leave it to the European Parliament, Council and Commission to work on the technicalities and milestones that will produce a sustainable solution.

❖

Resolution and liquidation of banking groups in the EU

A regulator underlined that the pieces of the resolution puzzle are now coming together with the implementation of the BRRD and the establishment of the Single Resolution Board (SRB). Attention is now shifting to the calibration of the MREL requirements and compliance with the TLAC standards. MREL is a crucial tool for improving bank resolvability. However, while Europe is making progress on resolution, DGSs and insolvency laws remain under national purview, which constitutes a stumbling block in the progress towards integration.

The outcome of the discussions shows that the calibration of MREL requirements remains challenging and raises specific issues notably for medium-sized banks. Europe lacks indeed the tools required to manage properly any crisis in these mid size institutions. Addressing the issues raised by the different liquidation regimes is also urgently needed.

1. The calibration of MRELs remains challenging

1.1. Stock taking and the way forward

A public decision maker stressed that resolution consists of three pillars: the resolution framework, the deposit guarantee scheme (DGS) and the insolvency laws. While Europe is making progress on resolution, DGSs and insolvency laws remain under national purview, which means there is no single counterfactual[1] for resolution.

MREL is a journey, which must be built up over time. The SRB has taken a gradual, multi-year approach. The SRB started with indicative MREL targets focused on quantity, but is now looking into MREL quality, subordination and the eligibility of particular instruments and will soon examine internal MREL.

1.2. MREL, like TLAC, should be risk-based rather than formula based

An industry representative stated that for international banks, it is vital to calibrate external MREL correctly as compared with TLAC. There must be a level playing-field internationally and Eurozone banks must not be handicapped by these requirements. MREL and TLAC should both be risk based rather than formula based. At the moment, there is a fixed number of 18% for TLAC, which will cause problems when RWAs increase mechanically through the finalisation of Basel III. MREL and TLAC levels might also increase mechanically despite there being no additional risk but formula-based methods will only create problems over the longer term.

Reasonableness is also needed over internal MREL. This is a less sensitive issue for G-SIBs, because they will raise a certain amount of external MREL which can be spread around their groups. G -SIBs, however, will still face issues with medium sized deposit funded banks. Many

G-SIB groups have such banks within their group, which means the problems due to these additional liabilities may also emerge for the G-SIB group. For that reason, other forms of MREL may be needed for internal use rather than straightforward cash instruments.

1.3. It makes sense to apply the MREL equivalent of TLAC Pillar 1 to domestic banks, provided that the Pillar 2 requirements take into account for their risk profiles, business models and resolution strategies

Another industry representative suggested that business models, risk profiles and resolution strategies are all essential components of any resolution strategy. While smaller systemically important banks can in some cases be treated as G-SIBs, it must be recognized that their risk profile and resolvability are very different because they are not global entities. When BRRD 2 was introduced, MREL was never intended to be higher than TLAC, which suggests that the Pillar 2 requirements should be proportionate. Subordination is an important issue in this debate. There are large corporates and utilities which deposit money into banks and require day to day liquidity, and these depositors should not be treated like classic debt holders regarding their ability to be bailed-in. Ensuring emergency liquidity access under resolution is also essential to ensure the EU framework is really effective for achieving resolution objectives.

A third industry representative highlighted the importance of simplicity and transparency in arranging MREL for the larger banks. Fully subordinated TLAC has been issued in amounts over 20% of RWA for over ½ of the world's G-SIBs, including the largest banks in the U.S., U.K, Switzerland and Germany. He stated that a European solution that fell significantly below these levels – either in terms of quality or quantity - could raise credibility issues in the global markets.

1.4. The market for European MREL still needs to develop

Another industry representative explained that Europe has made strong but slow progress in building bail in able buffers. Some bank systems are not yet able to issue statutory, senior non preferred notes, which are the main tools for building bail in able buffers. An international level playing field is important regarding the calibration of MREL and TLAC. Adding different measures and metrics adds complexity to complexity for investors. Moreover many banks do not yet know their internal and external MREL requirements or their preferred resolution strategy. There is an expectation that overall MREL and TLAC will be eligible anywhere within the Banking Union.

An official added that it creates concern that banks have not taken advantage of present market conditions to achieve more on MREL. In the available data on TLAC, there is a difference between the G-SIBs and the mid size banks. While the G-SIBs are moving towards the TLAC requirements, mid size banks have reduced their loss absorbing capacity. Authorities want to see more done by the industry in the presently favourable market conditions. Along with the crisis management side of resolution, Europe must ensure that these banks' balance sheets are cleaned up and that those banks can get going again.

1.5. Supervisory and resolution decisions are mostly European, but the ultimate guarantor of financial stability remains national. Such an asymmetry raises serious issues

A public representative stated that financial stability is a national concern. Even if a subsidiary deal with a small percentage of the business of a group, it can cause systemic problems in the host Member State. While there are always resolution plans for these scenarios, the origin of a crisis can never be accurately predicted. The host country of an entity can adapt the plan practically. But when a group faces serious financial difficulties, the Single Resolution Mechanism will prioritise the safeguarding of the group rather than a much smaller entity, which could lead to its liquidation. There are no elements of stabilisation that manage, efficiently and effectively at the European level to address this asymmetry, but these kinds of protection mechanisms must be implemented.

2. Addressing the specific resolution issues raised by medium sized institutions

2.1. The issues posed by medium-sized institutions

An industry representative stressed that the primary source of concern regarding the European banking industry is its level of profitability, which questions the capacity of the banking system to increase lending and absorb shocks. Imposing MREL requirements on medium sized banks with little access to the market can negatively affect their business. This might also cause a shift in strategy towards higher risk appetites in order to afford MREL.

An official highlighted the importance of considering mid sized institutions that can be systemic within a given Member State despite being funded entirely by deposits and having no access to capital markets. These banks are not really on the industry's radar, but answers must be found for them, because there must be resolution strategies for all systemic institutions.

A Central Bank official recognised that there are many questions concerning the implementation of MREL and TLAC in medium-sized banks. Insolvency regimes remain in the hands of local authorities. Medium-sized banks may wish to use the resolution fund, but the 8% minimum requirement may necessitate the bail-in of deposits, which will create a systemic crisis regardless of an institution's size. In the United States, there are different rules for large banks and for smaller ones. There must be a similar flexibility within the MREL regime.

A regulator explained that Europe's resolution framework is stringent in terms of conditions - such as the 8% minimum requirement of total liabilities to be bailed-in before any access to the Single Resolution Fund - and also in terms of its scope –going beyond GSIBs and even DSIBs. This is a natural consequence of the political decisions taken against bail outs and the desire to limit the size of the Single Resolution Fund (SRF). The most relevant feature of the framework is the bail in tool, the orderly implementation of which requires the availability of a sufficient amount of bail-in-able liabilities. Given this reality, there is little scope for making MREL requirements more flexible. While this is not a substantial problem for larger institutions, it creates problems for medium sized banks with traditional business models mostly financed by capital and deposits and with limited recourse to capital market financing.

These banks with balance sheets below, say, €80 billion and which are especially significant in a particular jurisdiction cannot be subject to normal insolvency procedures as this may generate systemic impacts. At the same time, they are unable to meet MREL requirements. If Europe cannot solve this problem, it will be unable to manage a crisis in such institutions. These banks form a significant segment of the European banking sector. 70% of significant institutions under direct supervision by the SSM are not listed companies; 60% have never issued convertible securities; and 25% have never issued subordinated debt[2].

2.2. The solutions

One solution is benign neglect, which amounts to waiting for the crisis and hoping to find an intelligent solution to manage it using European legislation, the common resolution framework or national legislation.

Second, Europe could acknowledge the implication of the resolution framework on the structure of the industry and try to restructure the industry around the common resolution framework. The financial industry would then have two subgroups: first, the relatively large banks, which are active in the capital markets, systemic in nature and able to meet MREL requirements, and; second, the smaller banks, which are unsystematic and could be subject to liquidation and insolvency regimes without much stress on the industry.

Third, Europe could modify its resolution framework. However, if the industry only seeks to reduce the MREL requirements, this will not work. If MREL requirements are reduced, the 8% minimum bail in requirement will need to be reduced as well, and if this is reduced, the SRF will have to be enlarged.

The only reasonable solution is somewhat politically complex: Europe must devise alternative procedures to resolution that have less stress on the financial system than the current array of insolvency regimes. At the very least, this could enlarge the capacity of insolvency procedures to deal with a crisis in mid size institutions without destabilising the system. This is certainly the right direction for resolution. The official emphasises that Europe lacks the tools required to manage properly any crisis in these mid-size institutions.

According to another public representative, a more integrated and proportionate approach to resolution and liquidation is needed to address this problem. He agreed with a previous speaker that financial stability is still a national factor. But the financial crisis had a key meaning: We need more international and European engagement, not less! "We need to underline the added-value of European cooperation. The Banking Union must be completed and more harmonised liquidation rules must be created" he said.

This official supported the recent proposal for a compromise in the Parliament: TLAC should be implemented in line with the global standard for G-SIBs. That means there should be no subordination requirement beyond the TLAC standard. Non-G-SIBs should not be required to comply with TLAC but should continue to be subject to MREL, because otherwise we would gold-plate the global standard. MREL must remain institution-specific. If necessary and being justified, the competent authority should be able to ask for a higher MREL. At the same time, MREL must be proportionate. Therefore, smaller/domestic institutions, which can be resolved under regular proceedings, should not be subject to a specific MREL requirement. Lastly it must be acknowledged that medium sized institutions will find it more difficult to issue TLAC or MREL eligible instruments than larger institutions. Flexibility for the resolution authority on MREL could help ensure a level playing field between large, medium and small institutions.

An official explained that Finland is presently experiencing the branchification of its banking sector. Managing the systemic risk presented by a banking sector valued at 400% of GDP means that the Banking Union must be very strong. There must be a much greater degree of convergence on MREL and TLAC requirements. Europe must create an insolvency system which attributes losses to creditors according to seniority. Among the various European authorities, there must be a system of checks and balances between different contractual obligations. Home authorities may not always fairly share the pot of money available to them in resolution situations.

3. Addressing the issues raised by the different liquidation regimes is also urgently needed

3.1. Developing a specific insolvency regime for banks is pressing

A regulator explained that the harmonisation of insolvency regimes in Europe is even more urgent given the difficult compatibility of a common resolution framework operated by a European authority, with a constellation of heterogeneous insolvency regimes in different Member States. These rules must also effectively address crises within financial institutions.

It is also necessary to develop an administrative way of managing the liquidation of financial institutions. It must be led by an administrative authority rather than a bankruptcy court or a judge. An example of this is the FDIC receivership function. Once a bank is declared failing or likely to fail, rather than sending this bank to a court, which will take a very long time and destroy a substantial amount of value, an administrative authority could conduct the liquidation, using tools not typically used by judicial authorities. Such a European procedure would be markedly more effective, preserve much more value and generate much less financial stability risk. This procedure could be used for a larger number of banks and therefore provide a good strategy that would complement the common resolution framework.

Another public decision maker suggested that Europe must enhance its insolvency procedures in order to address the problems concerning medium sized banks. There are presently 19 different systems and investors are treated differently in different countries. These problems also mean that 'plug and play' resolution and insolvency frameworks must function together. There must be a clear route to managed insolvency for failing banks which are not sufficiently systemic for resolution. Resolution cannot be the default option because the insolvency system is not good enough. There is more work to be done to address legacy issues about inefficient or incorrect procedures. Additionally, banks know the direction of travel on MREL. It remains puzzling why some banks refuse to issue good quality MREL. There is a level playing field as far as TLAC is concerned, and the minimum is between 16% and 18%, but that is not the maximum.

The speaker added that It is important for the industry to be able to assert that smaller and medium sized banks should be in a position to fail without the world coming to a standstill. If the world grinds to a halt when each and every bank fails, Europe has a different problem. However, each and every failure causes losses. The question arises as to whether banks are correctly positioned, which is a question for authorities and supervisors.

3.2. Addressing the concerns of host supervisors over cross-border resolution

3.2.1. The perils of ring-fencing

An industry representative warned that ring fencing may increase risk to the Banking Union overall and, ultimately to host countries themselves. It was prudent to ring fence during the crisis because of the risk of surprise burden sharing risks in a bail-out, but it is unnecessary in resolution context. Ring fencing produces a classic prisoner's dilemma; more risk is created when several countries conduct ring-fencing activity. We must design a system that protects host countries while preserving mobile resources. The mathematics suggest that the best solution for Europe would be to bring MREL closer to 50%. This may not be politically possible, but this would optimise the safety of the banking system both for specific countries and for the Banking Union. While there is a perception that ring-fencing enhances safety, in fact it can increase risk quite dramatically An official noted that it is important for Europe to develop among the various authorities a system of checks and balances between contractual obligations. Home authorities may not always fairly share the pot of money available to them in resolution situations. Europe must develop a system to accomplish this.

A public representative stated that ring fencing is not a sustainable solution, because this leads to even bigger competitive distortion and fragmentation. The concern of host authorities – that they may be left with losses in the case of failure – must be taken very seriously. Europe requires a balance between host and home countries, the answer to which is greater convergence. While the resolution mechanism is harmonised with the Single Resolution Mechanism, liquidation is mostly national and systems vary widely between Member States, which leads to regulatory fragmentation.

While harmonising these regimes is a big challenge, it is necessary for a true Banking Union. The crisis demonstrates clearly that Europe must take a cooperative rather than nationalistic approach to these issues. There must eventually be a European framework that provides consistent conditions for all banking groups in the Euro area. That encompasses unconditional financial solidarity among different entities of banking groups as well as an equal treatment of creditors in liquidation or resolution. The proposals which have been developed in the Eurofi paper constitute an important and timely contribution in this regard.

3.2.2. A common liquidation regime that does not burden host taxpayers with the costs of liquidation

A Central Bank official reminded the audience that it is important to develop a common liquidation regime that does not burden host taxpayers with the costs of liquidation. Otherwise, hosting a subsidiary presents a considerable risk to the stability of a host country.

The hierarchy of creditors is also a relevant consideration as mentioned in the Eurofi paper. Additionally, Europe requires a proper definition of the 'orderly wind down' of a bank. This is particularly true for medium sized banks, where there are many unknowns. There can be fears that a home country or parent bank will allow a subsidiary to fail.

If Europe does not address these issues, it will create huge imbalances and divergence in the banking sector. When people's savings are in jeopardy, populist approaches are triggered, and this is a very dangerous issue.

3.2.3. Using a branch structure could be a big step forward which addresses the legitimate fear of host countries about their financial liabilities

A representative of the industry sympathised with the fears of hosts. There can be a fear that a home country or parent bank will allow a subsidiary to fail, which is why there is such a thing as internal MREL. However, this position has existed in Europe for 40 years. Europe has a project called the Banking Union. In the same way that Brexit means Brexit, Union means Union. Europe must find the way to achieve that Banking Union. The idea of using a branch structure could be a big step forward which addresses the legitimate fear of host countries concerning their financial liabilities.

If the problem with branches means a lack of oversight for authorities, Europe must develop mechanisms to allow hosts to have more oversight of them. If Europe is going to move forward, it must go beyond rehearsing the home/host debate inside a structure called the Banking Union but which does not look very different from what the world looked like in the 1950s. Europe must be positive and examine ways of resolving the concerns of hosts.

Another official explained that the question of branches versus subsidiaries is a neutral question for the SRB. There are many supervisory questions about the oversight of branches, but this is ultimately a question around the development of the appropriate tools to redress resolvability with either subsidiaries or branches. A public representative added that in a branch model, the oversight of local authorities during a branch's life is very weak, but the local authority guarantees its deposits if it dies. The life of a subsidiary is more controlled, but when it dies there is a huge impact. The initial idea of the Banking Union was not to consolidate banks but rather to use consolidation to increase the efficiency of the banking system. The Banking Union was intended to guarantee stability in the Eurozone and break the link between governments, sovereigns and banks, but it was also meant to guarantee the existence of different business models. This has been forgotten.

To conclude the session, the chair underlined that Europe has always worked well when it had a roadmap. If there is a roadmap for greater harmonisation, all of the necessary objectives for the Banking Union can be achieved but the chair expressed concern about the number of pre-conditions which are placed by national jurisdictions on each step forward in the road-map.

1. No Creditor Worse Off (NCWO) is a safeguard included in the BRRD to ensure that creditors fare no worse in resolution than they would have done in insolvency. The authorities need to estimate the "counterfactual" – i.e. what creditors would have got in insolvency – to compare creditor recoveries with that expected in resolution.
2. The European Banking Authority (EBA) estimated in a report published in December 2017 that as of 31 December 2016, the shortfall for significant EU banks could be between €130 billion and €285 billion, depending on the final articulation of the MREL eligibility criteria. Moreover to the extent that both covered and (most) uncovered deposits will not be eligible for MRELs, the shortfall may be disproportionally high for significant (ie under the SRB remit) medium-sized institutions.

Priorities for further integrating EU post-trading

1. Progress made in the integration of securities post-trading at the EU level

1.1. Many actions have been undertaken in the post-trade area

A policy-maker stressed the commitment of the Commission to making progress in the post-trading area. Further integrating EU post-trade markets and processes in order to make them more efficient, resilient and competitive is a key objective and an essential element of the Capital Markets Union (CMU).

The Commission has already conducted many initiatives in the post-trading area. Several legislations have been implemented including: EMIR, which reduces counterparty and systemic risks in the derivative markets; CSDR, which increases the safety and efficiency of settlement systems; MiFID II, which improves trading functioning and investor protection in particular; and SFTR, which increases the transparency related to securities financing transactions. The Commission has also recently published the Withholding Tax code of conduct and a communication on conflicts of law, which are not binding, but aim at fostering more efficiency and clarity in these two areas. The Shareholder Rights Directive also aims to enhance the identification of investors and their ability to exercise their rights.

Some legislative initiatives are currently on-going including: the EMIR REFIT proposal, which is aimed at simplifying the rules especially for small operators; the CCP recovery and resolution framework, which will improve CCP resilience; and the EMIR review, with proposals to improve the supervision of both European and Third Country CCPs.

Progress is also being made at Level 2. The definition of Level 2 measures of the CSDR in particular on settlement discipline, are underway and should be adopted very soon. Certain segregation rules are already being reviewed to ensure consistency across the EU. The recommendations that have been made in the context of the ESAs review aim at making it easier for ESMA to ensure supervisory convergence and a more consistent implementation of regulatory requirements.

Moreover, much work has already been done and important improvements made to remove the 'Giovannini barriers', although some issues remain to be tackled according to the conclusions of the EPTF (European Post-Trade Forum) report. The Commission aims to publish a communication in Q3 2018 with proposals to remove the obstacles that have been identified in the EPTF report and following the Commission public consultation on post-trading, which ran in late 2017 to assess stakeholders' views on the existence and the scale of issues. Some of the barriers have been identified in previous Giovannini reports, but others are new ones resulting from evolutions of the financial market landscape (e.g. technology developments). At the moment, new legislative initiatives are not foreseen and the Commission is assessing the priorities for the future. For example on the specific issue of reporting requirements which was also highlighted as a main concern by the EPTF, the Commission has already launched a fitness check and a study on the rationalisation and streamlining of reporting obligations to reduce costs and burdens for the market.

An industry player underlined that in addition to the EPTF initiative three pillars are fundamentally determining change in the post-trading area: TARGET2-Securities (T2S); EMIR and related regulation that addresses the need for collateral and collateral mobility; and the CSD regulation (CSDR).

1.2. Effective progress is limited so far but there are reasons for optimism

Several speakers regretted that the outcomes in the market of the actions that have been led in the post-trading area are so far limited.

