Views

The EUROFI Magazine

APRIL 2020

Zdravko Marić

Deputy Prime Minister
and Minister of Finance
of the Republic of Croatia

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Challenges for economic policy-making of the "Great Lockdown"

And more than 160 contributions from leading public and private sector representatives:

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PUBLIC AND PRIVATE SECTOR VIEWS

Views

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This bi-annual Views Magazine comprises contributions from a wide range of public and private sector representatives on recent regulatory developments and the main macroeconomic and industry trends impacting the EU financial sector.

Some initial thoughts have also been provided about the implications of the Covid-19 crisis.

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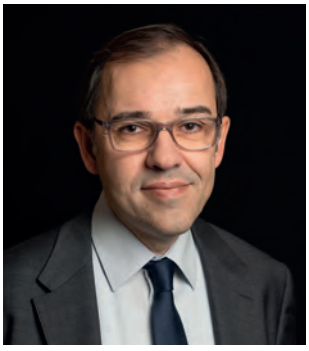
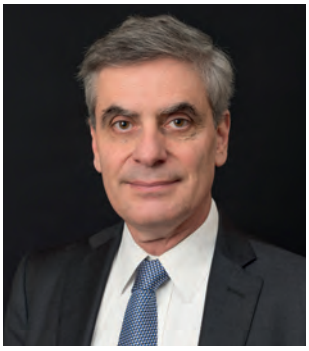
Covid-19: are challenges for the EU financial sector all new?





This Eurofi Magazine is published at a particularly challenging moment for the EU and its financial sector.

Many initiatives that have the potential to significantly change the EU economy are underway and still need achieving: the Banking Union, the CMU and the EMU, which all aim to strengthen and further integrate the EU and its financial system; the Green Deal and the sustainability agenda designed to respond to climate change and encourage greener investment.

Major changes are happening in the financial market in parallel, triggering business model and market structure transformations. Brexit will be a reality in 8 months' time potentially modifying the current dynamics in a number of EU wholesale markets. New technologies are developing, progressively changing many financial value chains and creating new opportunities and challenges for the financial sector.

The Covid-19 pandemic, unprecedented in its reach and impact in recent decades, may upset to a large extent this unfinished agenda, opening new questions, creating additional challenges or possibly a new agenda altogether, depending on the severity and length of the crisis. Why? Previously expected to grow by 3%, the global economy is anticipated to decline by 4 to 5% in 2020 if not more, due to the forced lock-downs. And figures look worse for the EU. Moreover a V-shaped scenario or even a narrow U seem increasingly unlikely, with much uncertainty about treatments, how and when businesses and travelling will go back to normal and whether a second wave of the pandemic is possible. A severe economic crisis seems therefore inevitable, despite the exceptional measures taken by the ECB and Member States, and is already materializing in several business sectors and impacting many EU citizens. The current market volatility is an illustration of this.

In terms of financial stability and capacity for the financial sector to support the economy, this crisis is happening in an environment that is quite different from 2008. Banks and insurance companies are strongly capitalized, much has been

done to increase transparency and reduce interconnectedness in the financial system, liquidity and leverage risks are better controlled in the EU non-banking sector… However, the Covid-19 and the 2008 financial crises have one main commonality: they are occurring in a financial context already weakened by lasting zero – and even negative – interest rates and an excessive level of indebtedness that the responses to the crisis may further deteriorate: indeed : (i) corporates and sovereigns that are already highly indebted and also investors are vulnerable to deteriorating economic and market conditions, eventually threatening the Euro and the unity of the EU if this situation is perpetuated; (ii) very low interest rates also undermine financial intermediaries and savers and foster bubbles.

This may create vulnerabilities for the financial sector that will need tackling (e.g. if corporate or consumer defaults increase significantly or if the contribution of banks and insurance companies to supporting the economy exceeds reasonable capacities…) and could potentially lead to a new financial crisis if the debt situation gets out of control or if there is an outburst of defaults.

As for the impacts of this crisis on the financial policy agenda, these are still difficult to measure and anticipate at this stage, but many questions will need assessing in the coming weeks and months: Will the Covid-19 crisis reduce the dynamics of sustainable finance because other priorities have emerged or on the contrary will green finance continue to be a major priority for kick-starting growth in the EU? Will CMU become secondary because bank financing is more readily accessible or on the contrary will capital markets be needed more than ever to develop equity and to fund innovation and growth? Will financial institutions be able to continue investing in their digital transformation in the coming months or is the lock-down making technology even more essential? Will global cooperation stall or will it thrive with all countries sharing a common goal to restore growth? Will Basel III final evolutions be eventually postponed sine die in the EU to facilitate bank financing, or will strict and harmonized prudential requirements remain the cornerstone of bank regulation? Etc…

Many of the articles of this Magazine address the new challenges created by the Covid-19 crisis. It is however still early days and many questions remain open at this stage, on which Eurofi will be working in the coming months with the public authorities and our member community.

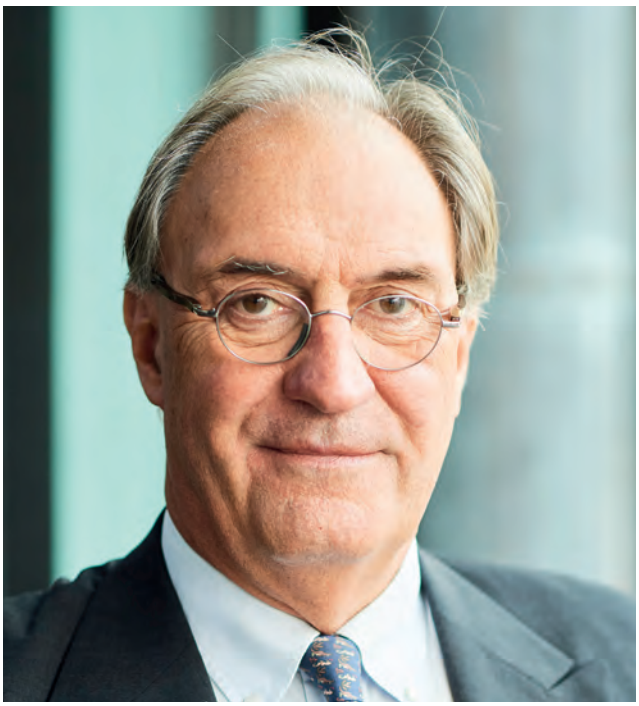
We warmly thank the 160+ contributors who have taken the time in these turbulent times to provide us with their views and thoughts and are sure that you will read their contributions on these challenging questions with great interest. ●

Didier Cahen, Marc Truchet and Jean-Marie Andrès, EUROFI

David Wright

President, EUROFI

A seminal moment for the European Union



It was really with great sadness and regret that we had to cancel EUROFI, Zagreb.

I would like to thank everyone for their understanding and cooperation in the very difficult situation we faced, especially the Croatian Presidency, our Members, high level speakers and participants. We hope that the video contributions from some of our distinguished speakers and contributions to this EUROFI magazine will provide some important policy sustenance for reflection until we meet again in September in Berlin under the auspices of the German Presidency.

We are facing events today unparalleled in our lifetimes. Unparalleled, economically, socially and financially, since the Great Depression over 90 years ago. Far worse than 2008. A shutdown of much of our economic activities, social separation and distancing, major uncertainties about how and when to begin to ease the major restrictions to restore a degree of normalcy - the customary former ways we lived and worked.

We are witnessing tens of thousands of premature deaths. We pay tribute to the extraordinary courage and devotion of the medical services and many other front line workers at risk every day. We shudder, we shiver at the economic forecasts, worsening by the day. This is a global crisis, a European crisis, a national, regional, city, rural crisis affecting everyone - with no one to blame. As Jacques de Larosière writes we are squarely all in the same boat.

And as President Macron and others have said these are seminal, defining moments for the European Union. Let us recall the Treaties which speak powerfully of "...an ever closer Union of peoples..." of a common desire .to deepen solidarity..." and "...to promote economic, social, territorial cohesion and solidarity among Member States...".