A public representative was frustrated by the limited progress that has effectively been made in the harmonisation and integration of post-trade, which should be a key driver of the single market. The momentum that was built up following the crisis and which led to the adoption of EMIR and CSDR in particular has run out of steam. Many pieces of legislation still remain to be implemented, such as CSDR, SFTR and some parts of EMIR. Although attempts have been made to address some of the most obvious conflicts of law through the CSDR and other pieces of legislation, Member States have continually put red lines in place that have blocked any improvement. The benefits of harmonisation for the market and for investors thus still remain to be felt. This is a concern since investors find it incredibly difficult to construct a portfolio across Europe at present and this lack of efficiency hinders investment. In addition, most MEPs understand the politics around the debates but not necessarily the precise role that market infrastructures and the post-trade environment play in the financial ecosystem, which increases the difficulty of making progress on these issues. It is hoped that the upcoming European elections will bring in some new 'champions' of this area. Indeed Member States do not consider post-trade to be a priority and this is why most of the Giovannini barriers are still in place.

An industry speaker agreed that very little real progress, in terms of outcomes, has been made, largely because of the pre-conditions that need to be achieved and multiple blockages that need removing. These issues need to be addressed in the upcoming communication of the Commission on EPTF. A great deal of work still remains to be done on the public sector side, notably to remove the fiscal and legal barriers that have been discussed for the last 15 years. These are the most difficult ones to remove and have a strong impact on daily operational post-trade processes. The lack of progress in this area explains the scepticism regarding the possibility for significant progress. The implementation of new post-trade rules also concerns many public sector entities (e.g. tax authorities, central banks…) that need to adapt to the new rules. There is, however, hope that some blockages can be tackled in two areas in particular. The first is shareholder transparency thanks to the Shareholder Rights Directive II. The second is fiscal barriers, which are possibly the most important ones, with the withholding tax code of conduct around which momentum needs to be built.

Another industry player felt that legacy systems and vested interests in the industry are the main reason for the lack of progress on the Giovannini barriers. Help is required from the public authorities and Parliament to overcome these. Progress is now needed because a number of triggers are approaching. The first is the CMU, which needs to be a success. Second, there is a great deal of political change on the horizon, notably with Brexit. A tipping point has also arrived with regard to technology, which may allow the industry to address legacy issues in a more efficient way.

There are however reasons for the slow speed of progress, some speakers believed.

An industry speaker explained that the post-trade area is complicated and much investment and time are needed for business models to evolve and for a great number of post-trade stakeholders and also market participants to adapt. The implementation of T2S, for example, requires broker dealers and banks to adapt to the new framework, which takes time. If the expected volumes are not yet achieved, this is due in particular to the fact that more time than was originally thought is needed for all industry players to benefit from the impacts of T2S. There are also concentration trends and impacts from increased competition that will take some time to materialise.

Another industry speaker stressed that after the implementation of new rules the following phase, which is the adjustment of business models and the migration of the whole of the ecosystem to take advantage of the possibilities offered by the new rules, is often overlooked or viewed too optimistically. T2S is a good example of this. The direction of travel chosen for T2S is the right one and is irreversible, but there has been collective over-optimism regarding the speed of that travel. Nevertheless, it will happen even if it takes a few more years than expected. For future changes, expectations need to be more reasonable. More account needs to be taken of inertia in the market, due to the complexity of the environment and the investments needed. In addition, all actors in the ecosystem have to implement many regulatory changes at the same time and are therefore making trade-offs in their investment decisions, which increases the overall implementation delays.

Some speakers on the panel felt that there are reasons to be optimistic that progress can be made.

It cannot be said that progress is not being made, an official stated. The Commission has done its part of the work with the legislations that have been proposed and adopted. Regulation is a process that is validated democratically, which demands time. And on the operational side, T2S has been implemented. Another official agreed that T2S gives reasons to be optimistic. T2S alone has removed some of the original 'Giovannini barriers', admittedly some easier ones. But it has also created momentum towards harmonisation which can be used to address the main upcoming challenge, which is the increase of mobility of collateral in the Eurosystem with the ECMS (Eurosystem Collateral Management System). This is a very important objective because collateral markets are extremely local when it comes to market practice and to the granularity of processing, cut-off times, static data and so forth.

An industry speaker was also optimistic about the work of the EPTF and the possibility to tackle the remaining post-trade barriers. The best way forward is to set up some joint work between the private and public sectors to monitor progress and to challenge each other. An official noted that, to some extent, the T2S arrangements allow for the joint monitoring of progress.

2. Possible need for additional action from the public authorities

2.1. Imposing market standards and harmonised rules

An official underlined that standardisation is an area where the industry has traditionally been left to take initiatives, complementing legislation. The question is whether more market-driven initiatives are needed to foster more standardisation or if the authorities have to step in.

An industry player called upon the Commission to be 'bold and prescriptive' about standards, even though there might be some resistance, first deciding what need to be the key priorities and also providing the support from a legislative perspective to encourage the industry to put the necessary changes into place. In addition standards need to be sufficiently granular in order to facilitate their implementation and to make sure that industry players apply them consistently. An example where such boldness has worked is the LEI (legal identity identifier) which was initially not used, at least not holistically, until it was mandated by EU legislation, after which everybody was using it. The LEI is a global standard but it is the Commission's LEI legislation which has been adopted globally. There is therefore very much an opportunity for Europe to act as the driver and the catalyst for change in this space. The UTI (Unique Trade Identifier) and UPI (Unique Product Identifier) need to be implemented in the same way. Another issue with standards such as UTIs is that there also needs to be a process of standardisation in their application. An official agreed that, with regards to standards, the implementation process is an important part. There first has to be agreement on the standard itself and then a governance structure needs to be put in place before moving on to enforcement.

A public representative agreed that the industry needs to be given a political impetus to implement standards and that co-legislators need to put them into the legislation and specify what needs to be done. Resistance from industry players mostly comes from their legacy systems, which they do not want to change. MiFID II is a good example of this; the industry complained about the impacts, but they are changing their systems and getting on with it.

Another industry representative stated that there are still many differences across Member States in the detailed requirements (e.g. practices, filings…) deriving from EU legislations such as CSDR. This is because EU legislations are translated differently in order to favour national interests, which is a contradiction of their objectives but it is a European reality. Therefore, it is not only about regulation and standardisation; the political dimension is also essential to make European regulation more European and less national in its implementation.

Some speakers believed that reinforcing the powers of ESMA as proposed in the ESAs review would help to move towards more consistency of rules at the EU level.

An industry representative suggested that providing ESMA with the power of authorising and supervising CSDs could help to address some of the issues related to the domestic implementation of CSD rules for example. A more harmonised and unified market infrastructure is required across Europe as a common foundation, alongside national ecosystems. Building that harmonised foundation requires European rules and also European supervision. A public representative believed that cross-border supervisory co-operation and convergence, as proposed in the EMIR review, should not be confined to CCPs, but should be applied to the entire market infrastructure of which CCPs are only a small part. A European supervisor would help to enhance cross-border efficiencies and this should be implemented for the whole of the market infrastructure and architecture.

2.2. The proposal of a single post-trade legislative package

A public representative suggested that for further progress to be made, the whole post-trade legislation should be reviewed in one dossier, similarly to MiFID II, thereby imposing one set of new rules and a new system that is more European. The Commission needs to be bold in this regard also. Politically, it is indeed easier to make progress with 'one big package'. Breaking it down into separate pieces of legislation means that each Member State can have their red lines on every component; whereas, if they are presented with one big package, they lose that possibility because they cannot impose red lines on all topics of a legislation.

An official supported the notion of a single package, stating that the post-trade space can learn from the payments space where a single piece of regulation was implemented that changed everything. End-to-end regulation (i.e. a regulation whereby for the end-user the price of a domestic transaction must be the same as a cross-border transaction) changed everything in the SEPA implementation. The same could be envisaged for post-trade. Similarly, in terms of defining roles and responsibilities for implementation, an equivalent of the European Payments Council, which is in charge of implementing the technical standards in payments, could be set up in the post-trade space in order to monitor the implementation process.

An official noted that defining what should be done respectively through regulation, technical standards, and monitoring the implementation of standards at the national level, is very difficult. It is not sure that a perfect approach can be found that is feasible and yields the same benefits in every sector and country of the single market.

A policy-maker was positively surprised by the strong call for more legislation and for policy-makers to be bolder and more prescriptive, and agreed that in some cases legislation is the only method by which barriers can be removed. Packages have advantages and disadvantages as demonstrated by the 'painful' experience of MiFID II. The Commission remains open to examining different approaches but it is doubtful that a single package approach to post-trade would be welcomed by MEPs and Member States. On-going discussions about withholding tax or the new role proposed for ESMA in the context of the ESAs review demonstrate that proposals with an ambitious European approach are difficult to get agreed. This would need to be carefully tested and trade-offs are needed. At present the focus is on finalizing and implementing what has already been adopted and an assessment of the impact of the current legislation may also be needed. However, if the conclusion is eventually that further legislation is needed, the Commission will not refrain from tabling new legislative proposals, including bold ones.

3. Expected impact of technology in the post- trading area

An industry representative considered that technology can help to solve some long-standing problems in the post-trade area, but cannot solve them by itself because many of them are deeply embedded in national company law and national fiscal rules. There are two particular areas where technology can help. The first is shareholder transparency and transmitting end investor information up the custody chain to the issuer, the regulator and other relevant entities in the country of issuance. The second is moving tax information up the custody chain, particularly about end investors and their tax status, and giving that to the tax authorities and withholding agents in the countries of issuance. An official believed that fintech and digitalisation can also help to improve collateral mobilisation because it will lead post-trade participants to reconsider their infrastructure and invest in new systems and processes.

There are however also domestic barriers to the use of technology the industry speaker underlined. One example relates to the proposed Level 2 measures of the Shareholder Rights Directive II which aims to build a unified operational process across Europe for all European shares. Intermediaries have to provide the name of the shareholder. The problem is that the definition of a shareholder is determined by national company law and varies across jurisdictions, making it difficult, if not impossible, to build a unified operational process potentially supported by technology in the EU.

Another industry player believed that technology and fintech will probably be the most important game changer in the coming years, including for post-trade. The question is where and when the changes will happen. Two years ago, discussions mainly focused on DLT (distributed ledger technology), now artificial intelligence, machine learning and a wider range of new technologies are also being considered. The success factor going forward will be the understanding of how this combination of technologies can significantly improve the way post-trade processes are performed. In this respect the approach proposed in the Commission's Fintech action plan not to introduce new binding rules but to promote enhanced supervisory action and dialogue with the industry seems appropriate, because fintech is still in the testing period. This should allow for a better understanding of the impact of fintech on post-trade as well as on many other financial services areas.

A third industry speaker agreed that technology can help the industry to be more efficient and is a potential game-changer in the post-trading space in particular, however it requires regulators to adapt their thinking about technology-driven solutions and how they should be implemented and monitored. For example, sensitivities around data location and where data is held are being overturned by cloud technology because it is very hard to point to specific locations. The current regulatory approach may need to be reconsidered in the light of these new developments.

MiFID II implementation: opportunities and challenges

1. A smooth implementation of MiFID II but some remaining issues

The Chair underlined that MiFID II, the review of the Markets in Financial Instruments Directive, is a key piece of post crisis financial market legislation and has got off to a good start. The panellists all agreed that the implementation on 3 January 2018.was overall smooth and there have been no major market disruptions so far. Even in the quite volatile trading environment seen in February, the market worked quite well. This was a challenge given the complexity and volume of legal requirements in the legislation and the significant IT efforts required.

The decision to postpone the entering into force of the legislation by a year has helped the market and the public authorities to be ready for 3 January, several speakers emphasized. In some Member States additional time has been needed to transpose the new legislation. The significant combined efforts of the public and private sectors to prepare the implementation and the on-going dialogue between them also helped to achieve this positive start. In addition extensive simulations run by market infrastructures with market participants before the starting date helped to test systems. The implementation required significant financial and human resources and some market participants struggled to get the necessary systems and documentation in place, but all still managed to comply with the new requirements.

Several speakers stressed that a great deal of work remains to be done however, which is understandable with such a complex piece of legislation. ESMA will be focusing its supervisory convergence work very heavily on

MiFID II and MiFIR in the short term in order to identify any further adjustments and provide guidance that may be needed.

2. Trading obligation and market structure changes

2.1. Trading obligation and impact on the current market structure

A policy-maker stated that the introduction of a trading obligation for shares and for sufficiently standardized and liquid derivatives to be traded on regulated platforms worked well with no disruption. This is partly due to the fact that the Commission had adopted the relevant equivalence decisions before 3 January. The initial preliminary figures are encouraging in terms of transparent trading, which seems to have slightly increased from 47% in 2017 to 51% in the first four months of 2018. In parallel, there has been a large reduction in dark trading.

An industry representative confirmed that there has been a significant decrease in the OTC trading volume due to a combination of the trading obligation and the ban of broker crossing networks, which is positive. One key objective of MiFID II is indeed to encourage a migration of dark OTC trading towards transparent venues in order to ensure relevant price discovery, which is essential because it forms the basis for informed investment decisions and contributes to investor protection. A question however, is where the trading flow is migrating to.

A regulator stated that impacts on the overall market structure are essential to assess. MiFID II requirements are triggering market adjustments and new players will appear. These changes are being monitored by supervisors but it is important that they receive feedback from all market participants. ESMA in particular is willing, if necessary, to clarify certain parts of the legislative process or to advise the Commission and the co-legislators on possible future amendments at Level 1. A number of new SIs (systematic internalisers) have emerged over the last few months, now totalling nearly 120 in the EU and the moves between the traditional trading venues and these new SIs are being analysed by ESMA. A competition issue in the tick size regime has been identified, as SIs are not covered by the regime in the same way as trading venues are. The way to fix this issue is currently being discussed, either via a slight amendment to one of the MiFID II technical standards as proposed by ESMA or by a fix of the Level 1 text. The issue of interconnected SIs and whether they are still SIs or not has also been taken care of. The most immediate issues have been tackled but further assessments of the impact are needed.

An industry player added that there has also been since the beginning of the year a very steep increase of trading on SIs, which has gone from 2% under MiFID I to more than 20% of daily trading volumes. In addition, the SI regime has not fully kicked in yet since the need for registration arises in September, so it is expected that more SIs will emerge. One of the reasons for this increase are different requirements between SIs and lit markets. In addition to tick sizes, other problems remain to be tackled regarding the transparency regime in particular. In order to achieve the objectives of MiFID II, it is important to ensure a level playing field which has not yet been reached with the SI regime. Some changes in this regime will probably be needed but evidence first needs to be collected.

Another industry player agreed that SIs are an issue. OTFs (organised trading facilities) such as swap trading platforms, which are new multilateral platforms that have been introduced for the trading of non-equity instruments, are also losing market share to SIs notably with regard to large asset managers; these used to go through brokers for simple products such as listed derivatives and listed futures options but they are now trading through SIs. The reason that asset managers put forward is that trading through SIs is easier because there is more flexibility on transparency requirements and they take on more of the reporting obligations. SI banks are trading against their own accounts however and the speaker was not sure if this situation is tenable. Another issue is the difference in the interpretation of MiFID II rules between the UK and continental regulators (e.g. France), regarding what should and should not be traded through an OTF. Fostering a common view among NCAs on this issue is complicated and OTFs risk losing certain clients if these differences persist.

2.2. Double volume cap mechanism

A regulator stressed that the double volume cap mechanism (at 4 and 8% of the total trading volume) aiming to limit the volume of trading of liquid equity instruments on dark pools through the application of waivers took more time to introduce than originally intended due to data quality problems. These are however in the process of being resolved thanks to the joint efforts of ESMA, NCAs, and trading venues. A first group of 700 instruments trading in dark pools under certain waivers were suspended in March following the assessments conducted by ESMA. That trading should normally move into the lit market, however, some of it has potentially gone into areas such as auction trading, which is an issue that requires further investigation in order to evaluate the impact of those measures.

An industry player stressed that this very technical measure is difficult to interpret despite the Q&As that have been published. Some flexibility for the large in scale waiver would be welcomed in particular.

3. Legal Entity Identifier (LEI) implementation and data quality and reporting challenges

3.1. Implementation of LEIs

A regulator stated that LEIs are a new and positive development that is helping to improve global data standardisation. They will notably allow regulators and market participants to share and exchange data in a far more efficient way than today and to obtain a clear and coherent picture of the market. Their implementation however takes time and is far from complete, with a faster uptake in some regions than others. Initially it has been difficult in Europe to ensure that all the participants interacting in the market, either buying or selling MiFID instruments or providing services in connection with them, have an LEI. The impact that the lack of LEIs would have on the production of quality reporting has been acknowledged by ESMA and the NCAs and accordingly, ESMA allowed the trading venues and the intermediaries to find interim measures for their clients at the end of 2017. Since then, there has been a significant uptake in the LEI provision in the EU and it is hoped that this will allow implementing the process appropriately. A further challenge is encouraging other major jurisdictions to adopt LEIs.

An industry representative agreed with the importance of LEIs. The transitory solution used was beneficial and provided a good structure of how to handle the LEI implementation. There are, in particular in the German market, many instruments that have been issued a long time ago with no ISIN and are not frequently traded but most of them have been handled now.

Another industry player was also grateful for the transition period that has been granted in relation to LEIs.

Brokers however have issues with Asian clients for example who do not want to use LEIs for reasons of confidentiality and move over to US brokers that have a subsidiary in Asia. A policy-maker felt that the implementation of LEIs is still problematic. There is some resistance from certain pockets on the LEI concept and principles.

3.2. Data quality and reporting improvements

Several speakers underlined that the challenges MiFID II involves in terms of data collection, data quality, and how the necessary systems to process data interact.

A regulator stressed that good quality data is essential for the success of MiFID II and the related supervisory work. At present it is however not sufficient. These are technical issues that can be solved over time but that nonetheless cause inconveniences. In addition the IT systems of domestic supervisors need adapting to the new data formats coming in, which will require some time. The sharing of data between NCAs also needs improving. Some reporting processes are complex and although data can be transferred quite quickly when all the systems are in place some links still need to be enhanced. One regulator specifically pointed out that the data sharing process between home- and host-authorities in the supervision of branches is currently a bottleneck.

An important improvement made through ESMA, is the cooperation and pooling of resources of almost all NCAs to create a common IT infrastructure for their reference data for financial instruments, through the so-called FIRDS (Financial Instruments Reference Data System) project. There is now a single system instead of 31 individual expensive and possibly incompatible IT systems. This common EU-wide IT project, which was developed on a voluntary basis without legislative mandate and with a coordinating role of ESMA, should be a model for future initiatives, the regulator believed. Developing common tools such as reporting tools or databases at the EU level which can then be used by all EU NCAs is the most efficient approach for supervision and also beneficial for the industry, as it creates uniform reporting formats throughout the EU.

Another regulator emphasized that well-functioning IT systems as well as good quality data is essential particularly for the parts of MiFID II dealing with the identification of liquid financial instruments and dark pools which require statistics to be produced and analysed.

A policy-maker added that there is still a need for a consolidated tape provider. The Commission had hoped that one would have emerged by now and will continue to encourage this to happen.

4. Investor protection and conduct of business measures

4.1. Cost of research

The Chair noted that the requirements to unbundle the costs of investment research from trade execution costs have raised many questions notably regarding SME equity research. An industry representative added that there are impacts also in the derivative market, including for listed derivatives, futures and options. Asset managers are asking brokers to reduce their fees and research costs as a result of the MiFID II measures. They prefer to concentrate their research and their trading volume on banks and to trade on SIs. This means that brokers will have to adapt.

A policy-maker considered that the measures relating to research, which aim to increase competition and avoid conflicts of interest, are appropriate. Indeed portfolio managers must now justify value for money and the selection of research providers. Although it is too early to draw conclusions preliminary feedback is encouraging. An increase in competition has been observed as well as a slight decrease in costs and there has been no sign so far of barriers to access to research on SMEs. The Commission will however continue to monitor the changes happening in the market to make sure that there are no unintended consequences from these measures.

A regulator stressed that some trends can already be observed in the Bulgarian market, which is a small market with small companies. The banks there are unlikely to offer products based on research and investment, which will remain the purview of investment firms. However only those that have the capacity to cope with the new requirements will continue to offer such products.