It is the moment to demonstrate that these admirable European principles, values and virtues matter. Practically. On the ground.

Now.

How? By sharing research; coordinating exit strategies; defining common travel and border policies; ensuring key medical equipment and testing is available to all medical services in the Union; avoiding beggar-my neighbour competitive distortions.

This is solidarity.

As is deploying sufficient financial firepower, European and National, to minimise the economic damage in the short to medium term. Firepower that includes massive fiscal support for the corporate sector whose markets have collapsed overnight. Employment support and subsidies. Supporting SMEs with grants and guaranteed credits.

Admirably the ECB has responded quickly, inter alia, with a huge increase in QE to maintain market liquidity and keep Eurozone sovereign spreads within reasonable ranges.

Eurozone Finance Ministers are proposing to open up the ESF, the Commission billions more in employment support to the Member States, including using the Community budget more expansively and the EIB to leverage its balance sheet to generate supportive SME credits.

Will these aggregated National and European measures be enough to steer to calmer waters? Financially? Politically?

Financially, the risks remain strongly on the downside the longer this massive, asymmetric, exogenous economy wide shock continues. The IMFs' latest World Economic Report is sober reading.

But politically, no this is not enough. The Treaty underlines the principle of solidarity. Indeed what are the EUs' cohesion and structural policies for if not to promote solidarity and support growth in the less developed regions of the EU? Likewise now some common, closely defined European financial instruments are needed firstly to ease the passage to recovery of all Member States. But second, and crucially, to demonstrate to European citizens in every corner of the Union that the EU means something tangible, real and solidaire.

Those in the Eurozone who are most strongly opposed to using some exceptional mutualised policy instruments, even in such dire and desperate circumstances, should reflect not just about their own history, but also consider that for certain strong Eurozone countries the reality is that the single currency provides a massive implicit currency export subsidy worth hundreds of billions of euros per year. Multiply this by the number of years the euro has been in existence (18) and the numbers move into the trillions.

The counterpart must be discipline, discipline, discipline and a renovated growth and stability pact with penalising sanctions for non-conformers, notably those Eurozone members unable to control their public spending.

Economic recovery from the virus in the EU will be slower than our international competitors and greatly hindered unless and until Capital Markets Union works in the near future.

To refinance an ailing and over- leveraged corporate sector with long term equity, reducing risk in the banking sector.

To facilitate long term EU investment.

To get the huge, ethical green investment agenda up and running.

To spread risk and help develop innovative SMEs in the EU, not overseas.

These laudable European objectives cannot be delivered without Capital Markets Union.

The Commission has set up a High Level Forum to define the game changing CMU measures needed, in detail. It should report in early June.

As one of the Chairs of this work under Thomas Wieser I can assure EUROFI members that we are working hard to deliver a bold, forward looking, granular package. But it will be up to the European Institutions to take this forward.

If I have one plea it is this - the European Council, the European Parliament and the Commission must agree ex-ante, en amont, on the CMU package, on the timetable for delivery and on rigorous monitoring to succeed. Otherwise it will be death, downstream, en aval, by a thousand bureaucratic cuts.

Conceptually I always return to Jacques Delors famous two questions:
1. Quels sont nos intérêts communs?
2. Quel est le niveau de notre ambition?

This is a seminal moment in the history of the European Union.

We must move decisively forward to recover together.