4.2. Distribution measures

A regulator pointed out that market structures differ between Member States. For example Austria has a very fragmented and decentralised banking market and a distribution model that is mainly commission-based with products produced and sold within banking sectors. These differences need to be taken into account in the implementation of MiFID II. The regulator was also confident that MiFID II can accommodate these differences. While this market structure is not expected to change fundamentally in the coming years, mainly because it provides customers with proximity and a wide regional coverage, MiFID II will impose greater transparency, especially on costs and the value of commissions. It is important to make sure that excessive constraints are not imposed e.g. by the measures regarding independent investment advice, the regulator stressed. In the longer term the financial sector is expected to evolve in these countries further in line with MiFID II objectives. Banks indeed now have to prove to customers the added value created from the commissions they charge. They also need to reassess their business models with the growing digitalisation of the sector, particularly for the provision of fairly basic financial services. In this sense, MiFID II has implications in terms of market structure also on the distribution side.

4.3. Product intervention powers

A regulator mentioned that some measures have been taken, in the context of the new product intervention powers bestowed on ESMA and the NCAs, to ban retail sales of binary options and to restrict the provision of CFDs (contracts for difference) to retail customers. This is quite an important and impactful measure and the extent of that impact will now be monitored.

Another regulator stressed some gaps and limitations with regard to product intervention powers applying to products offered by third-country firms. At present it is unclear how product bans concerning for example binary options and CFDs offered to European retail customers can apply to third-country providers.

5. Impacts of Brexit and possible need for a MiFID III

The Chair asked if the problems that have been mentioned during this discussion can be solved in the existing MiFID II framework or whether a MiFID III review will be required and also whether Brexit will have a significant impact in this context.

An industry player underlined that MiFID II was designed for 28 Member States. Brexit questions the on-going calibration process, which is based on data samples that cover all 28 countries, since the EU will be losing its largest capital market. For many instruments, the majority of the liquidity is in the UK. Therefore the definition of liquid instruments will need reviewing within the EU27 market structure. It will however be challenging to get that calibration right in terms of trading obligations, transparency regimes and, ultimately, equivalence, since markets are completely interlinked, with 50% of the trading volume in the cash market currently coming through UK entities. Another industry speaker added that, with regards to Brexit, the issue will be to get appropriate statistics from the trading platforms based in London. Another question is whether some swap platforms will be migrating to the continent. A regulator stressed that there is also a cross-sectoral dimension to Brexit. The Single Supervisory Mechanism is concerned that Article 47 of MiFIR may create regulatory arbitrage issues of prudential banking supervisory standards by allowing third country investment firms to offer their services in the EU without the establishment of a subsidiary or branch.

A regulator emphasized that although the overall effects of MiFID II will be positive for the EU market, increasing transparency and investor confidence, the impacts on smaller markets such as Bulgaria may need reconsidering. Many players in these markets feel that there has been 'over-regulation'. There is a risk that some investment firms might try to circumvent the rules or move towards unregulated sectors. This will need to be closely monitored in order to avoid smaller markets being 'suffocated' by MiFID II requirements. Rules might need adjusting in a more proportionate way.

Some speakers on the panel believed that the issues discussed can be tackled within the existing MiFID II framework and do not require a MiFID III, which anyway is not planned currently by the Commission. A regulator considered that as with any legislation, it is important to make sure that it is properly monitored and that it can potentially be adjusted. Since some of the detailed provisions of MiFID II and MiFIR are at Level 2, there is significant ability to adjust requirements in the context of the existing MiFID II framework before considering more fundamental changes. It should also be possible to make potential adjustments related to Brexit in the current framework. Another regulator added that Brexit offers an opportunity to review MiFID II arrangements notably regarding third countries.

The first industry representative stated that transparent and well-functioning markets are an essential component of financial stability. The necessary measures will need to be taken either at Level 2, within the Capital Markets Union or if needed through a MiFID III review. Brexit will require making some amendments but a detailed assessment of what is happening in the market is needed before any changes are decided.

FINTECH AND DIGITALISATION

Impact of fintech and digitalisation on financial business models and value chains

1. The magnitude of change in the EU from technology and innovations

1.1. Short and medium-term expectations

An official questioned whether there will come a 'Kodak moment' for banks, (i.e. when they disappear off the radar and are replaced by other entities). Banks have been around for centuries, but other successful business models have disappeared in recent times. The knowledge banks gain from seeing customers' transactions is threatened by the advent of organisations with better capabilities to analysing data, as well as legislative changes such as PSD2 making it possible for other players to access that data. There are interesting questions surrounding the impact of somebody else taking over those customer relationships. Other elements to consider include the public policy response.

An industry member remarked that the buzzwords of a few years back are now becoming a reality in many business areas. Common Application Programming Interfaces (APIs) on open platforms are connecting better to clients, while big data and Artificial Intelligence (AI) provide clients with solutions. In the middle and back offices, there is much better utilisation of processes and robotics, though Distributed Ledger Technology (DLT) is still in the making. The perceived impacts are focused on the financial industry, but it may not be where they are most felt.

DLT is capable of disruption in other areas. Global regulators have agreed with the position early to decide whether the technology will ultimately transform financial services. Most people know about the advantages of DLT: it creates complete equality of information and allows for easy identity management, data transfer and transaction records. Over time, this might lead to greater efficiencies and cost savings. At this stage, the technology is still coming out of proof of concept and is yet to reach its full potential. Both regulators and customers want to see it running reliably for a while before they commit to any major services.

A regulator believed that financial technology stands for change and can be seen in every segment of banking, whether instant payments, mobile banking or robo advisers, and of course digital currencies. There is a transformation in banking and competition between fintechs and banks, but no widespread disruption apparent at present or in the future.

An industry representative disagreed. Exchanges such as Nasdaq operate markets for different asset classes, CSDs, CCPs and brokers. They provide technology to more than 100 marketplaces and more than 50 countries, and are essential to how markets run. The technology is developing fast and causing disruptive changes particularly in the Nordics. It offers reduced cost of production and distribution, and increased convenience in consumption in financial services. That has a scale opportunity far beyond what has been achieved in retail that will drive change in the financial industry and banks in particular, and may cause some consolidation too. This speaker gave the example of Klarna, a payment solutions provider in stores, and iZettle, which allows entrepreneurs to establish a payment-receiving company in as little as 15 minutes.

A public representative doubted that anyone truly knows what will happen in the next five or 10 years. In Lithuania, the fintech hub is growing faster than anywhere else in Europe, yet the future remains unclear. However, though Fintechs come with risk, not investing in future technologies may be a bigger risk than investing. Resources ought to be dedicated to learning such processes.

1.2. The impacts on business models and value chains

An industry representative underlined that digitalisation can have a dramatic and immediate impact today by applying robotics to activities that are not currently well automated and making them operationally efficient. There are examples from industry of payment processing being handled by robotics and taking less time than it used to with greater accuracy. Banks that cannot offer high tech services on demand are likely to shrink as a function of the market mechanism.

Institutions might fail given the competition they are facing for part of their business, but fintechs do not have to only mean competition; they can also partner the development of the existing banking models. An industry representative underlined that the old fashioned perspective is that banks are being threatened by the startups, which are eating into their value chains, but others have pointed out that fintechs and banks can cooperate. A public representative advocated cooperation in preparation for the future. Sandbox regimes allow those who work together to learn together. The main differentiator among European banks in the future will be the national and political context in which they operate. In some countries, customers can apply for a mortgage online, for example, because public authorities have open data solutions enabling banks to access the tax forms and information needed to make the process smoother for the customer.

Some warn that technology providers or start-ups must be careful not to become distracted by the technology instead of the service. An industry representative stated that costs have been a big driver of innovation and technology for a long time, but development has also sought to own the customer or the new services they expect. Banks know their customers and that is how they can have value for them. The customer will not only have an interface with a bank or another player, hence multiple ownerships. The challenge now is how banks can partner with non banks or non traditional players to offer their customer added value. Banks do not own the customer anymore, but maybe the customer owns them. An industry speaker described their bank's platform for providing financial advisers with services for their end clients. The clients do not see the originating bank at all, and ownership becomes a collaborative matter. Symmetrically, the industry speaker's bank also maintains an open platform with fintechs to provide the most appropriate service the customer expects. All of a sudden, it is not so much about who the client is, but what solution is being provided.

An industry representative explained that when blockchain was first announced, one of the first use cases was payment and settlement. If fintechs are smaller entities developing technology outside incumbents, they are a great thing and should be encouraged. The incumbents should not be afraid of the technology, however. The knowhow and experience they have gained over the years have to be successfully twinned with that technology for success. DLT might be a threat or an opportunity, but it will open up new forms of cooperation in the field, breaking up monopolies and allowing newcomers to enter.

An industry speaker underlined that one aspect that is often ignored when talking about the transformation of the industry is the cultural change that will take place within banks. The industry has not seen a competence shift of this scale occurring for decades, with banks recruiting more tech people than financial experts. This is a challenge to the regulators to catch up when it comes to competence and interaction on these issues.

A Central Bank official stated that the banks need to watch out for the risk of monopolies appearing through successful deployment of new payment networks or other more advanced technologies. A regulator was reassured that competition policy, a competition commissioner and national authorities would address the threats of monopolies. However, in regions where banks are up to date in their technology these monopolies are less likely to form. Yet, there might be a risk of new monopolies appearing, not necessarily from fintech but big tech if they manage to monopolise parts of the more advanced technologies. The markets may not remain national or regional, and lead to a few globally dominant players. This needs to be watched for down the line. That is a challenge for the competition authorities and the political landscape.

1.3. Challenges posed by cryptocurrencies and DLT

Many panellists agreed that whenever payment systems are not sufficiently well developed and efficient they offer opportunities to cryptocurrencies although they are not currencies. A system of instant payments should take effect in Europe by the end of the year, alongside a much better cross-border transaction system. Such systems will ensure productive competition.

One regulator described cryptocurrencies as 'a gamble', whilst an official suggests they are misleadingly named, because they are not assets or currencies at all, but 'crypto tokens'. A public representative explained that the term is subject to many different definitions. It is in particular an opportunity for small and medium sized companies to attract additional capital via initial coin offerings.

Cryptocurrencies are potentially a great technology for transferring ownership of something from one person to another, if applied correctly. Everybody should be allowed to invest in what they want, and it should be for the consumer, not governments, to decide whether they want to use cash or some form of digital payment system.

However, the risk is if consumers perceive the safety of such products as going beyond what they actually contain. The main task for regulatory authorities rather than forbidding cryptocurrencies, is to avoid creating an artificial sense of security. The state should seek to ensure a sufficient level of transparency, obedience to the principles of AML, cybersecurity and the other main means of managing such risks.

Initially, one of the main reasons that blockchain technology was used was to escape transparency, but this is no longer a feature of cryptocurrencies. Rather, by defining how the product obeys the laws of AML and other rules, this asset or currency can be enabled to facilitate the real economy. It could be even argued that, giving access to the complete transaction history, cryptocurrencies may offer some advantages to regulation and AML.

A regulator wondered whether cryptocurrencies offer the possibility of central banks going back to their roots and seeing ordinary households as their immediate customers. Yet a Central Bank official does not regard central bank digital currencies as a possible backwards step. Instead the role of central banks has never been to work in competition with private banks. Indeed, if a central bank were to issue digital currencies to retail customers, it would look like cash but, in practical terms, be very different entailing grave consequences for the architecture of the financial system. Actually a central bank digital currency for retail investors would be in direct competition with retail investors' deposits in private banks due notably to the fact that this central bank digital currency would provide these retail depositors with a de facto safe haven in the event of a financial crisis. This would consequently question the ability of retail deposits to contribute to the financing of the economy.

An industry representative explained that their institution started to apply DLT in less heavily regulated areas where consumer trust could be secured. Its first application was e voting. It has since moved on to a mutual funds prototype, in a project together with the Nordic bank SEB, in which client currency is converted into a cryptocurrency, shares exchange against money and it then goes back to the seller's account as normal, but with improved database handling. This is a private chain and permission based. The exchange is also now deploying an application to handle collateral moving between European CCPs. This is more interesting from a regulatory point of view and has possibilities for a large amounts of efficiency to be gained.

Finally, initial versions of blockchain are very different from how DLT is now being applied in financial services. In particular the information is distributed, but verification is limited to a smaller group of entities. However, there is concern about cash movements being disconnected from the central banking system. This is something that needs to be better understood when the technology is ready to take on board more advanced services.

2. Technology's role in the development and further integration of EU markets

An audience member asked how fintechs are affecting European financial integration. When online banking began, people felt that borders would crumble and integration would improve, but the speaker questioned whether fintechs would help. There are issues about the interoperability of the different solutions being developed and, although there is supposedly a Banking Union in Europe, the retail markets are relatively fragmented. A regulator responded that a lot more than fintechs are needed to integrate financial services across Europe. He worried fintechs should be overvalued by a big margin but did not see disruption coming at present or in the future.

Another participant challenged this opinion, citing that online banking has clearly contributed to the death of the physical branch. Another regulator doubted there would be major disruptions to the system. The fintech discussion is about improving services for customers, both via what banks are currently doing and what fintechs can add. They might not be equipped to go it alone. By combining, entities will ensure an efficient system of instant and cross-border payments. This might not be considered a disruption, but rather a contribution to a better-functioning single market.

A public representative did not see the integration of financial markets as the essence of fintechs. They are about consumer needs, and making consumers great again. The discussion should be about making transactions quicker and less costly. The removal of any barriers at the EU level will speed up the spread of best solutions and so better reflect consumer needs. Consumers do not care about how technologies work; they want fast transactions, clear investment opportunities and to be secure in the knowledge of where risk is. The discussion should therefore be about consumers' experiences.

3. Objectives of EU policy for technological innovation in finance

3.1. Fintech regulatory targets: technology neutrality, trust enhancement, systematic cooperation

A regulator suggested that fintechs should be welcomed for triggering stronger competition within or against the banking sector, spurring on innovation, and creating better products at lower prices. However, such competition should not be initiated by circumventing rules, regulation or safeguards.

An official explained that two different views of regulation have been explored: one of regulation as a cost that will drag down the industry, and another as an entry barrier in which a potential competitor needs to demonstrate competences to gain trust. An industry participant depicts a third alternative in which regulation is a necessary cost. The industry representative applauds the revised Payment Services Directive, the consequences of which are positive in breaking up monopolies and encouraging banks to change. The right regulations can be beneficial in ensuring a level playing field in financial services for newcomers. Politicians and public authorities will ultimately have to deal with these issues, because players within the same services should not be allowed to do the same things and be regulated differently.

The Bundesbank takes a neutral stance to technology and thinks more about supervising activities than favouring one technology over another. The Danish financial supervisor like many supervisors, has established a fintech division and a sandbox, and is waiting to see the impact.

An industry speaker outlined how they increasingly cooperate in areas that they would have done on their own before, such as KYC and AML, using technology to enhance their procedures. He appealed to the authorities to maintain their approach of not regulating technologies, but striving for what enhances trust.

That trust should see more collaboration between the different regulatory processes, not only in the digital agenda, but in data protection, cybersecurity and transparency issues. A public representative advocated cooperation in preparation for the future. Sandbox regimes allowed those working together to learn together.

An industry representative explained that in the initial days of the fintech buzzword, there was a mindset of technology looking for a problem to solve. It is now much more important that both market participants and regulators look at the strategy and take problems with business processes first, before seeing how to deploy the technology. The best way is through collaboration, because the incumbents understand the complexities of the businesses, the legacy systems and why certain things behave as they do. That has to be better than some kind of disruption.

3.2. Pragmatic policy initiatives

The broad terms used in talking about fintechs make sense in discussions about regulation and understanding technology. The proposal for the supervisory authorities is to consider fintech and all its activities. Policies must avoid fear of the technology and avoid ideas being shut down.

Any action plans cannot try to regulate fintech broadly, but they look at targeted initiatives assessing the risk in deploying the technology in each case. Such specifics include everything from replacing entire payment systems to robo advice. This argues against the proposal to create an overall fintech regulator. They are not a single invention but a collection of entities that rely on data as their driver.

Yet an official suggested that there are tricky decisions facing regulators in relation to fintechs. A fintech can be a bank, an investment service or payment platform provider, but the regulatory basis for each is very different. It might be difficult for ordinary customers to distinguish between these various roles. This depends on how national legislations define banks and how well understood those definitions are.

What can be expected from the EU Fintech policy framework?

1. Expected impacts of the proposed EU Fintech Action Plan

The Chair underlined that the European Commission has recently proposed a Fintech Action Plan aiming to foster and support the development of fintech in the Union. The Commission has chosen not to 'take a legislative hammer' and has favoured a more balanced policy response. Except for crowd funding, there is no legislation in the Action Plan, but rather a series of measures focused on promoting supervisory action, dialogue and monitoring.

1.1. The need for a measured and balanced policy approach to fintech

The speakers on the panel supported the approach proposed by the Commission.

An official approved of the 'light touch' approach that has been chosen. This is the right way forward because it is still unclear how fintech will develop in the future. It is difficult at this stage to direct requests for further regulation towards specific issues in this area and regulators should avoid favouring certain technologies. That is partly due to the varying levels of maturity of different national markets regarding digitalisation and fintech. For example in Member States where the use of physical payment instruments (e.g. paper cheques) still plays a significant role, the potential scope for fintech is more important than in countries where most payments are made by credit card. The official also advised against being 'caught up in the hype' and recommended considering the facts objectively. When the internet arrived in the late 1990s, many people at the time predicted that brick and mortar banks would disappear, which did not happen. The fundamental nature and risks of financial services will not be changed by fintech and technology, which is why a light touch approach is preferable.

An industry representative believed that a measured approach, in terms of timing and scope, is needed for policies applying to technological innovation. Not all bank branches are going to close. In addition, regulating activities or processes before knowing exactly how they will evolve is difficult. The industry is still looking for new ways to use blockchain for example.

A level playing field in the rules is also needed between incumbents and newcomers. These innovations are being embraced by the industry and customer behaviour and client interaction are changing with less people visiting branches for example, which means that less of them will be needed in the future. Basically, 75% of banks' daily client interactions could be done without a bank. A fintech could for example create a price comparison app with PSD2 and acquire client payment instructions. It could create a brokerage function for deposits and aggregate all the cash balances for all clients and all the banks. This means that banks will have to fight to keep their customer interactions if they do not want to be reduced to doing the KYC and AML, but rules need to be balanced. Big tech companies, which could play a significant role in fintech, are a particular challenge in this regard. The restrictions that are being considered on what banks may do with client data such as using clients' spending data to predict savings behaviour and implement AML policies, for example, must also apply to all users of data including fintech and big tech companies.

An industry representative concurred with the need to establish a level playing field. In that perspective it is the activities that must be regulated, not the legal structure nor the delivery mechanism. The regulatory framework should also adapt to the changes underway in the value chain with banks increasingly partnering with fintechs and other parties, which also implies thinking about outcomes, rather than processes.

Another official was also comfortable with the approach chosen, but suggested that the Commission should consider more broadly all the regulations and supervisory practices that may unduly affect the development of fintech. Some 'hidden' issues may hinder financial innovation. The policy discussion about fintech should not be limited to 'fringe' issues specific to certain technologies or processes but should consider the core elements of financial regulation and supervision because fintech has the potential to fundamentally change the entire financial sector.

1.2. Adapting the regulatory and supervisory approach to the digital world

A regulator stressed that the regulatory and supervisory approach to financial services will need to be adapted to the greater complexity of the digital world. Many digital companies are taking a more global business approach, when many laws (notably contract laws) and principles are still specific to different Member States. Concerning GDPR, it is also important for financial supervisors to work more closely together with the data protection authorities.

An industry representative was unsure about whether the proposed action plan will be able to drive change quickly enough. The EU could learn from how these issues are approached in other jurisdictions. The financial industry is not going to change overnight, but it would be a mistake to think that technological change is not happening at a rapid pace. Customers are driving a change in business models, because they expect speed, low cost and convenience and the industry needs to adapt quickly.

The speed at which possible stability and competition issues associated with these changes are recognised by the regulators is a first challenge if they want to avoid constantly playing catch up. The development of mobile payments is driven by sub-Saharan Africa and similar drivers can now be seen in Asia. Some of these regulators may be considered as less sophisticated in their regulation, but in many ways, they are now ahead in this space. In China, some $9 trillion worth of payments were made by mobiles in 2016, but it was $17 trillion by the end of October 2017, which means a 40% increase. The Chinese regulator introduced a set of regulations in December 2017 that were partly aimed at mitigating some risk issues associated with these changes but, by that stage, mobile payments already had a large market. This development is positive for innovation and competition but regulators could possibly have been quicker off the mark from a financial stability perspective.

A second challenge in the EU is a potential lack of consistency, the industry speaker felt. For instance, the EBA issued guidelines last year about how national competent authorities (NCAs) should approach regulating the cloud, but domestic regulators such as the DNB or the FCA were already a long way ahead in issuing their guidance.

Cooperation across sectors is also increasingly essential, with the need for financial services, data protection, privacy and competition regulators to work together. The Monetary Authority in Singapore for example has set up the Fairness, Ethics, Accountability and Transparency Committee involving industry participants, as well as financial services and privacy regulators to examine how companies are using artificial intelligence (AI) and big data to advise their clients and develop new supervisory tools.

1.3. The importance of developing knowledge and competences regarding fintech

The most important aspect of the Commission's proposal, a regulator considered, is that it aims to encourage NCAs across Europe to learn more about fintech. The ESAs also have an important role to play in fostering more convergence in this area. Many changes are happening in the market and the measures proposed should help regulators and supervisors to understand better new business proposals, technologies, risks and also the implications of rules and regulations for fintech in order to avoid unnecessary barriers to innovation. The Innovation Hubs launched in a number of Member States including the NL and the UK already address these issues domestically and encourage discussions with firms. This helps supervisors to identify priorities and better manage expectations.

An official suggested that making a more general use of sandboxes in the EU would also help to develop the fintech competences and knowledge of regulators and supervisors. Supervisors 'should become sandboxes themselves'. The Chair agreed with the importance of developing knowledge about technology and its implications for regulation and supervision. A fintech lab is being set up by the Commission and cybersecurity workshops are being organized for example to facilitate this learning. An industry player added that the Fintech

Action Plan needs to be driving the same cultural change within the public authorities as the one that is happening in banks and how they are thinking about customer interaction, internal processes and collaboration with other parties.

Another official gave examples of how the public sector can play an active role in the debate by using technology for its own processes and monitoring developments in the market. The European Stability Mechanism (ESM) for example is fully cloud based. Its staff use social media for their internal conversations and it was the first public institution to join a fintech circle gathering startups developing new financial services. In addition the ESM, which is a supranational public issuer of more than €40 billion in bonds and €25 billion in bills this year has developed its own market intelligence tool that uses deep data analytics. This tool can be used to understand better how the markets react to political events or how different geographies are changing behaviour before and after QE based on the analysis of trades. The ESM is also using fintech to develop a new European debt issuance platform aiming to reinvent the way these markets function and improve their efficiency. The ESM also monitors all the latest trends in the market, not only in fintech, but also in legaltech, regtech and risktech in order to improve their processes. A sandbox has been put in place, with 40 staff members who test and pioneer new fintech solutions.

1.4. Specific risks and issues associated with fintech

A regulator hoped that the Fintech Action Plan will allow regulators to develop an appropriate approach to disruptive techniques like distributed ledger technology (DLT) or AI. It is positive also that the Action Plan has ambitions concerning cloud computing and cybersecurity, which are complicated areas. The speaker however felt that Europe could move faster in developing a view on crypto currencies, crypto assets and initial coin offerings (ICOs).

An official stressed that the risks associated with technology and fintechs need to be appropriately mitigated. The first and biggest of these is cyber risk. Many executives in the financial sector do not understand these tech-related risks. In addition the financial system is very vulnerable since one single person can potentially bring down the entire system of a bank or of a market infrastructure. A second major risk, the speaker believed, concerns cloud services, because they are concentrated in a few big players. If there is a major outage, it could disrupt the financial system severely. If participants cannot access their data or trades, it could have a market impact and ultimately cause a crisis.

An industry representative however believed that the focus should not only be on new risks that might be created with fintech but also on the new opportunities and whether these new activities are more or less risky than the present situation. The cloud is a great example of this. It is true that there is a risk if everybody is outsourcing to two or three platforms and one of these goes down. However, cloud service providers so far have a much better track record than most banking institutions in their ability to keep services up and running or getting them back up if they fail.

Answering a question from the audience about the possible negative impacts on fintech of a proposed digital financial services tax, an official mentioned that the Council is far from unanimous on this issue, therefore this is unlikely to be a threat to the sector. The text already includes some language excluding crowd funding and trading platforms from this proposal, a policy-maker remarked. An industry speaker moreover added that it is still unclear whether banking services would automatically be considered as digital services and if this tax would be applied to them.

2. Cross-border development of Fintech in the EU and expected impact of the crowd-funding legislation

The Chair mentioned that 11 countries in the EU have their own crowd funding legislation. The Commission is proposing an optional EU crowdfunding regime which will enable platforms that comply with this common set of rules to provide their services across the EU with a passporting regime.

Most speakers on the panel were favourable to a unified EU regime for crowd-funding platforms.

An industry representative felt that in order to scale up a crowd funding platform, more than one local market is needed. For small companies starting up a crowd funding platform, having to manage different legal requirements creates a great deal of complexity. However a further development of crowd-funding would help certain start-ups, therefore this can only be beneficial.

A regulator agreed that regulatory convergence and a pan-European regime are needed to allow crowd-funding platforms to be active in multiple jurisdictions. The EU standards could however be improved in some areas such as consumer protection and transparency, when considering existing domestic regimes such as the Dutch one. In addition, there could be more alignment with other EU regulations such as MiFID II and more clarity on what secondary trading might involve for instance. Secondary trading indeed provides investors with the ability to trade shares and also with a way to step out of their investment, which is not easy in certain markets at present. This would foster more investment in crowd-funding.

An official supported the optional approach proposed by the Commission, because it does not interfere with the national schemes that already exist. Initially some domestic regulators were worried that a crowdfunding regime would favour the development of more lightly regulated shadow banking activities. Two years after the creation of the framework in Austria for example, it is functioning well despite some hiccups, but it is too early to say how necessary this regime is though. Crowd funding is based on the assumption that additional funding solutions are needed for some companies which are not able to secure sufficient financing through the regular system. It offers an answer to this problem, however it is not really fintech. The reason for this lack of funding should be further assessed and whether it is related to excessively strict financial regulation for instance.

An industry representative disagreed with the idea that crowd funding only exists because of some possible failures in regulation. New markets develop because consumers (i.e. SMEs seeking funding and investors seeking alternative investments) want different services or ways of transacting. Whether fintech plays a decisive role depends on the ability of policymakers to envisage how markets might act differently and to embrace that change.

Another industry player was not convinced that a European crowd funding regime is necessary to support European capital markets. Crowd funding provides local solutions to local funding problems faced by very small companies. It is necessary for investors to be aware of how these platforms work and the risks they are exposed to and for crowd-funding firms to follow sufficient requirements. In that sense appropriate rules are needed but encouraging European development seems to be a rather ‘farfetched' objective the speaker felt.

Another official considered that crowd funding is not really fintech, but more a regular business supported by technological innovation and had mixed feelings about the EU proposal. The speaker's jurisdiction has decided not to regulate crowd-funding at this stage specifically because these activities fall within the scope of other regulations, including MiFID II. This is good because it avoids regulatory arbitrage On the other hand pressure is being brought to further standardizing requirements for crowd-funding platforms at the EU level. Even if this is not fundamentally a pan European business, standardisation could help platforms in small countries to scale up across the EU.

An industry speaker, giving the example of a payment platform regulated in Finland but offering banking services across-borders to micro-entrepreneurs, stressed that cross-border barriers hinder the development of fintech companies within the EU in many other areas than crowd-funding. For example in Germany micro-entrepreneurs prefer to have a German DE IBAN code, so the platform applied for this but the answer of the German authorities was that DE IBANs can only be offered by financial institutions who adhere to the German payment code of conduct (in addition to the SEPA rulebook). This is totally contrary to the spirit of the single market but not specific to Germany, the speaker believed. Another issue is that German businesses and some German banks do not accept payments to accounts with an IBAN from another EU Member State or add surcharges, even from Finland which is in the euro area, which is 'clear IBAN discrimination'. And when these problems were reported to the regulator there was very limited interest in solving them. Other barriers to the European development of fintech companies are the differences in the way EU legislations such as PSD 2 and GDPR are implemented across the Union. This makes it very complex for small fintech companies.

An official regretted this fragmentation of rules in the single market, which is a broader issue than fintech. This problem has been going on for decades, but the regulators in various countries keep on erecting barriers. One of the most important advances in that regard was the creation of ECJ to which infringement on the free movement of capital can be reported.

3. Link between Fintech and the CMU

For some speakers fintech is a key element of the CMU. One official stressed that technology helps to create more transparency and facilitates investment decisions. Technology can also help to develop cross-border markets. For example crowd funding and ICOs make it very easy to invest or perform financial transactions across borders, which remains sometimes difficult at present in Europe. A unified set of rules aiming to create a digital single market is moreover also needed, as well as a combination with the Banking Union. Bringing all these initiatives together (i.e. fintech action plan, CMU, digital single market, Banking Union...) and not running them separately will make the EU much stronger. An industry representative also felt that fintechs can support capital markets. In the US, savings do not go via banks as in Europe and find their way into capital markets more easily. Technology can play a role in changing this balance in Europe, which is purely structural, although clients are slow in changing their habits.

Other speakers considered that fintech is a facilitator but cannot be a substitute for efforts needed to build the single market. An official agreed that technology can in particular facilitate the provision of information, which is essential for the CMU, but first the data needs to be made available. One of the biggest obstacles to the CMU is a lack of harmonized corporate data, especially on SMEs, for investors to make informed decisions. This is notably due to different financial reporting standards in the EU. Another official felt that fintech is necessary for the CMU but not sufficient. Innovation in technology is necessary for EU financial markets to be competitive and, without that support, it will be difficult for the CMU to be successful. The basic questions or problems with the single market are however more important questions to solve.

Digital payments: opportunities and challenges for the EU

Introduction

A Central Bank official underlined that digitalisation has improved access to information and enhanced innovation in payments and financial services. The number of new services for customers and companies entering the payments market is increasing. The PSD2 regulation will most likely accelerate this. The question is how this will simplify and improve the lives of financial services end-users and customers.

1. Opportunities and challenges for banks opening up to third-party service providers and likely increased competition in payment markets, falling under 'open banking'

A regulator stated that PSD2 applies from January 2018, although full transposition has not yet happened in all Member States. PSD2 fundamentally changes the landscape, introducing third party entities to the market and obliging banks give access to their customers' payment accounts in a standardised fashion. It focuses on the payments market, redefines it and opens up opportunities. PSD2 also defines security requirements for payments in EU law. It is technology neutral, although there are questions over how closely it follows practical developments in this respect. PSD2 offers clear opportunities for innovation and improvements in services. For customers, it seeks offering better and more secure customer authentication, management of payments, accounts and related data, in order to further develop the payment market.

Disruption in itself should not be viewed as disintermediating or marginalising existing players. Opportunities exist for collaboration on responsive payment services. However, the EU's long-term challenge is in understanding new third-party players' business models when acting between consumers and what PSD2 designate as account servicing payment-service-providers' which facilitate the access to electronic channels. Banks are perhaps bound to lose their monopoly and need to keep up with the innovation, but will more likely retain management of inter-PSP payment infrastructure. Consequently, maintaining a level playing field between banks and third-party players will be essential.

There are also challenges around implementation, data protection regulations and the strengthening of

AML and counter-terrorist-financing rules that interplay with PSD2. The most controversial technical standard is on strong customer authentication and secure communication, which will apply from September 2019. A number of PSD2 stipulations apply as of January 2018, so there is a transition period for market participants to navigate. This is being supported with opinion, interpretation Q&As announced by the EBA and a working group monitored by the ECB to detail the criteria that will be used to assess a new API compliance with the rules and standards that will be defined.

A Central Bank official notes that digitalisation is changing society in general. The challenge for Europe is to make it a European journey, and not one that has to be adapted across borders. The Euro Retail Payments Board (ERPB) and EBA are collaborating on harmonising practices and defining European rules. PSD2 together with the regulatory technical standards provides a context and principles for harmonising APIs and practices and processing payments.

Other challenges lie in the security and cyber-resilience of the new systems. Digitalisation increases the speed of exchange, but infrastructure safety must be ensured. The upcoming General Data Protection Regulation is another challenge requiring those in the field of payments to be careful, as a great deal of data is exchanged in this context. An industry representative explained that harmonised implementation of PSD2 across Europe will be key, as besides the regulation and respective technical standards, many details remain to be finalised.

In this context, the Berlin Group[1] is working on detailed technical standards for PSD2. The industry representative explained that banks will provide technology in a sandbox for the regulator to assess the appropriate level of flexibility and quality of APIs provided for third parties. Consequently, for regulators as well as for the banks and new third-party market entrants, the preferred option would be moving towards standardised API connections. But for this to take off, banks need to be exempted by the National Competent Authorities in cooperation with the EBA, from the obligation of providing a fall-back solution for third party access through the customer-facing online banking channel. The API standardisation initiatives should therefore follow the work of the industry group that was kicked-off by the European Commission for evaluating the API standards and suggesting best practices.

1.1. Risks of data protection and opportunities of new regulation

A public representative hoped that PSD2 would increase competition, resulting in better services to customers, lower costs, and better use of data, which would also improve services. Policymakers will insist that customers are protected from fraud. Legislation will protect consumers and data, but the legislation contains a conflict; PSD2 talks of explicit consent, whilst GDPR just talks of consent regarding the use of customers' data.

Security will improve as technology advances. Technology itself improves lives, is more secure and customers will be protected. However, challenges remain. Fraudsters will always seek to exploit the system, but such fraud is more easily detected using technology.

1.2. Fragmentation risks from different API standards

An official pointed out that the PSD2 initiative is supported because it is good for competition and consumer experience. Yet an important issue with the new environment is cyber-risk. The risk of fraud is not new, but new technologies allow fraud on a wider scale, and the infrastructure to protect the safety of payments is critical. Protection of privacy is also a challenge. Consequently, developing an API quickly is crucial, as is potentially making it available earlier than required by RTS. Indeed, with PSD2 to provide the benefit of an EU-wide environment for new players, APIs are an essential part. It would also be a pity to have multiple EU APIs, so work on a common API is welcome.

1.3. The potential risks of AML

An industry representative noted that AML remains a challenge and innovation does not mean setting aside or dispensing with the principles underpinning the need to establish clearly the inherent risk and to mitigate it appropriately. New technology and the new landscape present challenges to find fit-for-purpose and risk-responsive methods to KYC.

There is a potential risk in just bringing established methods into a new space without understanding the threats created by technology and aligning responsive standards and solutions. Furthermore, remote identification is not necessarily riskier. It is a fact of life and it can be dealt with by working collaboratively with existing industry players.

1.4. Cooperation between industry players in the light of new regulations

An industry representative explained that the rapidly evolving way in which commerce is conducted is specifically shown by the convergence of online and offline. Non-payment companies have embedded payments; commerce platforms embed payment in the customer experience, and consumers shop in a retail setting before purchasing online.

Digital payments allow merchants to recognise customers, follow them and ensure that there is no friction in the transaction. End-payers are not interested in the payment but in the purchase. Payments should be seamless.

As this develops, it is critical notably for payment and credit card companies to demonstrate additional value. Banks can work with merchants to improve services in collecting payment information. In addition, there are challenges to security and fraud that could be countered by predicting behavioural patterns, identifying irregularities and connecting with customers. Credit card companies and Distributed Ledger Technology players are developing partnerships to facilitate moving money between businesses, which is of interest to small and medium-sized enterprises. Providers can also offer them financing by utilising data on merchant's customer receivables and payments.

1.5. A strategic disruptions in the payment area: an unclear and weak distribution of liabilities throughout the value chain

An industry representative noted that PSD2 introduces third parties into the relationship between banks and customers and creates a question of who is liable to the customer. If a payment goes wrong, the customer will ask the bank for reimbursement. Under PSD2, in case of unauthorised or fraudulent payment transactions, the bank has to reimburse the transaction immediately. This brings potential problems because there is no relationship with the third party. Every player in the payment value chain must be liable for what they do and the customer should be clearly aware of that situation.

2. Changes to the instant payments industry

2.1. Benefits to banks and customers from instant payments

An industry representative suggested that banks will not benefit from new payment system as much as customers. Some countries are organising to launch the service collectively; in others, large banks have already started to exchange instant payments on RT1, the first operational clearing and settlement system for SCT Inst, which is operated by EBA Clearing. There are expectations concerning the implementation of the new service because it is not about national needs but rolling it out at the European level. Making instant payments a reality adds to the efficiency of modern payments'. The launch by the Eurosystem of the Target Instant Payment Settlement (TIPS) service in November 2018 is awaited, as it could be a solution for smaller banks. Inter-operability possibilities increase customer choice and value, which paves the way for having instant payments as the new norm for transferring funds from one account to another between banks. Instant payment is based on an account-to-account model the need of which is definitely demonstrated by many situations faced by customers, such as e-commerce, P2P and even in some cases at the physical point of sale. However card-based payments remain essential in certain cases.

2.2. Instant payments and the role of TIPS

A Central Bank official agreed that instant payments are an essential tool for Europe. Unfortunately, a true Europe service for instant payments with full interoperability of market solutions is not yet in existence. The EPC has developed a SCT-Inst scheme, following requests from the ECB and ERPB and adherence to this scheme is increasing.

Operators have now opened their instant payment services, some at a national level and some at the Euro area level. The Eurosystem supports the establishment of an integrated instant payment market through TARGET Instant Payment Services (TIPS), which will enable payment service providers to offer fund transfers in real time and around the clock, 365 days a year, and using the SCT-Inst scheme. It is designed to offer multi-currency settlement in central bank money for usage throughout the EU and not just the euro area. It will commence live operations in November 2018.

Making payments that are instantly final and secure and are embedded in the customer experience is important for European economy development, innovation and developing new initiatives. It is in addition an opportunity to break national silos and create EU wide functionality. The European dimension is important and a key achievement for consumers and businesses will be implementing new frameworks and technology with a European dimension, allowing businesses to scale and consumers to enjoy cross-border benefits. Initially, instant payment will compete with cash and existing payment formulae but it also has the potential to change customer behaviour.

The beauty of instant payment is that too much functionality cannot be added, so it is simple. The processing infrastructure has to be extremely resilient, and strong throughput, in order to allow processing in under a second. Yet instant payments will only be taken up if there is the capacity to pay and if consumers and service providers are able to use it. Initiatives are planned to trigger entrance into the market, such as the TIPSapp event, which took place in February 2018.

2.3. Potential challenges of instant payment

However, a regulator highlighted related risks of AML and counter-terrorist financing. A Central Bank official noted that discussions have been held with banks on applying regulations to the instant world. This is a challenge because only a few seconds are available, so instant payment transactions that have to go through further sanctions screening will have to be rejected. In such cases the payer can make a regular credit transfer.

Tackling these problems will change as a result of the technology, payment speed, frequency and instantaneous nature of payments. The same developments utilised to develop the instant payment system are relied upon for managing risk, with new methods of identifying AML risk and challenging potential transactions that raise concern.

Developing payments at the European level means risk management must also develop at that level. Instantaneous cross-border payments with national risk-management systems will face problems. Technology must be utilised across borders. In a cross-border context, consistent implementation is crucial and is a challenge for the future. If the capacity for harmonisation does not exist, payments will be rejected. Banks will not risk pushing illegal payments, because they are instant.