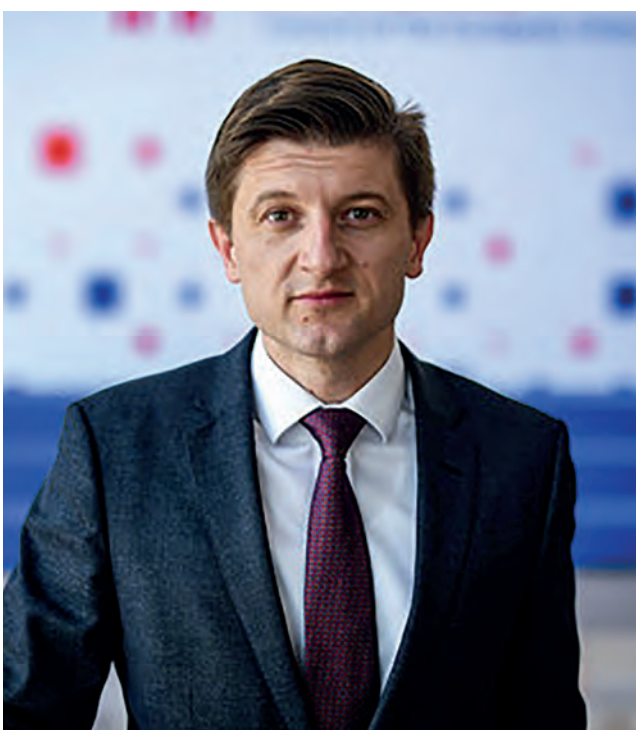
Now. ●

Q&A

Zdravko Marić

Deputy Prime Minister and Minister of Finance of the Republic of Croatia

Priorities of the Croatian Presidency in the context of Covid-19



What are the priorities of the Croatian Presidency in the economic and financial area to face up to the health and economic crises?

Croatia started its first Presidency of the Council of the European Union (EU) from 1st of January 2020 at a particularly eventful period for the EU as a whole, bearing both numerous challenges and opportunities. I will mention only few; the beginning of the new institutional cycle, negotiations with the UK after Brexit, negotiations and agreement on the Multiannual Financial Framework 2021-2027 (including on the sectoral legislation).

Our Presidency program is built upon the Strategic Agenda priorities, focusing in particular on the proposals and initiatives contributing to uniform and sustainable economic growth, raising convergence, strengthening competitiveness of the Union (including deepening of the Economic and Monetary Union) and responding to demographic challenges.

However, we and the EU as a whole have found ourselves facing unexpected and global threat. The COVID-19 pandemic represents unprecedented challenge with severe socio-economic consequences. New circumstances have changed our way of life and require prompt and adequate response. I could witness that the whole EU is determined to respond to this crisis in the spirit of solidarity. We, as the Presidency of the Council of the European Union have already taken certain steps to ensure coordinated actions at the level of both the EU and Member States.

Furthermore, the Eurogroup in inclusive format has recently reached an agreement on the Economy Package in an amount close to half a trillion Euros. This Package of financial assistance includes several crisis response instruments which implementation should ensure the ground for the recovery of the EU economy.

In the field of financial services, it is expected that banks and other financial institutions have a key role to play in dealing with the effects of the COVID-19 outbreak by maintaining the flow of credit to the economy. If the flow of bank credit is severely constrained, economic activity will decelerate even more sharply, as undertakings struggle to pay their suppliers and employees.

Against this background, the European Union and Member States are taking various, exceptional measures to incentivize banks to continue to play their role. These measures include, for instance, government-backed loan guarantees or payment deferrals. Similar or other measures, which do not entail the involvement of the public sector, are being taken or are being contemplated. Their common objective is to ensure that loan payment modification or forbearance (restructuring, refinancing or simply deferral of payments) is an effective tool available to banks to deal with financing households and corporates experiencing temporary difficulties.

To ensure that banks can play their part in supporting the economy through the COVID-19 period, policy makers and regulators want to bring as much certainty to the matter as possible.

It is crucial that banks continue financing households and corporates, including small and medium enterprises (SMEs) experiencing temporary difficulties amid the COVID-19 pandemic. To this end, making full use of the flexibility provided in the prudential and accounting framework is essential at a time when sufficient financing to cover financial pressures is vital for the economy.

In light of the current situation, the EIOPA announced and published recently a statement on dividends distribution and variable remuneration policies in the context of COVID-19. The insurance companies are expected to follow up on EIOPA's statements to take timely and comprehensive measures to preserve their capital position, including the temporary suspension of all discretionary distributions, and to continue to act in the best interests of consumers.

The Croatian Presidency will continue to closely monitor the evolution of the situation and to coordinate between European and national measures. Where necessary, we stand ready to take further actions, including legislative measures, if appropriate, to mitigate the impact of COVID-19.