2.4. The take up of instant payments and instant settlement

While within the eurozone, there is probably proper justification for this service, for countries not yet in the eurozone, the justification for this initiative depends on the service level of existing national infrastructure, which differs for different countries. In some cases, instant payments might bring little difference for the customer.

There are non-euro area countries (e.g. UK, DK and SE) where instant payments have been launched successfully to optimize cash usage in P2P payments and make customer-to-business and business-to-business more efficiently. However, notably in Bulgaria, the need for instant settlement is notably questionable within the B2B space, few business areas need it, as fast payments exist and finally the need for complex infrastructure cannot be justified based only on B2B. Even in the business-to-consumer space, the need on both sides could be questionable, as for instance receiving a salary instantly or within a couple of hours does not make a great difference. The extent to which merchants receive their money settled in seconds or hours is also questionable at least for larger merchants. The difference to the consumer is not big, and historically, the card business developed such services on a different level (with immediate payment confirmation, but delayed settlement). In addition, there is still no proper charge-back infrastructure for repayment and refunding in case of incorrect, unauthorised or fraudulent payments . In particular, as instant settlement has an irrevocable nature, it is questionable how the merchant can automatically refund or execute a charge-back.

An industry representative explained that one essential aspect of international card schemes is the acceptance network. Replacing card payments with SCT Inst needs the full deployment of the service be it on the issuing or the receiving side. It will take some time to provide Pan-European reach.

2.5. The expected development of instant payments in the EU

A public representative felt that instant payments are a logical step for assisting financial inclusion and small businesses. As national infrastructure varies across the EU, the best strategy is to allow faster payment solutions that are based on common payment rails, to develop in each country and link them. In time, the eurozone might be in a position to achieve full coverage of instant payments within the Single Euro Payments Area (SEPA). So far even within the eurozone, different countries have different infrastructures. Member States know their risks and infrastructures best, so allowing organic growth will get a better product for consumers.

A Central Bank official objected that the establishment of linkages between instant payment solutions faces constraints. Indeed, domestic schemes have initially called for interoperability and resulted in zero interoperability.

In addition, in instant payments, risk is different from a normal payment. Risk does not have to be managed between initiation and settlement, because there is no time between them. The point is perhaps valid across currency, but it makes no sense to have national silos within the same currency as it multiplies costs for no benefit.

An industry representative explained that demand for instant payments must be clearly articulated. Issues exist with interoperability and the ability to move money quickly. Consequently, Fintech companies are trying to fill the gaps caused by the clunky nature of moving money across borders or between banks globally, but the different routes, time taken and the opportunity for failure are all real.

If the existing system is painless for the consumer, their demand to use instant payment may be less. If a merchant does not receive quickly enough, either that will be addressed, or they will persuade the consumer to use an alternative. One potential downside will be limited functionality, which the consumer will not want, so there is an opportunity to show value. There are also potential issues with fraud, charge-backs and risks that consumers may not want to take. The demand for the system and what it solves remains to be demonstrated. At first, it is a replacement for cash and cheque, and then perhaps more will follow.

An official noted that there has been some reluctance from the banking sector in particular, but the expectation is that instant payment will be a success. In the corporate sector more broadly, there is enthusiasm for it and that creates pressure for solutions to be made available quickly. There are many players that can develop technical devices using instant settlement, which is good for efficiency.

3. Bitcoin and cryptocurrencies

3.1. Possible regulation of crypto payments

A Central Bank official pointed out that there is a great deal of debate over crypto-assets and virtual currencies. It should be borne in mind that those assets do not qualify as currency and in most cases do not fulfil the functions of money. A central bank only looks at currency and regulates digital euro payments. However, also innovative technologies, such as distributed ledger technologies, are being assessed against the background of possible future usage in the field of market infrastructures. At present, conventional technologies such as the ones used for TIPS are considered efficient and safe. Payments in crypto assets are comparably expensive, with the recent cost of a Bitcoin transaction being €25, the same cost as carrying out 12,500 transactions on the incoming TIPS service.

3.2. The benefits of cooperating with DLT providers

An industry representative agreed that the future of cryptocurrency as an asset is dim, but it will flourish as a technology where there is a need for disruption, either where payment has been slow or where it is unclear whether it can go through the system. On some level that is also what the instant payment initiative is attempting to solve. Only time will tell the extent to which these two will compete with each other.

1. A Pan-European payment interoperability standard and harmonisation initiative gathering 25 major players in the payments industry from 10 different euro-zone countries and from the UK, Sweden, Denmark, Norway, Iceland, Turkey, Bulgaria, Hungary, Serbia and Switzerland

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Cybersecurity: on-going improvements and remaining challenges

1. Current development of cyber-risks and main underlying factors

1.1. Cyber-threats are spreading throughout the whole financial ecosystem globally

A recurring question the Chair emphasized is about what is new in cyber-resilience compared to information security and the protection of systems. A key change, the Chair felt is that it is not only critical players or FMIs that require protection, but the entire financial ecosystem. In fact, the weakest part of the ecosystem could be the entry point for cyberattacks. This makes it more complex and challenging. The more digital the system, the more it is exposed globally, so it is important to collaborate across borders and oceans.

A Central Bank official agreed that complexity is the most relevant vulnerability of the financial system. It is a complex ecosystem in continuous and rapid transformation, consisting of a large number of market components, including FMIs and banks, utilities and service providers. The openness of financial services to the internet and the entry into the market of new non-financial entities have introduced risks: third-party risks and the concentration risk stemming from service providers offering common solutions and potential exposure to a large number of market components. Innovation, technology and fintech used by the financial sector also have consequences that the industry must be aware of.

A Central Bank official concurred that threat levels are rising and moving upstream. These days cyber-attacks extend beyond end-users such as consumers and business and are increasingly targeted to financial institutions directly. The motives behind vary and can include financial gain, espionage and disruption of services.

A regulator noted that endpoint security (i.e. participants who have the ability to send and receive payments) is essential notably in the case of wholesale payments, which are a tempting target for criminals. They are often large value and final, so it is difficult to claw them back once the money has gone. The security of these systems is also particularly critical because they are used to implement monetary policy. A survey of jurisdictions' wholesale payment systems and messaging networks has led to worrying results. Many payment-system operators had no requirements in place to prevent or detect fraud. Those that had did not have a great deal of adherence to these expectations. In terms of the immediate response, if fraud was detected, there was limited awareness of the requirements to inform the rest of the wholesale-payments ecosystem or even law enforcement.

An industry representative agreed that cross-border payment-systems are an attractive target: attacks can be performed remotely and the chances of traceability and ending up in prison are low. It is also low cost. Malware to develop these attacks is also relatively accessible. There is also a market for beneficiary and mule accounts that can be used to receive pay-outs at the end of the process. This is an increasing risk and raising awareness is essential.

The people working in organizations are also a challenge, an official stressed. The best technology systems can be put in place but cannot account for human error, such as leaving a computer unlocked before moving away from a desk, which requires basic hygiene. Information-sharing must also take place in a way that protects privacy.

An industry representative also stressed the global dimension of cyber-threat. Payment systems for example are global and it is no use immunising a particular geography or particular institution. All are exposed to one another, so international standards and promulgating best practice across the world are important. Europe is a sophisticated, educated geography but payments travel all over the world, where there are many levels of investment, awareness and capabilities.

1.2. Increasing sophistication of cyber-attackers

An industry representative stressed that attackers are ever more sophisticated in their methods and more ambitious in their targets. There has also been an increase in the investment that attackers are prepared to make, Attackers are prepared to sit within a target bank for 12-14 months and evidence shows that they are spending much time learning about systems and how best to operate them.

A Central Bank official explained that the reason for this is that cybercrime is profitable and has a business model behind it i.e. good returns on investment reinvested in creating even better attacks. Innovation and technology are also being used in that world and reduce the resources needed to conduct sophisticated attacks. In addition relatively sophisticated attacks are now available to the lower range of cybercriminals through the web. A Distributed Denial of Service (DDoS) attack (an attempt to make an online service unavailable by overwhelming it with traffic from multiple sources) that can create serious problems for banks can easily be created by a single clever attacker.

2. Improvements that can be expected from cyber-security approaches at the EU or global levels

2.1. Many cyber-resilience initiatives are on-going at the European and global levels

The Chair outlined the work done by the central banks, as well as at the G20 level and in the context of the CPMI IOSCO contribution. This has been translated into cyber-resilience principles that have been approved in Europe and developed into a Eurosystem cyber-resilience strategy for FMIs and have shown concrete deliverables. Many initiatives are underway in Europe because of previous attacks. A Euro Cyber Resilience Board for FMIs has been established, which is part of the global guidance. A public consultation on cyber resilience oversight expectations prepared by the committee of central bankers on market infrastructure and payments (MIPC) has also recently been launched. A document defining an ethical red-teaming framework (teams testing attacks) called TIBER-EU is also to be released shortly, allowing for the definition of red-teaming testing on FMIs and possibly on financial institutions in general.

A regulator added that a number of standards exist at the global level. The ECB consultation mentioned above is based on CPMI-IOSCO cyber-resilience standards. In addition, there is ISO, and NIST in the US. Potential gaps in the standards and how they are implemented at the global level are being reviewed, given the evolution of cybercrime. The implementation of such standards at the global level is however challenging.

A regulator stressed that a high-level strategy has been developed at the international level by CPMI to tackle wholesale-payment frauds, setting out elements to prevent, detect, respond to and communicate around these frauds. This strategy will be finalised and published in May, including industry action on all elements of the strategy. It is important that industry should cover not only what is usually meant by 'industry' but also interactions with central banks, because they operate the wholesale-payment systems. The operationalisation and implementation of the strategy will be monitored in 2018 and 2019, to assess the need for further action.

2.2. A holistic and adaptive approach to cyber-resilience is needed

A Central Bank official considered that fully understanding the behaviour of individual components of the financial system is not enough to know how the whole system will react under stress. This implies a different approach to cyber-resilience based on several pillars: first the cyber-resilience of individual entities, secondly the resilience of the financial system and thirdly cooperation among all components of the market and also between the authorities and the market. Individual entities need to move away from perceiving payment systems for example as closed, with critical service providers owned by financial entities operating with mutual trust. Entities are now operating in a complex environment where risks have no physical or national boundaries. Even the most reliable counterparties can be hit by cyberattacks with potentially systemic effects.

Outsourcing to third party service providers outside the financial sector such as telecom or cloud providers is another issue, another Central Bank official added. With banks increasingly outsourcing services, limiting cyber-resilience approaches to banks is insufficient. It is essential to interact with these entities as well. This however depends on the providers' willingness to allow a review of resilience.

An industry representative added that cyber-resilience approaches need to be adaptive and dynamic. Banks have been facing crime and fraud since their inception and have always been able to adapt to new threats and the public authorities should be confident in their capabilities for adaptation. It is important to foster a dynamic approach to these risks, analysing what is happening in the market and converting threat intelligence into actions and changes in organisations in a reactive way. This is the way banks have been working for a few years with whole teams detecting attacks, searching the dark net for lost data or planned attacks, etc. There are also international networks sharing warnings and moving tremendously quickly. Regulators could assist by encouraging this type of approach and by helping to build exchange platforms between the industry and the public authorities to better understand risks and possible responses. One issue is that there is no more link between the size of a player and its potential dangerousness for the system. Smaller entities can now own a complete bank customer database and can interact with the whole financial system from anywhere in the world. Regulatory approaches should thus be global and consider the ecosystem very broadly.

A regulator noted that this area calls out for a true public-private partnership as exemplified in the way the Bangladesh Central Bank attack was handled. There should be more and more public-private cooperation going forward. The Chair agreed noting the importance of creating trust among key actors as cyber-resilience is not about weakness but being a victim of crime.

2.3. Building awareness about cyber-threats is essential

A Central Bank official emphasized that awareness about cyber-risks is essential and needs to be developed among employees and anyone in contact with a financial institution. Examples of basic cyber-threats are a small computer in the network permanently turned on or phishing that is becoming more advanced every day. Exchanging information and analyses about cyber-threats e.g. in the context of testing exercises is an effective way of developing awareness.

Another Central Bank official agreed with the importance of awareness. A survey conducted among the European FMIs has confirmed that although special attention is given to technology there is less attention to risks related to individual behaviours and internal processes, about which more efforts need to be made. This concerns incentives also. Any FMI has to invest in cybersecurity, but it is difficult to take into account every effect produced on the overall system. Exchanging information and analysis is a way of increasing awareness. In Italy, a cyber-resilience unit was set up at the beginning of 2017 in cooperation with market components and authorities. In 18 months, that unit has analysed around a thousand cyber-events and issued 200 warnings of possible cyberattacks. This allows individual entities to develop awareness and the ability to analyse events that are larger than would have been possible for each individual entity. Oversight expectations are another methodological tool that can potentially be used for self-assessment by FMIs in particular. This allows constructive dialogue between regulators, overseers, banking supervisors and market components.

An industry representative noted that having appropriate internal processes is another key layer of defence. No matter how good defences are and no matter how clever people are, there can always be a malicious insider, so processes that ensure no single dependency exists on one person are also key.

2.4. The importance of testing and exchanging information

A Central Bank official considered that testing is a fundamental element of cyber-resilience that must be in place and explained how the TIBER-EU test, which is an ethical red-teaming exercise already running in some Member States, works. A red-team develops an attack on live systems using practical scenarios based on threat intelligence while a blue-team is in charge of defending the systems. Some positive features of this exercise are that it uses the whole system and that it involves cooperation between supervisors and the industry, analyzing how to deal with threats together. The test is run with a few entities at a time and the standard is reviewed after each test. Another key feature is board involvement within industry participants and monitoring and quality assurance during the test. It takes nine months to prepare and follow up, but the attack lasts for eight to 10 weeks, so it is shorter than a scenario where attackers take time to move through an institution. If the attacker does not get in after six weeks, they are assisted, so the institution can test the detection of movement that should not be within their entity. There is then a review with all the teams involved and with a broader community to share and accelerate learning. This is also an effective way of improving trust among the different stakeholders, because the exercise does not start with a supervisor identifying a weakness, but institutions sharing information, learning and becoming more resilient.

Another Central Bank official stressed that, while testing frameworks are useful in revealing weak spots and suggesting improvements, the developing Eurosystem framework also has implications for the standardisation of performance-testing activities in seeking mutual recognition and preventing placing a heavy burden on FMIs. A proportional approach to the monitoring of cyber-security has been developed with three different degrees of cyber-maturity, which can be applied to various types of FMIs according to their systemic importance. This framework has been constructed to be entity-agnostic, so it is a model that other institutions could use, perhaps with adaptations and a point of reference for regulators and supervisors.

The Chair emphasized that the TIBER-EU framework is being developed to assist harmonisation. Entities, both FMIs and banks, exposed to a multitude of different regulators or supervisors can apply this framework and use it to demonstrate the resilience of their systems based on a common EU framework. It also helps to find an appropriate balance in the testing, because there is a strong risk in cyber of overshooting and asking for too much. It is also important to realize that a cyber resilience problem will happen at some point; having protection in place does not mean it will not happen. It is also important to plan for data integrity issues or data disappearing, and to assess resilience to these scenarios, rather than only building protections.

An industry representative welcomed the on-going work on standards led by the public authorities and the attention that it has brought to cyber-risk. A testing framework is useful particularly for institutions operating in many different jurisdictions, such as critical service providers and banks, and those operating across borders, such as FMIs. Trust between authorities will however be essential because otherwise it will take a great deal of time to deal with these tests. The speaker agreed that a danger with cybersecurity is in going too far. Another danger is having too many standards and tests. That can end with the industry box-ticking and not improving things. The more consistency there is in approaches at the international level, the better.

Another industry representative was in favour of an adaptive approach to testing standards. These should not be written for the ten years to come because it is not possible to know what will be needed then. On-going observation of threats should be in place in every bank and firm. Regulation and supervision should focus on the ability to link threat intelligence not only to security but also to business operations and product design. Mechanisms must be present to allow swift reaction and adaptation at the right pace, from low-speed adaptation to crisis management. Another point is that if a database of weaknesses in different financial institutions is created, it must be protected as this would be a likely target for hackers. It is also important to have a positive approach to cyber-resilience, the speaker felt, putting forward capabilities and best practices, rather than only weaknesses in the defences. Three years ago a DDoS attack was a crisis-management situation; now, it is business as usual. Trojan horse intrusion attempts are also detected and tackled weekly.

2.5. Using technology and artificial intelligence (AI) to fight cybercrime

A member of the audience asked whether the use of technology can reduce the human-factor risk, in particular increasing the capacity of detection using AI. The Chair commented that many institutions conduct fake phishing tests in order to raise awareness for example. An industry representative felt that the human factor is important but is not the key to resist cybercrime. Raising awareness about spear-phishing and similar things is important but not sufficient to mitigate all risks given the amount of people clicking on messages and the increasing sophistication of phishing approaches.

An industry speaker felt that technology can help. Many of the defensive layers that people currently have in place will be technology-driven using AI or machine learning, but clearly it cannot be the only approach. Technology will allow banks to screen outgoing transactions against a pattern or chosen parameters. Over time, the machine will fine-tune itself to the activity that is generated. Each bank is unique and the business it wants to do in any currency with any counterparty at any time of day will vary, but it will start by setting parameters and, over time, the machine will get cleverer at detecting anomalies.

Another industry representative agreed that AI which will be wide-spread in operational security centres within three years and will increase detection and remediation but it will not be sufficient to detect fine signals and systems will need to be adapted constantly. The industry speaker also emphasized the importance of layering information systems in order to protect core data and activity from innovative layers and clarifying what needs to be visible in the system. In this respect the DSP has been beneficial, pushing for more APIs and a layering of systems. This type of approach should be encouraged by regulation.

3. Conclusion

The Chair noted that there is a great deal of agreement between the panellists. Cyber requires private and public-sector institutions to consider it and challenge assessments non-stop, and reassess what is being done to adapt to the rapidly evolving environment.

GDPR: impacts, opportunities and challenges

1. The main challenges posed by digitalisation regarding data protection and privacy

1.1. Public trust and confidence in the use of data needs to be re-built

An industry representative underlined that, particularly in light of recent scandals surrounding Cambridge Analytica and Facebook, public trust and confidence in the use of data are low and need to be re-built. There is now a great awareness amongst the public of the 'economy of information'. Many people were under the impression that data services and social networks were free. They have come to realise that this is not the case and that the raw material that these companies are using is actually the data that the people are giving to these companies.

An industry representative explained that there is currently a shift in terms of public opinion and the trust that people have in the GAFAs (Google, Apple, Facebook and Amazon) as well as the trust that people have in the regulations has lessened.

An industry representative stated however, that despite increased awareness of data issues generally, people are not necessarily aware of what is acceptable or otherwise in terms of the use of their personal data, nor are they necessarily aware of the value of that data. The GDPR (General Data Protection Regulation) strengthens the rights of individuals as far as the right to portability is concerned and the right to be forgotten is concerned but people have different definitions of their rights in terms of privacy.

This increasing awareness can provide an opportunity for companies to distinguish themselves and to be more competitive by demonstrating and prominently advertising compliance with data privacy regulations.

Trust has very important implications in the insurance industry because insurance is very much about collecting data on an individual or a company in order to assess risks and to decide whether or not to underwrite those risks. A balance needs to be struck in terms of collecting enough data to do the job without collecting too much data.

Another industry representative noted that the industry is taking these issues very seriously. The representative's institution, for example, was one of the first groups to have adopted BCRs, which are a set of guidelines internal to a multi-national that allow the multi national to share data between its different subsidiaries located in different countries. It has also set up a data privacy declaration and made a commitment that it will never sell customer data to third parties, regardless of consent.

1.2. The pace of digitalisation is challenging regulation

An official explained that the right balance needs to be struck between the stability of the rules and the need to adapt to a moving economy. Digitalisation is moving very rapidly and regulators should try to anticipate the issues in order to maintain the right balance between protection and the actors' capability to do their job and to innovate.

1.3. Definitions of 'data controller' and 'data processor'

An industry representative suggested that defining the concepts of 'data controller' and 'data processor' can present a significant challenge. If one company's software is running on another company's system in order to process data, it can be unclear which of the two companies is the data processor for the purposes of the GDPR. It is therefore important to define these terms; otherwise everyone will essentially be a data processor or a data controller.

1.4. Conflicting regulations

An industry representative explained that companies are being faced with conflicts in terms of what to do with their data. For example, the GDPR might require a company to 'forget' data that it needs to keep in order to comply with other regulations and laws. In addition, the requirement to maintain audit trails can result in a customer's data being retained after that customer has been 'forgotten'.

1.5. The need for expertise

An industry representative stressed that the complex issues raised by digitalisation require investment in expertise. To that end, the representative's institution has set up a data privacy advisory panel to provide support on these complex issues, comprised of eight external experts. These experts can also be useful in addressing the governance challenges that companies will face in implementing the GDPR.

1.6. Much awaited rapidity and efficiency lead to mainly considering people as digital beings

An industry speaker believes that the notion of viewing people and users as data is a 'necessary evil' for things to work quickly and efficiently as, for example, a loan officer cannot interview 100 million mortgage customers a month. However, people do have a choice as to whether they want to be seen as digital beings or as actual people and they do have the option of going into a branch and being interviewed for a mortgage.

2. Opportunities arising from decentralised technologies like blockchain, AI, big data and machine learning

2.1. Portability

An official stated that data portability creates an opportunity to develop services and to increase the awareness of citizens regarding the value of their data, namely that it is their data and they can use it to fulfil their needs with different actors. In addition, it is necessary for the companies to know what data they should give back to the citizens.

An industry representative underlined that interesting portability initiatives have been observed around the world, such as the 'blue button' in the United States that allows patients to transfer their data from one health institution to another. The 'Rainbow Initiative' in France aims to facilitate cross-sector portability in order to help improve businesses and define new services. The GDPR provides a very good opportunity, through the portability right, to imagine new services and partnerships.

2.2. Blockchain

An industry representative remarked that their institution has launched a service that allows people to be aware of whether their flight will be delayed using blockchain technology.

2.3. New sources of differentiation

An industry representative noted that those companies that provide data privacy assurances will distinguish themselves in the marketplace and be more competitive. Offering insurance liability in case data is disclosed, for example, is a good way to engage with customers and to build new products.

New fintech and payment companies do not need to contend with legacy technology and therefore have a very good handle on their data. They have not had to migrate systems and they have not had to significantly change their operational procedures.

2.4. Dynamic consent

A policy-maker underlined that technology allows for consent to be given quickly and seamlessly. A customer is likely to be annoyed at continuous pop-ups in their apps asking for permission to use their data. On the other hand, if no questions are asked, the process might be very fast but the customer does not know what is being done with this data and when it is being accessed. A middle ground may be to create a log so that, after using the app, the customer can see what data was accessed at which step.

2.5. The exploitation of opportunities will differ amongst countries, industries and companies

A regulator noted that the impacts and opportunities arising from technology will depend upon countries, industries and company sizes. The current pre-GDPR protections differ from country to country so that adaptation will be easier for some countries than for others. Particular industries, such as insurance, are focused almost entirely on data and will therefore experience greater impacts and opportunities than other industries.

Larger companies can take advantage of the opportunity to not only value data but to protect it in a way that gives consumers confidence. As proportionality is difficult in terms of protecting very sensitive data, these opportunities will be more difficult for smaller companies to take advantage of, and the challenges that they will face will be greater.

3. Opportunities and challenges created by the GDPR

3.1. Opportunities

A regulator commented that, although the new regulations bring many uncertainties, they are nevertheless welcome when bringing definitions to data privacy and data values. The US and the EU have very different views on the way data privacy should be handled, and it is a good thing that Europe should have defined these prior to the recent data privacy scandals.

An industry representative believed that the GDPR represents an original model in Europe, as compared with the US and Asia, since it strikes the right balance between data use and data protection, thereby inducing trust between companies and institutions on the one hand, and customers and citizens on the other. In particular, the GDPR explicitly allows for personal data processing and provides that data analytics can be used as part of commercial and contractual activities. It also allows for anonymised data to be used for statistical purposes, which is extremely important for financial institutions and insurance companies.

The GDPR, if seen as a fundamental business issue rather than solely as a compliance issue, also provides companies with an opportunity to rethink their relationships with customers and external partners by offering rights of access and rights of portability as an extended service. There are interesting questions surrounding whether companies want to hide somewhere in their website that the customer has a right of access or a right of portability, or whether they want to present this information prominently on their website and to advertise it as an extended service.

Another industry representative explained that in the context of people believing that the companies they deal with should not share their information, as demonstrated in a Eurobarometer poll conducted by the European Commission at the time the GDPR was launched; banks may have a role as 'trusted third parties'.

A regulator stressed that the notion of 'privacy by design' in the GDPR shifts the regulatory focus from ex ante declarations to ex post controls, which can reduce the administrative burden. It is important, however, that this should be taken into account in every process across Member States. Public regulators will have to adapt their supervision to the processes and the governance in relation to these issues.

A policy-maker added that the implementation of the GDPR will be accompanied by a European Data Protection Board that will include the Member States' data protection authorities and the European Data Protection Supervisor, thereby providing opportunities to elicit clarifying opinions on the regulation in areas such as derogations for freedom of expression and freedom of the press.

3.2. Challenges

An official suggested that the protections provided by the GDPR, while welcome, should not prevent companies from providing the services that citizens expect of them nor prevent them from developing the innovation that will lead to new services in the future. Insurance companies, for example, are expected to be able to process sensitive health data, which has particular consent requirements. Member States will need to decide commonly how to interpret the rules on consent without preventing insurance and pension payments from being made.

An industry representative noteed the cost of implementing the GDPR, with the representative's institution spending €90 million to ensure compliance, which involved around 8,000 of its 120,000 employees across 16 countries. The GDPR states that a company should only collect data that is necessary for its business. However, insurance companies are always trying to refine their underwriting models and their pricing models to find the fairest price, which sometimes means imagining new segmentation criteria and therefore requires more data for research and statistical purposes. There is a question therefore as to what extent this will be possible.

The GDPR also stipulates a time limit for companies for data retention. However, in the life insurance and pension business, it is necessary to keep customer data for many decades in terms of accumulation and paying annuities. There are therefore important questions over what amount of data can be kept for 50 years, for example, as opposed to 20 years.

The GDPR's 'privacy by design' requirement, which is extremely ambitious, will require the input of many more parts of a business in the design of a product besides simply IT, data and digital specialists.

4. Further policy initiatives

4.1. The GDPR is the priority

There was agreement amongst representatives that the primary focus should be the application of the GDPR as opposed to considering additional regulations. The GDPR entails significant investment and adaptation efforts. In addition, public authorities need time to adapt their controls and to contend with interpretation issues. To this end, the G29, the organisation of public authorities in charge of the protection of privacy and data in Europe, is being asked to develop a common interpretation on data issues in order to strike the right balance between privacy and efficiency. There are also uncertainties around the number of data requests that will follow the implementation of the GDPR.

4.2. Regulating GAFAs

An industry representative commented that, while the financial institution sector, particularly the insurance sector, is heavily regulated, there seems to be a regulatory void in terms of digital platforms and GAFAs. It is therefore hoped that there will be slightly less regulation for financial institutions and slightly more regulation for GAFAs in the future.

4.3. E-privacy, the free flow of data and cybersecurity

A regulator noted the importance of the European Commission's e-privacy proposal, which is considering whether services like WhatsApp or Facebook Messenger should comply with the same privacy rules as traditional telecom operators.

An official suggested that a balance needs to be struck between the development of the Cloud and the companies' ability to store data wherever they want on the one hand, and having the right regulations on the other.

An industry representative highlighted the problem of daily cyber attacks that target data as opposed to money, and calls for greater measures to tackle these attacks, believing that the public sector seems to underestimate the importance of the issue. An official stressed that there are currently several actions in the fintech action plan on cybersecurity and that the Commission will be following up on this soon.

4.4. Data sharing and data copying

An industry representative stated that data sharing raises interesting problems that may require regulatory clarification. IP addresses are often shared by people, meaning that data is shared among them and belongs to all of them. If someone requests that their data be deleted, an issue arises as they will actually be requesting to delete someone else's data as well. Data copying also raises questions. If someone's data is copied, it is unclear whether the copies remain that person's data. Clarification is required.

4.5. Artificial intelligence

A policy-maker underlined that the European Commission has issued a strategy on artificial intelligence, which is of great relevance to the financial sector in terms of, for example, robo-advice and various predictive models. In line with high levels investment in artificial intelligence in the upcoming budgets of the European Union's research programme, the Commission believes that artificial intelligence should be at the service of humans and that it should be ethical. An artificial intelligence alliance is being set up that will consider what humanity will look like in the future and at how technology can serve humanity as opposed to directing humanity.

4.6. Data issues do not necessarily require a regulatory response

An industry representative stressed that the issues raised by the development and use of data do not necessarily require a regulatory response. In particular, data issues are increasingly being dealt with by CSR teams in large institutions. Data initiatives are therefore being considered from the perspective of being a socially responsible institution and do not necessarily require regulatory intervention. For, example, the representative's institution has launched a research fund that finances research on data and technology risks and the security of data in the cloud environment.

The representative's institution also believes in 'giving data back', for example using the large amount of data that it collects from its customers to provide a public good such as informing people about theft and flood risks in specific areas. In addition, the institution believes in being transparent with its algorithms so that customers can easily understand how their data is being processed.

IMPROVING FINANCIAL STABILITY

Vulnerabilities in global and EU financial markets

1. General vulnerabilities in the financial sector at global and EU levels

Global growth has broadened and strengthened during the past 18 months but different risks could threaten the sustainability of expansion in the medium term.

1.1. Global indebtedness notably in the context of monetary policy normalization and geopolitical risks remain a major vulnerability

An official outlined that while the global economic situation continues to improve, there are risks to the outlook. Private and public debt levels are at historic highs, which could cause repayment problems as monetary policy normalises. Global financial conditions remain generally loose, which could enable a further build up of vulnerabilities. Additionally, there are also geopolitical risks and escalating tensions over trade.

Another official identifies three major vulnerabilities or global risks. First is the possibility of an interest rate snapback with a sudden tightening of financial conditions. In spite of the global recovery, inflation and wage growth have been very subdued despite tightening labour market conditions. Any sudden change in inflation expectations could trigger rapid change in the overall picture notably for bond yields. Second, there is some general geopolitical risk, such as changes in trade conditions or trade wars. On-going tensions can change the perception of confidence in markets.

1.2. The US monetary, fiscal, trade and regulatory policies entail significant risks for the US and the major global economies

A further official also identified risks connected to fiscal policy, the relationship of fiscal to monetary policy, and changes in regulatory reforms since the crisis. While some attempts have been made to amend the core reforms of Dodd Frank, there has been consensus recognition that the reforms have largely worked. While some legislative changes will be made to address unintended consequences and alter conditions for smaller or community banks, there is currently not enough bipartisan support for larger legislative reforms. The significant change in the US is the recent tax reform, which has injected a significant boost into the economy. Continued growth is anticipated over the short term. However, the longer term outlook is not very bright. Based on a recent Congressional Budget office Report, tax reform will lead to inflationary pressures which will likely lead to further interest rate rises.

An industry representative suggested that vulnerabilities can be considered through three lenses: Main Street (economic), Wall Street (financial) and Capitol Hill (political). The impact of recent tax cuts in the US will be higher than the consensus expects, but these will increase the deficit and lead to additional Treasury issuance. The market impact of this emerging scenario can already be seen in widening LIBOR-OIS spreads.

Second, there is a difference in trends of the loan to deposit ratios of smaller and larger banks. Large banks' loan to deposit ratios continue to fall as they effectively attract deposits quicker than they can make loans due to a higher regulatory bar (e.g Collins, Leverage Ratio etc), and the opposite is true for small banks which means they are more reliant on wholesale funding.

Third, there is the risk arising from declining market liquidity, for example the ability to sell high-quality liquid assets in a stress. Fourth, shadow banking presents a considerable risk. It is a very large sector - Non-Financial sector is now 220% of global GDP while GSIB's capital market assets collapsed by around 40% from 2010 to 2016 (per recent AFME & PWC study) - , and regulators have fewer powers to intervene.

Finally, there is geopolitical accident risk. The US administration's so called trade rift with China is being driven by US's long-term frustration with the ineffectiveness of the World Trade Organisation's dispute-settlement mechanism. It is a different strategy, but risky.

1.3. Non-performing loans in some banks and the lack of profitability of the EU banking industry are still concerning issues

A regulator stated that Europe is moving in the right direction: capital levels of banks are higher, Non-Performing Loans (NPLs) are decreasing and a secondary market is developing. However, while banks' profitability has improved, costs have not been cut sufficiently. In particular, the cost of staff remains high. The banking sector has also made some important investments in technology. There are also new vulnerabilities coming from the improved cyclical position of the economies. While the current cycle is strong, in most countries there is no GDP gap. As increasingly number of countries had therefore raised the Countercyclical Capital Buffer above zero; therefore macroprudential policy implementation is becoming reality. A few years ago, the ESRB issued warnings on residential real estate, and this remains an area of concern in some countries. Additionally, in a number of economies leverage is particularly high on the private side. Finally, there is also a question around how the financial sector will be able to absorb and react to technological developments.

A Central Bank official explained that the differences in the price to book ratios of various national banking sectors demonstrate how the market assesses European banking vulnerabilities, which they connect with future profit prospects. While lasting low interest rates can pressure margins, they also reduce NPLs and foster credit demand. NPLs, however, are a key vulnerability. NPLs are still very high in some banks and banking sectors. It is positive to conduct structural reforms that improve the labour market and clean up the banking sector, because this reduces NPLs. Second, the industry's cost to income ratio is a vulnerability. The industry must query whether it is a reasonable equilibrium to have cost to income ratios above 50%. Reducing the excess capacity in this area will convince the market of the sector's future profitability. Last, but not least, an important vulnerability for European banks is the lack of a fully-fledged EDIS (European Deposit Insurance Scheme) that closes the third pillar of the Banking Union.

An official added that there is also a significant risk around demographic evolution. This is currently an issue in Japan, but will become an important challenge for many countries in the future.

2. Specific drivers of vulnerability in the financial sector derive from technology and data

An official stated that it is important to be neither excessively pessimistic nor excessively optimistic. The banking sector has been strengthened substantially, and the challenge is now to implement Basel III in advance of the Banking Union in Europe.

Usually, the trigger for a new crisis is relatively unknown: the sub prime sector, for instance, was a relatively minor element in the global financial system. For a similar reason, the BIS seeks to identify novel elements of risk. This entails the less regulated parts of the financial system such as shadow banking, crypto assets and the large fintech firms which are active in the payments market such as Alibaba or Tencent. There are many aspects to these less regulated spaces which are not monitored and could trigger risk events. These are the 'unknown unknown' areas, where proper analysis of these new risks is required.

2.1. New technologies and data create significant challenges for banks

An industry representative explained that fintech is the collective noun for new trends in technology and data, and these developments are creating significant challenges. Fintech spawns useful innovation and reduces costs for both customers and banks. However, it also brings challenges and risks. The quantum of data owned by banks creates considerable cyber risk. There are also risks around payment volumes being disintermediated and reductions in pricing from end-to-end processes being disaggregated and portions being commoditized. Stress testing often focuses on asset quality, but it must evolve to recognise alternative risks. The recent Bank of England stress-testing included a fintech dimension, and banks were asked to quantify the impact of fintech related risks. More generally, regulators should be vigilant of financial stability risks shifting away from the banking system, and increasing complexity of the financial system as products are compartmentalised and serviced by a range of new providers.

Additionally the technology advances cause increased competitive pressure with new competitors challenging established financing mechanism by offering higher returns (e.g. automated deposit rate shopping) and lower costs for services (e.g. e-payments).

2.2. Policy frameworks such as PSD2 and GDPR also pose competitive and operational risks for banks

Banks have become customer orientated businesses, but PSD2 requires them to share their data with fintech providers. This creates an asymmetrical relationship, because fintech providers do not have to share their data.

Additionally, GDPR is a serious operational risk due to the new responsibilities on financial services companies. Institutions are undertaking a considerable amount of work to secure their data, develop internal clarity on data and implement policies, procedures and standards and build what are called "Authorised Data Sources" (ADS).

2.3. Banks must be nimble to keep pace with structural change

The industry must anticipate change and decide how to respond. Sometimes the industry waits for technology to evolve, and sometimes it has a responsibility to move quickly. In payments, for example, the industry took a 'wait and see' approach and has had to catch up quickly to face effective disintermediation. This is why in the US, banks built into their mobile-banking apps the ability to make instant, online and real-time payment to an individual using a cell phone number or an email address.

However, the opposite is true for artificial intelligence. The banking sector moved very quickly to avoid the disintermediation of client relationships through the use of virtual assistants like developed notably by Google, Apple and Amazon (e.g. Alexa, Siri). Some major banks have created their own virtual assistant built into their mobile banking app to avoid a disintermediation of their relationship with their customers.

The days of the technology department being separate from the business are gone. Technology departments are no longer separate from businesses and will have to be reintegrated. These challenges require huge investments from banks. The speaker's institution spends $500 million on data and $ 3 billion on technology every year in line with their responsible growth strategy.

3. The challenges faced by EU regulations and supervisory arrangements for addressing on-going vulnerabilities

3.1. Risks presented by CCPs and ongoing work to address this

An official outlined that the financial system has benefitted from the G20 mandate for mandatory clearing of standardised OTC swaps, but there are new concerns about the role of CCPs and the associated risk. The 2015 joint working plan developed by BCBS, CPMI IOSCO and the FSB has produced positive results. The CFTC continues to work on this subject and collaborate with global partners regarding CCP risk. On a micro level, CCPs must focus on daily margining, governance and risk surveillance, which will alleviate some of the pressure and concern about CCP risk. While good progress has been made, this area requires acute surveillance and oversight from the private and public sectors.

CCPs are also highly interconnected. Obviously, CCPs manage and mutualize risk, but it is important for the sector to consider the relationships between the clearing house, its clearing members and other affiliates. Resilience is very important, but recovery and resolution are also crucial topics. It is important for the industry to focus on the circumstances following a crisis and how it would resolve CCPs. The industry must diligently focus on this.

3.2. The ESRB's macroprudential policy approach

A regulator stated that the European non banking non insurance sector is very large. The shadow banking system reached the size of the European banking sector in 2016. It is an important source of lending to financial institutions and is highly interconnected. In countries such as the Netherlands or Belgium, it is an important source of lending to non financial corporations.

The ESRB is increasingly using large amounts of data and receives between 50 100 million data points every day from EMIR. Currently, the ESRB is testing a system that will provide 100 financial stability indicators two days after trading activity, which will start to change how policy is developed. He noted that there are very large margins of improvement in the data quality of data collected by trade repositories. At some point, supervisors will need consider poor performance in data collection and transmission as an element of risk. The ESRB's EMIR processes are operational, and the same procedures will soon apply to AIMFD. In the future, this will also cover the Securities Financing Transactions Regulation, the Securitisation Regulation and MiFID.

3.3. Examples of challenges faced by macro and micro prudential regulations in Europe

A Central Bank official explained that regulation plays a key role in protecting against vulnerabilities. Europe must finish its Banking Union. The industry must ensure there is a fully-fledged and fully mutualised deposit guarantee scheme in Europe as well as a backstop for the Single Resolution Fund. It is important for Europe to move forward on risk sharing in order to finish building the banking union.

The essence of macroprudential policy is in addressing the lending cycle. Unfortunately, the lending cycle is still different in different European countries. Some countries inside the monetary union are experiencing double digit lending growth, and they are applying a positive Countercyclical Buffer (CCyB) while other countries are still deleveraging. European banks do not need a neutral CCyB that is the same for all countries. He expressed the view that, while macroprudential regulation should be used to manage different lending cycles, it is concerning to see that some countries are using it to fragment the European banking market.