What are the initiatives required to restore confidence in the European Union, whose heterogeneous performance worries the markets (possible use of EMS, corona bonds etc...)?

After extremely long and exhaustive meeting of the Eurogroup in inclusive format one has to admit that we have done it. We reached an agreement even if it took us more than sixteen hours, and even if some divisions among Member States came to the surface again.

I am proud that we have overcome our differences and showed European solidarity and unity in these difficult times.

We have already seen a rapid, massive, co-ordinated impulse from the monetary and fiscal authorities and from the regulators. Nearly 3% of GDP of fiscal measures, enhanced flexibility, and additional liquidity schemes of 16% of GDP. That was our first line of defence emerging at the national level.

And now, on top of that, we agreed on Comprehensive economic policy response at EU level which focuses on three safety nets – one for workers, one for businesses and another one for countries.

Regarding the workers, we welcomed the creation of a temporary European instrument to support national safety nets in this crisis – so called SURE proposal. This will put together our collective financial strength at the national and European levels, to channel up to €100 bn to the national systems facing the greatest pressures. Additional layer of EU protection for jobs is needed as we currently rely solely on the safety nets that are in place at member states level. These take many forms – schemes to support short-time work, unemployment benefits and many other schemes. This will now be taken forward and fine-tuned in the legislative process.

The second safety net is for businesses facing difficulties, in particular SMEs. In that respect support has been shown for the initiative of the EIB to create a pan-European instrument which aims to guarantee €200 bn of lending with a focus on SMEs.

Finally, the safety net for member states will take the form of Pandemic Crisis Support building on the existing ECCL credit line of the ESM amounting close to €240bn. This is an important safeguard for all euro area countries during these times of crisis. It will be available to all ESM members, with standardised terms, on the basis of an up-front assessment by the European institutions.

Any euro area country requesting this support remains subject to the EU's economic and fiscal co-ordination and surveillance frameworks. The only requirement to access the credit line will be that the country would commit to using these funds to support domestic financing of direct and indirect healthcare, cure and prevention related costs due to the COVID 19.

I fully agree with all measures mentioned above, but one thing is important to emphasize. Crisis caused by COVID-19 pandemic does not recognize Schengen borders or euro area borders. It is a crisis affecting all member states. All 27 of us. Having that in mind, it is important to think about member states outside the euro area which do not have the ESM at their disposal. For these member states, the safety net for crisis times is quite limited. We are all part of the single market and significant negative spill overs can still happen between euro area and non-euro area member states. In that context, I am satisfied that the Balance of Payments Facility, an instrument for non-euro area member states, is part of the Report of the Eurogroup in inclusive format. As it is rightly stated in the Report, this instrument should be applied in a way which duly takes into account the special circumstances of the current crisis.

It is important to think about the period when the crisis ends and plan accordingly, as we need to be prepared to go back to normal. That is why it is of great importance that Eurogroup in inclusive format has already discussed this issue and agreed to work on a Recovery Fund, which would represent strong impulse to investments that we will need to build a better, greener, more resilient and more digital economy.

Finally, I want to emphasize that the Croatian Presidency has so far ensured that all the legislative proposals at the Council level are adopted and will further work to ensure smooth dynamic and reaching of agreements at the Council level. ▶

▶ The COVID-19 pandemic poses a big challenge for the European economy. We will act together in solidarity and we will deliver solutions consisting of necessary progress in strengthening the European Union.

What are your views regarding evolutions of the EU economic governance: when should the Stability and Growth Pact be restored? Does it need renovating? What measures would finally make it effective?

Member states' fiscal outcomes ultimately emanate from domestic political choices across policy domains and from exposures to exogenous shocks. The financial and the sovereign debt crisis, pointed to the need for a closer coordination of national fiscal policies to address the risk of spill-overs within the Economic and Monetary Union. This resulted in a strengthened Stability and Growth Pact, a review process of euro area countries' draft budgetary plans, and the golden "balanced budget" rule of the intergovernmental Fiscal Compact.

This has led to further improvements in fiscal results in Member States and in strengthening of their national fiscal frameworks.