Third, while there is a good reason behind TLAC for G SIBs, Europe has put itself somewhat in a corner with its MREL requirements applying for all banks across Europe, regardless of their size, business model or, importantly, their access to capital markets. These may be detrimental for consumers and depositors. Europe must take advantage of the BRRD's four resolution tools to address these issues.

Additionally, regulators must stick to the output floor in Basel III and maintain leverage ratios, otherwise, during the next crisis they may discover that 'the emperor has no clothes'.

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Supervision of EU and third country CCPs

1. Objectives of the proposal and progress made

A policymaker stated that the primary objective of the Commission's proposal is to improve the supervision of EU and non-EU CCPs (central counterparties), both of which are growing in importance.

The proposal, however, is not about changing the equivalence framework as such. Instead it is aimed at creating a level playing field for EU CCPs both amongst themselves and with respect to third country CCPs. The basic elements of the proposal are the creation of a new supervisory mechanism within ESMA for the supervision of both EU and non-EU CCPs as well as the tiering of third country CCPs into two categories: Tier 1 third country CCPs that are not systemically important and which will remain subject to the rules that already exist; and Tier 2 third country CCPs that are systemically important. In addition, there may be a requirement that some third-country CCPs are deemed of such systemic importance that they cannot be recognised and would need to be established in the EU in order to offer their services within the Union.

A public representative indicated that the EU Parliament is finalising compromises and intends to complete negotiations with the Council on the proposal before the end of its current term. Some important issues remain outstanding but it is likely that the final legislation will not differ greatly from what Parliament has thus far presented. The general architecture has already been agreed.

2. Proposal concerning the supervision of EU cross-border CCPs

2.1. Enhancing the supervision of EU cross-border CCPs

A public representative explained that the choice has been made to move towards a European solution for the supervision of EU cross-border CCPs and that ESMA is the only suitable institution for this task. Parliament intends to establish an internal committee within ESMA for supervising CCPs. The composition of this committee has already been decided upon by Parliament, subject to Council negotiations.

A phasing-in approach is under consideration so as not to put the entire supervisory burden on ESMA right from the outset. In addition, a division of tasks between the NCAs (national competent authorities) and ESMA has been proposed depending on the decisions to be made. Three main types of decisions have been identified: those for which NCAs can take decisions by themselves, those where consultation with ESMA is required; and those where ESMA's binding consent is required. Two important criteria have been agreed upon to categorise the decisions: the European value and the cross-border dimension of the decision; and the fiscal responsibility at stake. Applying such criteria, decisions around authorisation, liquidity models, settlement and interoperability would be taken at the ESMA level whereas decisions around reporting, exposure management, default funds and other financial resources would take place at the national level. The default procedure will be for the decision to be made at the national level and for it to be escalated to ESMA in certain circumstances.

A regulator stated that a key reason for moving towards a more European level of supervision is to optimize the use and management of skills and expertise at the EU level. The usual argument against further concentrating CCP supervision is that fiscal responsibility for saving a CCP might ultimately be tied to the Member State where the CCP is located, as indicated in the EU recovery and resolution proposal. The regulator however pointed out that such a 'tail of tail event' has never been experienced before. In addition, before reaching resolution, losses will already have been allocated among the clearing members that are typically located in multiple Member States. Thus, the notion of the economic impact on the sole home State of the CCP is an illusion. It is therefore necessary to have a broader European perspective of the supervision of CCPs.

The regulator moreover agreed with the proposal of the Parliament to integrate the decision-making regarding CCPs in the existing ESMA structure rather than creating a separate entity as was initially proposed by the Commission and which may create inconsistencies and duplication.

An official agreed with the need to move towards a single supervision of CCPs but noted that this does not mean 'a single supervisor'. There are a number of stakeholders and authorities that can positively contribute.

An industry player stressed that accountability and applicability are important in the supervision of CCPs, which means clarifying who is in control, particularly in a stressed environment. Although considering a broad range of views and input is useful when the framework and processes for managing CCP risks are being designed, decision-making clarity is required as the pace of the operation speeds up. This is necessary in order to avoid a scenario of multiple parties with vested interests slowing things down. Deference (to the home country authorities) also makes sense in that perspective the speaker felt.

Another official agreed with the importance of a clear chain of supervisory command during times of crisis. The official outlined that home supervisory authorities should consult and liaise with other authorities that have an interest in a CCP that operates in their jurisdiction, but it needs to be clear whose 'hand is on the steering wheel' during times of crisis and this should be the home supervisor. The Bank of England in particular has much experience in terms of establishing multilateral colleges and crisis management groups, including bilaterally with the US CFTC and the ECB. These arrangements all involve clarity over crisis management responsibilities.

An industry player concurred with the usefulness of involving in advance of any crisis situations the relevant stakeholders when it comes to large CCPs, as they can provide a valuable input that helps to balance the interests of different stakeholders However, the speaker echoed previous comments that clarity of supervision is paramount during times of crisis and it is important that there should be 'one hand on the tiller'. The home regulator should have responsibility for the supervision of CCPs based in its jurisdiction at that time. It is indeed always possible that a state, or a financial organisation in that jurisdiction, will have to provide a backstop to a CCP in crisis. In this regard, the speaker disagreed with the view previously expressed that the failure of a CCP should not be worried about because it is a tail of tail event i.e. an eventuality that most probably will not occur that. On the contrary that is precisely the type of event that supervisors and CCPs should be concerned with, even though it should not be the main driver of day-to-day supervision.

2.2. The role of Central Banks of Issue (CBIs)

There are several challenges with regard to the role of CBIs that Parliament is still working on in consultation with the ECB, a public representative explained. Amending the Commission's original proposals, Parliament intends to implement a 'comply or explain' procedure in instances of disagreement between ESMA and the CBIs on issues relating to monetary policy in particular such as liquidity management, collateral and margin requirements. In addition, a list of requirements is being proposed that the CBI can impose upon Tier 2 systemic third country CCPs as a pre-condition for recognition. The list is intended to be exhaustive but with the possibility of future expansion.

An industry representative felt that the experience so far with colleges of supervisors has been positive and emphasized the importance of closely involving CBIs in the supervision of CCPs for three reasons: CCPs are a key component of the payment and settlement flows of the financial sector; CCP members are mostly supervised by central banks either as credit institutions or as central bank counterparts; and some instruments cleared by CCPs (notably repos and interest rate derivatives) are relevant to monetary policy and/or financial stability.

The industry representative stressed however that CBIs should have a proper say on a clearly defined set of CCP decisions which may have an impact on financial stability (e.g. those relating to liquidity risk controls) and not just a right to be consulted. By extension, this also means that CBIs should be involved in all the steps relevant to those areas of competence when granting a CCP authorisation, or an extension or withdrawal of services. In addition to the areas where the CBI should provide its consent, it is also vital to ensure an efficient information flow between the relevant authorities and the CBI especially in a crisis scenario. This should hold true both for EU and non-EU CCPs, when it comes to key clearing markets for the Union's currencies. However, the principle of deference should continue to apply to markets that have no systemically relevant euro volumes.

The speaker's institution (a global CCP) is regulated as a bank. The reason for this choice is the wish to have continuous access to the liquidity resources of the central bank in order to mitigate possible liquidity stress scenarios involving clearing members, rather than relying on commercial bank and repo markets, which may break up in times of stress. Answering a question about the relevance of imposing bank licenses to systemic CCPs, an official responded that this is not considered necessary in the UK. The Bank of England has made access to the Sterling Monetary Framework open to all CCPs that are either authorised within Europe or recognised by ESMA. From whatever country, they can have access to the Framework if they meet the relevant requirements and a banking licence is not necessary.

A regulator stressed that while strong co operation between market regulators and CBIs is desirable, clarity and speed in decision-making is essential as previously stated. In this regard, the Parliament's proposal to move away from the need for systematic consent from the CBI and to a more consultative role, possibly with a 'comply or explain' procedure seems appropriate.

An official stressed that the types of issues that CBIs need to address regarding CCPs and their level of influence given their monetary policy and financial stability mandate and their role as lender of last resort still need further defining. At the core of the topics that have to be addressed from a CBI perspective are liquidity risk and the activities of CCPs that have a bearing on liquidity risk management. The official agreed that clarity in decision-making is essential, as evidenced from previous crises but emphasized the need for stringent conditions for disregarding the recommendations of the CBI. 'Comply or explain' should only be exercised on the basis of a qualified majority and the possibilities for overruling the CBI perspective should be quite limited in practice.

3. Proposal concerning the supervision of Tier 2 systemic third-country CCPs

Some comments were made regarding the supervisory arrangements for so called 'Tier 2' systemic third-country CCPs, although the Commission's proposal in this regard was not discussed in detail.

An official emphasized that while the CFTC is agnostic about the choice of CCP supervisors in the EU it does not want third country CCPs to be treated differently from those in Europe. A different set of supervisors for European and for third-country CCPs may lead to disparate treatment and go against the objective of a level playing field. The official added that deference should be the basic principle in both the application of rules and in supervision when it comes to the treatment of third country CCPs. This means that the primary supervisor of a CCP based in the US should be the CFTC and that a US-based CCP should comply with US rules. This approach which has been used in different contexts works well because it provides clarity as to who CCPs need to look to regarding regulation and supervision, which is important for the market in particular.

Moreover, the CFTC considers that the 2016 agreement with the EU regarding CCPs that took three years to agree has created an appropriate framework based on the deference of rules and the sharing of supervision. The CFTC seeks assurances that this framework will continue as Europe implements any changes in its own legislation. Concerning the review of equivalence agreements, a public representative noted that there is a commitment from the Commission to conduct regular reviews of all recognition decisions and not just those that were agreed in 2016. Those reviews will take place periodically, probably every two-and-a-half years, if this is agreed by the Council.

Reviewing the equivalence framework is not a problem for the CFTC, the official stated, provided that the review is based on changes in market conditions, and not on political considerations predicated for example solely upon Brexit and a competitive interest from certain countries to relocate certain activities.

An industry player agreed. There is now a EU-US equivalence regime in place and there is no reason why it could not be further leveraged for other jurisdictions going forward.

A regulator noted that experience has shown that the equivalence model used in the EU is not sufficient to handle all situations. In certain circumstances, it is not appropriate to rely fully on a third country supervisor and, as such, additional supervisory tools are needed at the EU level. That does not reduce the importance of co-operation and reliance, but it is necessary to be able to assess whether the risks that are specific to one's region and jurisdiction are properly assessed and addressed by the third country regulator. In doing so the EU is actually moving in the direction of the US, endowing its supervisors with the same type of supervisory tools that US supervisors can use regarding third-countries. The Commission's proposal still provides several cases where supervision will rely on third country supervisors; for example for Tier 1 CCPs and to some extent for Tier 2 CCPs. The regulator moreover considered that the supervision of third-country CCPs operating in the EU cannot be different from the supervision of EU CCPs. The same regulators will need to be responsible for both otherwise there will be a great deal of loss in terms of scale economies and expertise.

Another official believed that three areas should be further assessed in the proposal concerning Tier 2 third country CCPs. The first area is the requirements expected of third country CCPs by the EU authorities. These should be consistent with the requirements placed on EU CCPs and should be based on international standards. The second area is deference, which needs to be further developed in the EU proposal and used to the extent possible. This is indeed the most efficient way for supervisors to cooperate across borders and to make sure that no conflicts or overlaps appear. Third, the proposal is silent on crisis management arrangements, which is unacceptable. It is important to know what will happen in a crisis.

A public representative emphasized it is most likely that third-country CCPs clearing cash equities and those clearing agricultural derivative contracts will be excluded from Tier 2 measures. This will have to be further assessed and confirmed by ESMA but the conclusion so far at the EU Parliament level is that those third-country activities are not systematically important for Europe. The EU Parliament has moreover completed the Commission's proposal with more attention to the exchange of information and to the quality of supervisory co operation. A template for a memorandum of understanding has notably been introduced that will be treated extremely seriously. Elements are also being added regarding the handling of emergency situations.

4. Proposal concerning 'significantly' systemic third country CCPs

4.1. Possible denial of recognition or 'location policy'

A public representative stated that the Parliament has improved upon the Commission's proposal in relation to the identification of 'significantly' systemic third-country CCPs with a more proportionate and evidence-based decision process based on some level of cost benefit analysis or at least objective criteria. The aim is to avoid any arbitrary decision, which may be disruptive for clients and members. In addition an adaptation period is proposed after the decision has been made. Moreover the denial of recognition could be proposed by service (and not for the whole CCP).

An official considered that a location policy makes sense in some cases. It would be unacceptable for the EU authorities not to have the final say on how to address a major source of systemic risk developing offshore, particularly during periods of crisis. In a crisis it is important to have a single decision-maker, but currently, in the case of a multi-currency CCP that has systemic importance for different currencies including the euro, it is the home authority of the CCP that has the final say, which is not appropriate. This is not a theoretical problem, as shown during the sovereign debt crisis and it should not be allowed to happen again, hence the importance of at least considering this case as has been proposed by the Commission. The official also felt that relocation decisions should not be limited to periods of crisis, since that will be a time when a clear rulebook is required and when it would not be appropriate to change clearing and settlement arrangements overnight. Finally the official did not see the need for an additional impact assessment since lessons can already be drawn from the sovereign crisis.

Another official disagreed with this assertion and responded that the enhanced regulatory requirements provided in the CPMI-IOSCO PFMI principles, which were published after the financial crisis and supervisory co-operation can be used to address the risks posed by third-country CCPs, without needing relocation. As well as enhanced regulatory standards for financial resilience, which protect the entire system, standards of regulatory co operation have improved significantly over the recent years notably with the implementation of colleges and this forms an efficient basis for the supervision of Tier 2 third-country CCPs. In addition, reliance on multi-currency infrastructure exists in various forms across the market and works well. For example, a range of jurisdictions use CLS for multi-currency FX settlements and ICSDs for securities issuance. US supervisors are also comfortable with the volume of US interest rate swaps and other derivatives that are cleared in other jurisdictions and rely on supervisory cooperation to gain the assurance they need. The official also noted that the reference to the sovereign debt crisis should not be taken to imply this was specifically a Eurozone vs non-Eurozone issue. As public reports of historic incidents, including by the IMF, have shown, it was not.

The official added that splitting the market by the location of participants will fragment it. That will increase cost and financial stability risks for all and will remove the benefits that accrue from global pieces of infrastructure. An industry representative claimed that these impacts can be mitigated with market-driven solutions. Solutions have been developed for example in the interest rate derivative market. The official however disagreed with this idea that fragmentation would be 'neutral' in terms of financial stability risks and costs.

4.2. The implications for monetary policy of different centrally cleared instruments

An industry representative considered that the two largest centrally cleared markets of relevance to monetary policy and financial stability are repos and interest rate derivatives. Repos (repurchase agreements) are a physically settled market with potentially significant liquidity needs and are also one of the main tools for central banks to conduct monetary policy. Interest rate derivatives of a certain size can also influence how interest rates of central banks are set and thereby directly influence monetary policy.

An official from a CBI disagreed that repos and swaps should be considered in the same way in terms of their interest from a CBI perspective. CBIs are primarily concerned with products that are crucial to the implementation of monetary policy and that generate significant liquidity needs (typically because they are physically settled), hence the focus on repos. Swaps are not typically used for monetary policy implementation and, as they are cash settled, the liquidity need generated by interest rate swap clearing is significantly less than for repo clearing. Therefore, from a monetary policy perspective, CBIs are likely to be less concerned with the swaps markets than they are with the repo markets.

Another industry representative agreed that repos and swaps should be considered differently with regard to their potential impact on monetary policy. Repos are closely related to monetary policy and are used directly by CBIs and governments for the purpose of monetary policy transmission. They are based on sovereign debt which reflects the creditworthiness of a sovereign and are part of the underlying sovereign bond market. Repos and bonds are moreover physically settled products, which means that one has to exchange physical cash for the physical bond and that there is a material liquidity need both in normal conditions and times of stress. During the Lehman crisis for example the priority regarding the repo portfolio was to ensure there was quick access to material liquidity i.e. physical cash in order to buy bonds to cover the short positions and hedge the risk.

Echoing the previous comments, the industry speaker believed that swaps are different. They are hedging tools used in the real economy and globally traded. They are cash settled so there are no material liquidity issues. In addition swaps are not directly linked to sovereign debt or repo, therefore they have no direct link to euro currency stability. Again, during the Lehman crisis, the main priority was to hedge the swap portfolio, and this was done with similar products (OTC swaps that cash settle) and therefore there was no need for physical liquidity or settlement. In addition as with all swaps variation margins can be used and there is normally also cover through the initial margin and default funds.

Against that backdrop, the industry speaker did not believe that denial of recognition is the right answer for swaps. In addition the swaps market is global with participants worldwide. Any artificial fragmentation through a denial of recognition will only serve to disadvantage smaller and isolated markets in Europe. It will mean no access to efficient markets, increase in costs, removal of choice and competition, and ultimately an increase in systemic risk. The answer for cleared swaps, therefore, in terms of systemic risk, financial stability and competition is concrete enhanced supervision and specific requirements as proposed by the Parliament.

An official stated that the nature of the asset and the size of the market cleared by the CCP need to be considered and disagreed with the previous assertions that interest rate swap markets have nothing to do with monetary policy transmission. On the contrary interest rate swaps markets are at the heart of the pricing of sovereign assets, have a strong bearing on the transmission of monetary policy impulses and thus need including in the scope of the proposals. The official also stressed that liquidity risks during times of crisis, where the essential part of the interest rate swap market in Europe is settled offshore, will also be significant and will have a systemic impact as well as an impact on monetary policy.

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Tackling vulnerabilities from asset management activities

1. Risk mitigation provided by existing fund regulations and standards

1.1. Market trends and main risks

An industry representative emphasized that the discussion about the risks associated with asset management activities is timely. Asset management has become an ever more growing business in the current monetary environment because of the relative attractiveness of the returns provided. The critical role played by the asset management industry in funding real economies beyond bank funding has also been recognised in the EU and the US in particular.

It is evident that there is a need for greater economies of scale and more concentration in the market to face up to investments such as those in digitalisation and technology.

Recently, there has been a large shift from core products towards more specialised ones. In particular, ETFs (exchange traded funds) have grown significantly because of their strength in tactical asset allocation. There has also been strong growth in AIFs (alternative investment funds), in quant products as well as a shift from rates into credit products. Asset managers are also operating increasingly in international markets. There is notably a great deal of investment from outside the EU into European high-yield asset classes.

A regulator stressed that attention should also be given to sovereign funds and managed accounts. Managed accounts may be a greater threat than mutual funds because account holders may pull out of a managed account for specific reasons such as a lower return and there are no restrictions in that case on the redemptions that can take place. Other products that may be problematic are those that promise high yields, because these promises are often not controlled. There should be greater scrutinisation of investment policies by supervisors at the outset to control promises of high yield.

Answering a question from a member of the audience about the main crises that have been experienced in the asset management sector and the lessons that can be learned, several speakers considered that the LTCM crisis of the 90's was the worst one because of its global dimension. One lesson learned from that crisis is that the manager of the fund had no idea whatsoever of the risks that were being taken in connection with their extraordinary level of leverage. Madoff is another example to consider since it shows that when there is a fraud it will create risks whatever risk management tools are in place.

1.2. EU fund regulations already address most risks at the individual fund level

Against this backdrop, the question arises as to whether the UCITS and AIFMD legislations are still effective and provide an appropriate framework for the market environment. Speakers on the panel answered positively.

An industry representative stressed that European fund legislation addresses liquidity and leverage risks in particular. It is very strict on the leverage side. UCITS, under which two thirds of EU funds are structured, allows practically no leverage; the maximum leverage allowed under the commitment methodology is 2:1. The AIFMD has also introduced limitations on leverage that, if broken, can result in specific reporting.