Nominal deficits were significantly reduced, which confirms the success of the deficit criteria. On debt criterion, although there has been a trend of decreasing public debt to GDP ratio in recent years it has remained close to historically high levels in many Member States. Part of the explanation lies in the pro-cyclical nature of debt developments and the low economic growth and inflation in some Member States.

More demanding part of the Stability and Growth Pact relates to the preventive mechanism. In this area, we can see that Member States have made progress towards meeting their medium-term budgetary targets (MTOs) after 2011, but in recent years fiscal efforts have gradually diminished while large fiscal positions remain. On the expenditure rule, in most Member States the increase in primary expenditure was less than or equal to the growth of potential GDP in the post-2011 period, suggesting an increasing control over expenditure growth.

However, at the same time, there has been an increase in the complexity of the fiscal framework itself, which today constitutes an extensive system of rules and procedural steps.

Although the overall developments in fiscal outcomes are positive, questions are increasingly raised about the need to further improve the fiscal framework. Some of the objections are related to weak implementation of fiscal rules, pursuing of pro-cyclical policies, use of unobservable variables (output gap and fiscal elasticities) that are prone to ex-post revisions affecting the current assessment of compliance with the rules, etc.

In our discussion at EU level we always emphasize that simplicity, flexibility and predictability are desirable features of a well-designed fiscal framework. However, a trade-off between these characteristics is necessary. Predictable and flexible rules cannot be simple. Simple and predictable rules, on the other hand, cannot be adapted to changing economic conditions. Finally, simple and flexible rules are not predictable.

In the context of the EU economic governance review (Six-Pack, Two-Pack Review) and related public consultation, initiated by the European Commission in February 2020, a reflection has started on whether improvements to the common fiscal rules are necessary based on both a backward- and forward-looking assessment.

However, since the review was launched, the world has changed considerably in the wake of the coronavirus pandemic. The focus of fiscal policy is now squarely on facilitating the resolution of the acute health crisis and mitigating the socio-economic fallout of COVID-19, which has triggered the worst economic downturn since the Great Depression.

Nevertheless, Stability and Growth Pact was one of the most important topics at the EU finance ministers' meetings.

On 23rd March, EU finance ministers agreed with the assessment of the Commission, that the conditions for the use of the general escape clause of the EU fiscal framework – a severe economic downturn in the euro area or the Union as a whole – are fulfilled.

The use of the clause will ensure the needed flexibility to take all necessary measures for supporting health and civil protection systems and to protect EU economies, including through further discretionary stimulus and coordinated action.

Furthermore, the general escape clause will allow the Commission and the Council to undertake the necessary policy coordination measures within the framework of the Stability and Growth Pact, while departing from the budgetary requirements that would normally apply, in order to tackle the economic consequences of the pandemic.

This has proved that SGP has built in flexibility for the crisis times. However, question on how fiscal rules can prevent pro-cyclical fiscal policies and ensure that fiscal buffers are created during good economic times still remains?

Large-scale national fiscal stimulus coordinated at EU level was undoubtedly the right response to avoid permanent damage to the economy's growth potential and ultimately, to debt sustainability. Nevertheless, it is clear that the public deficit and debt levels relative to GDP will be increasing significantly. These will have to be put on a downward path, which in particular for public debt proved difficult in some countries already before the crisis. At the same time, national fiscal policies should provide adequate support for rebuilding the economy. This is also related to the issue of the appropriate aggregate fiscal stance to increase the effectiveness of monetary stimulus. In addition, fiscal policy will have to cater for new priorities such as environmental sustainability and the digital transition.

Looking ahead, it will be important to achieve a common understanding on how to ensure that the EU's fiscal framework remains fit for purpose and is able to reconcile these different objectives. Striking the right balance will require careful consideration, but should be feasible. If the fiscal rules were for instance to further promote public future-oriented investment, preferably in areas consistent with EU priorities such as environmental sustainability or the digital transition, this would not only be conducive to the economic recovery, but also constitute an opportunity for increasing the economy's growth potential and competitiveness. This would in turn benefit the long-term sustainability of public debt.