Another industry representative however believed that too many EU regulatory requirements have been poorly thought out; for example, rules that curtail the use of reverse repos and thus restrict the amount of high-quality government securities that can be counted as liquidity, although these securities are the best source of liquidity available. In addition, under proposals in the BRRD II (Bank Recovery and Resolution Directive), EU counterparties are effectively prevented from being used by funds for direct short-term lending, call accounts or to be used as a repo counterparty. This is because the EU authorities appear to be willing to subject EU banks that are at risk of failing to a moratorium or to a stay of longer than the two days that is the standard in the rest of the world. That increases the difficulty of managing liquidity for investment managers.

The speaker saw two reasons for such regulatory issues. The first is that EU regulations are the result of negotiations between several EU institutions. The second is that there seems to be more consideration by them for controlling the market and market participants than for regarding end investor needs.

A regulator stated, in response, that regulators and supervisors have to anticipate what may go wrong. When problems emerge, the question is no longer what the clients or investors want but rather what should have been done differently to avoid the crisis. Supervisors therefore have to think more broadly in order to define what is necessary from a public policy point of view to mitigate risks.

1.3. IOSCO liquidity and leverage guidelines and the interplay between the global and regional dimensions

An official stated that there is a great deal of interplay between what is done at the international level and at the regional one. The benefit of a global organisation like IOSCO is that it can bring together many different perspectives and articulate a framework that most jurisdictions can then adopt, exemplified by IOSCO's recent recommendations on liquidity risk management. In that instance, IOSCO was able to rearticulate the basic principle, which is that liquidity risk management should belong to the responsible entities, i.e. the asset managers. The content of these recommendations remains at a fairly high level and aims to focus the attention on key issues from a liquidity risk management perspective, from the inception of an investment fund to its launch. IOSCO laid out the high level framework that the industry should follow. It is then up to each jurisdiction to decide how to carry that forward. Responsible entities are already looking at the recommendations in great detail and beginning to make some changes.

An industry representative agreed that creating a single set of global rules is difficult and that rules are best defined by the National Competent Authorities (NCAs) based on global standards, when these exist. Rules also have to take into account the investment policies used by asset managers. In this context, the impact of IOSCO liquidity rules on EU funds is likely to be limited given existing EU UCITS and AIFMD requirements. Concerning leverage a common corpus of rules has also been developed over the years in Europe. Consequently, the speaker suggested that IOSCO's work on leverage should take a two-step approach with a first filter that would put aside funds which already follow strict rules regarding leverage (such as EU UCITS and AIF funds). The second step would be to create a matrix to better assess the extent of the leverage risks of the remaining funds.

Another industry representative stated that it would also make sense to create a consistent definition of leverage at the global level that could apply to both UCITS-type funds and AIFs.

Responding to the first industry representative, a regulator expressed the wish that IOSCO's proposals should reflect a broader view as opposed to believing that a particular part of the world, whether the US or EU, has got it right and that the rest of the world should follow suit.

Another regulator stressed that since risks need to be managed by managers that are investing worldwide, all regulations or guidelines must be consistent across the world.

1.4. The US fund liquidity framework

A regulator explained that in October 2016, the US SEC (Securities and Exchange Commission) passed regulations that place liquidity requirements on funds in terms of assessment and measurement. These regulations also make it clear that responsibilities for compliance with such regulations depend on the managers all the way up and they are therefore consistent with the IOSCO standard.

The SEC has had an ongoing dialogue with the industry regarding liquidity issues in particular and has received a fair amount of feedback from the asset management industry.

2. Enhancing the regulation and supervision of asset management activities

2.1. General approach and trends

A regulator stated that there is a trend towards a more prudential regulation in the asset management sector with leverage, liquidity and stress testing requirements being prime examples of a prudential toolbox. At the same time conduct regulation has been further developed in the banking and insurance sectors (in addition to prudential regulation). It is important however that these regulations should be applied in a way that takes into account the specificities of the activities concerned. This principle needs to be applied notably in the context of the operationalization by IOSCO of FSB proposals regarding leverage, which is underway.

An industry representative emphasized that risk management concerning asset management should be focused on activities, investment strategies and asset owners rather than on the legal entity (i.e. the management company).

Several speakers were also in favour of a principles-based approach to fund regulation. At the international level, this allows the creation of a level playing field in a compatible way with domestic regulatory environments. At the EU level this allows the creation of a platform with

EU wide standards and principles which may co-exist with specific products and investment strategies operated at the domestic level in close cooperation with the NCAs, an industry speaker suggested. There is however a strong tendency to be 'ultra-rules based' in the EU, a regulator pointed out, which is not always the optimal way forward to address these issues. For example on the liquidity management side, while specific principles are needed, there is a high risk of being too detailed. Applying higher level principles in this case would be preferable in order to retain sufficient flexibility.

A regulator noted the difficult quandary of prevention versus action. The more ambitious supervisors are in favour of prevention, the more likely they are to impose excessive requirements on the whole industry and to create problems that may not have otherwise arisen.

2.2. Liquidity management tools

The panellists considered that liquidity management should predominantly be the responsibility of fund managers, while recognising that regulators have a role to play in handling crisis situations. This is the way IOSCO recommendations in particular are formulated, an official stressed. There is a clear role for regulators and tools have been proposed, but this should only be a last resort solution.

A regulator stressed that supervisors require tools such as swing pricing, redemption gates or redemption suspensions in order to handle certain stress situations, such as run-type risks if they arise. These are essentially micro rather than macro-prudential tools. Although a broad range of liquidity management responsibilities and tools at the supervisory level may not be the way forward, supervisors still need to be able to draw upon 'crisis management tools' in order to act quickly when required.

One key question however concerns when to strike the balance of where the supervisor steps in as opposed to the fund manager. The regulator was not in favour of the supervisor stepping in very early, even on redemption issues. Supervisors should not supersede fund managers' decision-making in normal market conditions.

An industry representative concurred that supervisors should have crisis management tools, but stressed that those tools should only be used to manage crises and not in a more regular fashion. Part of the job of asset managers is to know their clients and to understand their subscription and redemption cycles. They should know when corporate dividends and bonds are repayable or when insurance companies should be paying out on global catastrophes for example.

Another regulator emphasized that in the event of a crisis, regulators may not be in a position to make informed decisions, as they may not understand the asset managers' holdings and the market that they operate in. Instead, in the midst of a crisis, regulators are likely to be overwhelmed and should not impose their judgements on asset managers who are 'living and breathing the markets' and possess the necessary information to make their own decisions.

An official also emphasized the extreme difficulty of prescribing specific tools to be used across all jurisdictions. Regulators can describe what these tools are, but the application of those tools from a regulatory point of view will depend upon the fund and the market circumstances, which the NCAs are in a better position to appreciate. In this vein, IOSCO, in its recommendations, identifies the tools that may be needed and defines the role of the regulator. By and large, the industry itself has done a good job in managing liquidity and this is to be acknowledged. However developing a strict toolbox approach to liquidity management may not be the best use of time, at least on a global basis.

From an industry perspective, risk management is probably the most important part of the value chain, an industry representative stated, hence dealing with risk management is a key discipline for financial institutions. Another industry representative emphasized that the existing regulation is effective because it fosters a risk culture in terms of independent risk governance and independent valuations, namely that methods and models are not only designed for portfolio managers and fund managers but also for independent risk controllers.

2.3. Guidance on liquidity risk stress testing

Another regulator stressed that progress has been made in the EU at the micro level on stress testing, though this is still very much a learning curve. A reliable macro stress testing concept has yet to be formulated but it is nevertheless a worthwhile pursuit.

An official agreed that stress tests are essential to assess the liquidity needs of investment funds. The SEC for example does not dictate the form of the stress testing, but specifies its objectives and responsibilities. Such requirements appropriately put the responsibility for addressing liquidity issues on the funds and on their managers, and are therefore consistent with IOSCO standards.

An industry speaker pointed out that liquidity stress tests are very specific to the asset class and to the product category in question. In order to avoid herding all the fund managers in the same direction, the stress tests should be performed at the fund level. Another industry speaker suggested that stress tests should not be too prescriptive because of the different types of strategies pursued by funds.

An industry representative also stressed the importance of combining the effects of suitability and appropriateness when considering investor protection and its impact on liquidity risk. Questions need to be asked as to how strongly regulations affect investment behaviour. There are also unintended consequences impacting credit products and corporate bond markets. There is certainly much higher volatility now than there was 5 or 10 years ago because fund managers are faced with a much smaller number of market makers. All of this in combination makes simulating liquidity risk more complex than before.

2.4. Improving reporting

A regulator stated that there should be a greater focus on improving reporting by asset managers and on scrutinising their investment policies in order to mitigate the risks associated with certain products. An industry representative agreed that regulators should be able to use the data provided to understand how funds differ from one another, to spot the outliers, query unusual credit decisions and then to act to avoid a potential crisis situation.

Industry representatives were also in favour of a more centralised approach to reporting that would allow the production of a single set of reporting data as opposed to separate sets for each domestic regulator and also for ESMA. They also expressed the wish that authorities would communicate on their use of the reported data and publish aggregate figures.

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Insurance comprehensive systemic risk framework

1. Clarifying systemic risk in the insurance sector

An official stressed that the International Association of Insurance Supervisors (IAIS) is taking a step by step consultative approach. The IAIS is trying to develop a holistic framework which can address the risk of the disorderly failure of firms and also go further to address the collective impact of certain activities and vulnerabilities across the sector. Insurance differs from banking or asset management, and can play a role in fostering financial stability by spreading risk across time and different sectors. The IAIS's interim consultation paper establishes two key sources of vulnerability: liquidity risk and macroeconomic exposure complemented by a third source aimed at covering what not addressed in the first two categories such as common or pro-cyclical behaviours that do not directly stem from either liquidity risk or macroeconomic exposure. IAIS stakeholders have pointed out that counterparty exposure is another form of interconnectedness that must be considered in a comprehensive framework.

An industry representative underlined the importance of recognising the shift towards looking at systemic risk in terms of actual externalities via an activity based approach (ABA). The insurance industry is a natural source of stability, but the industry has also to address its possible remaining vulnerabilities. The key issues to understand and assess here are the systemic risk transmission-channels which stem from large asset liquidations or the consequence of too concentrated counterparty exposures in the insurance sector. The challenge for the insurance industry is to be able to manage both 'tsunami' and 'domino' systemic risk.

Another industry representative noted that the question of risk has to be addressed in the context of the 2008 financial crisis, which demonstrated that intrinsically insurance increases financial stability. Nevertheless, it is important to develop the industry's thinking on risk. Yet, so far, addressing systemic risk has only been effected through the largest institutions, although precisely because they are the largest, they present the least systemic risk because they are the most diversified, have the best staff talent, invest the most in tools and processes, and are already under scrutiny from their national supervisory authorities.

An official also noted that supervisors must better understand the important role insurers play in enhancing financial stability. While measuring these contributions can be challenging, consideration should be given to the issue before the industry endorses any additional policy measures.

An industry representative also acknowledged the amount of work, particularly by the IAIS, that has gone into reaching the current point of discussions. An effectively holistic approach to systemic risk could be necessary since in the insurance sector, activity creates systemic risk rather than specific entities. However, the industry cannot be satisfied by only addressing counterparty exposures or activities facing macro-prudential exposures in the sole insurance sector. In this respect it is important for regulators to clarify what the industry is talking about before imposing targeted policy measures. In particular, transmission channels which are very relevant for the counterparty exposure issue should be better understood since counterparty risk means concentration risk, which is cross sectoral and not insurance-sector specific.

A regulator pointed out that the industry agrees that there should be a better understanding of the activities that create systemic risk in insurance. Specifically, nobody is talking about cyber risk, which is a systemic risk that stems from insurance activities.

2. Features of the forthcoming systemic risk framework

2.1. The way towards an ABA

An official felt that the IAIS's project was progressing, although it was not straightforward. The IAIS is working towards a holistic approach with three main elements: continued global monitoring of risk, a continued commitment to implementation monitoring, and the agreement of policy measures. First, risk monitoring must assess the source of risk whether it is the 'tsunami' or 'domino' approach. He clarified in this respect that while large companies are well diversified and managed, the IAIS is not trying to capture the possibility of failure, but the vulnerabilities that might lead to the failure and the impact of an actual failure. Second, cross sectoral aspects of risk monitoring, have to be defined, since while some activities might be substantial in the insurance sector, in the context of the broader financial sector they might be less important.

The official felt that at this stage to establish policy measures is more difficult. The industry must enact policy measures, which will manage both 'tsunami' and 'domino' risk, but it is important to wonder whether ABA policy measures will cover both.

The focus must be on insurers ensuring good liquidity management and planning, good management of counterparty exposures and concentration, and finally recovery planning. However, it remains to be seen whether there is a need for any development of the regulatory toolbox, in particular regarding measures over and above liquidity management planning and counterparty exposure. Stress testing is a major part of that, but it is difficult to carry out stress testing if the valuation bases do not provide consistent results.

An industry representative stressed that it is important for any ABA to use a balance sheet approach, which would include efficient liquidity risk management plans, rigorous liquidity stress testing and ensuring a proper identification of material liquidity risks. This approach will also remove the need for supervisors to chase individual products or legal entity names. Much work remains at the supervisory level to assess ORSAs and ensure all risk is being properly considered within insurance companies.

An industry representative believed that the industry must demonstrate that an activity based approach can cover all types of risk. Any ABA will also need granularity otherwise the approach would make no sense and just represent an additional form of compliance cost.

An industry representative stressed that any international ABA must link into local and regional approaches and be implemented into jurisdictional law and current frameworks. However, IAIS still lacks international capital standards, which means there are no common asset and liability valuations or risk measurement bases. In this respect IAIS should suggest principles for identifying and measuring risks while developing broad definitions for policy measures.

Another industry representative suggested that policy measures developed from an ABA should be qualitative rather than quantitative. If the industry manages to develop an ABA, policy measures must be rooted in local jurisdictions, and this means the industry needs solid qualitative frameworks. While the industry is not in favour of the EBA, it could be applyed more broadly to the market since if liquidity risk management plans make sense for large companies, they probably also make sense for smaller ones.

An industry representative highlighted that there have already been a number of successful activity–based approaches in the asset management industry. Specifically, there is now such an approach in derivatives. The insurance industry is better off today because of these types of reforms. There are similarities between the NAIC's macroprudential initiative and the policy measures initially identified by IAIS.

A regulator thought that the industry should wait before abandoning its well-functioning entity based approach. This move should be discussed when the industry has a better understanding of the activity based approach. An official stated that while qualitative measures are a good start, they are only a minimum requirement. Another regulator stressed that it will be difficult for supervisors to accept a purely qualitative approach, because the aim of standard setters is to reach a quantitative regime.

A regulator supported the comments, noting that it is currently premature to abandon the entity based approach. The industry is following a step by step approach to manage systemic risk, starting with the identification of the source of risk and then elaborating which measures are needed since the insurance industry had reached an entity based approach because it was in a crisis and it could not wait for another similar trigger to elaborate other or additional policy measures. There is also a risk that the ABA could be an excuse not to do anything. The regulator stressed the importance that all parties should contribute to the elaboration of proper and specific policies for the sector.

2.2. Proportionality

An industry representative stressed that any policy measures should be applicable to all of the players in any targeted activity. Whatever the activities are, they should be assessed cross sectorally and the aims of any activity should be considered when creating policy measures.

An official suggested that the entity based approach only identifies the largest companies, and not necessarily those that contribute most to global financial stability risks, and an ABA could assist in the identification of such risks.

A regulator noted that industry figures often referred to 'proportionality' in this debate, and indeed it is not proportionate to ask every company for a detailed liquidity plan since a higher level plan might be sufficient for smaller players. While all players should be treated equally, proportionality is necessary because it is important to distinguish between the global, European and national levels of systemic importance.

In respect of proportionality, an official felt that the conceptual scope of an ABA is all insurers. While this may not be possible, the industry must perform a cost benefit analysis on any policy measures and assess how to apply them proportionately.

An industry representative explained that whilst it may seem that policy measures can only be implemented for either the largest or smallest group of players, progress can be made between the two extremes.

Another industry representative agreed that it is important for the industry to demonstrate how an activity based approach could be proportional. The NAIC's macroprudential initiative has already taken a step towards requiring all insurers in the US to provide more liquidity data. Similarly, there are some ICPs that could apply to all insurers and supervisors.

3. Implementation issues and the development of policy measures

An official explained that the US approach is broadly similar to IAIS, although the US has been moving away from an entity based approach. In the US the Treasury has indicated that entity based evaluations of systemic risk are not the best way to mitigate risks associated with asset management in the insurance industries. The NAIC wants to see IAIS develop further detail on its plans before it can fully endorse IAIS's work. The official supported the initial focus on asset liquidation and counterparty exposures as transmission channels.

The official stressed that while there could be some implementation challenges the NAIC's macroprudential initiative would dovetail nicely with IAIS's ABA work. The NAIC's priority remains supervisory collaboration and coordination through supervisory colleges and bilateral discussions. Greater convergence between jurisdictions is possible, but the need for global standard setters to focus on outcomes will probably always exist as each organisation's jurisdictional regulatory approaches continue to adapt to their own markets and the evolving needs of their policyholders.

An official stressed that the IAIS's focus is on global financial stability and systemic risk, which means the industry needs a global approach amongst supervisors. To facilitate meaningful collective discussions, the industry must speak the same language. The IAIS wants to achieve outcomes at the global level, but implementation must take account of national legislative systems. The approach of the IAIS does not take account of national systems because these are questions of implementation. If a national system meets the IAIS's outcomes, it has already implemented them.

A regulator noted that EIOPA contributed greatly to the work of IAIS. EIOPA has developed an approach to better understand the sources of systemic risk for the insurance sector. This is a relevant aspect in light of future work in the context of the Solvency II review. While Solvency II already includes certain tools or measures to address some of the sources of systemic risk, at present issues such as excessive concentration or certain risky activities are not being effectively addressed. EIOPA has published two papers on "Systemic risk and macroprudential policy in insurance" and "Solvency II tools with macroprudential impact" and plans to publish a third one on other potential macroprudential tools and measures to enhance the current framework in Q3. The final objective is the revision of Solvency II in 2022.

An industry representative suggested that it is premature to comment on implementation and its challenges. However, it is important to consider regulatory fragmentation, which may lead to regulatory arbitrage. Additionally, the industry representative expresses concern at the use of the term 'macro-prudential'. The insurance industry requires prudential regulation and supervision, which is targeted at policyholder protection and financial stability. While it is reasonable for supervisors to assess whether additional tools are necessary, discussing insurance in macro-prudential terms is dangerous.

Another industry representative remarked that in terms of the current standards, there is much to be done on ICPs to ensure firms avoid excessive counterparty exposure. The industry could also strengthen its standards for stress testing and liquidity as well as counterparty exposure. There is much more work to be done to prescribe the elements of a good liquidity stress test or define what a material risk actually is.

An industry representative highlighted the importance of discussing the process used to devise policy measures, which raises the important question of democratic control. In Europe, there is a political, economic and social context, which affects how policy measures are developed. Public investment in infrastructure is at an all time low, and there are questions about where more growth or infrastructure investment is needed. It is important for the industry to control or at least monitor the development of policy measures, and stakeholders from Europe are encouraged to engage with the process.

A regulator stressed existing opposition to combining the agenda of systemic risk with the agenda of growth in Europe and sustainable finance. Many regulators agree that avoiding systemic crises is not contrary to sustainability.

Another regulator suggested that additional tools might be necessary, but the problem is often how the topic is presented. EIOPA is trying to establish whether it needs additional tools with its step by step approach. However, the regulator disagreed that it is dangerous to talk about insurance in macroprudential terms. Not discussing it in these terms may result into a copy and paste in legislation from other sectors. There is a need to supplement the existing tools with other tools or measures to address the other potential sources of systemic risk, regardless whether this is labelled as macro-prudential policy or not.

Various regulators agreed on the fact that in terms of implementation risks, proper impact assessments would be necessary before the implementation of any new rules.