Possible trade-offs could also be eased by having a fiscal framework that encourages a more growth-friendly composition of national budgets. This could be achieved through a better prioritisation and targeting of national public expenditure as well as through less distortionary taxation. This in turn underscores the importance of pursuing fiscal and structural reforms.

By mentioning structural reforms, one has to reflect on the MIP procedure, an indispensable part of EU economic governance which helps to identify and correct macroeconomic imbalances. We are all aware that the level of implementation of the structural reforms is still unsatisfactory and progress is needed in this respect. One possible solution to improve the correction of macroeconomic imbalances is to reach an agreement on the Reform and Investment Support Program (better known as the BICC and CRI), as it would provide incentives for Member States (in terms of financial resources) to implement structural reforms. We strongly support reaching an agreement on this file, and we hope it will be done during our Presidency.

What should be the regulatory priorities of the Commission to effectively progress towards more cross-border private risk sharing through the Banking Union?

For the EU as a whole new legislative framework introducing specialized insolvency regime for banks and possibly other financial institutions where best practices from most advanced Member States in terms of legal and operational aspects of dealing with insolvency of financial institutions should become mandatory for all Member States. The priority is to make insolvency proceeding more effective, simpler and faster than the current practices in many Member States, even though banks are complex institutions with long maturity of assets. We believe that co-legislators must come to the solution of removing institutions from the market in a reasonable timeframe, in a rather simpler and cheaper way for all included players – meaning for taxpayers, resolution authorities and the creditors and debtors themselves.

All types of creditors should benefit from more efficient system focused not on procedural and legal aspects of insolvency proceedings but on market-based solutions. It is important to have specialized mechanism for insolvency of financial institutions (not just banks) with strict and clear timeline for actions with sole purpose of reducing value destruction to the minimum and with very modest cost of entire proceedings (role model could be FDIC and/or Dutch and UK experience). Efficient, swift and value-preserving removal of market participants is essential in prevention of moral hazard and is a cornerstone of any initiative to enhance cross-border private risk sharing in the Banking Union.

Budgetary cost in case of failing banks in any participating Member State should in medium term be zero with positive impact both on financial stability and international role of the euro in sense that it would reduce the probability of financial crisis and facilitate recovery from such crisis if it occurs.

More efficient market should by definition create more competitiveness, reaping all the benefits of the Banking Union as a true single jurisdiction which will eventually lead to level playing field, reducing the need of litigation and naturally facilitating resolution of disputes.

The development of capital markets is important for the financing of the CEE region: what are the key priorities and are they appropriately addressed by on-going initiatives at the EU or regional level?

In terms of economic and financial developments, CEE countries lag behind other EU countries. Fostering development of capital markets, as an important part of financial system, should be high on the list of priorities for the CEE countries. The reason is that capital markets are equally essential for countries' economic growth as conventional banking financing and only if combined, they represent well diversified pool of financing opportunities.

While capital markets in developed member states have been continuously broadening financing options and savings opportunities for retail investors, the development of capital markets in CEE keeps lagging behind its more developed peers and banking sector still dominates as a source of finance or saving channel (e.g. deposits).

During first phase of implementation of capital markets union various impediments for the development of CEE capital markets such as structural, regulatory, supervisory and cultural were identified. Although number of measures to address and resolve these were already introduced, during the following period focus of EU policy makers should be on how to best tailor next set of measures that would benefit countries with less developed capital markets. At the same time, CEE member states, understanding the specificities of their markets, should commit to implementing such measures in a way that would deliver best effects.

One of the key priorities is to introduce capital markets to SMEs and retail investors. One of the measures to introduce educational activities to improve their financial literacy. In addition, we have to (re)build investors' trust in capital markets and encourage them in reorienting part of their savings from bank deposits to financial instruments on capital markets. In order to achieve it, we have to ensure that investor protection measures deriving from sound and prudent legal and regulatory environment are properly implemented. At the same time, we have to bear in mind that protection of investor implies providing transparent, quality information that are presented in understandable and simple way.

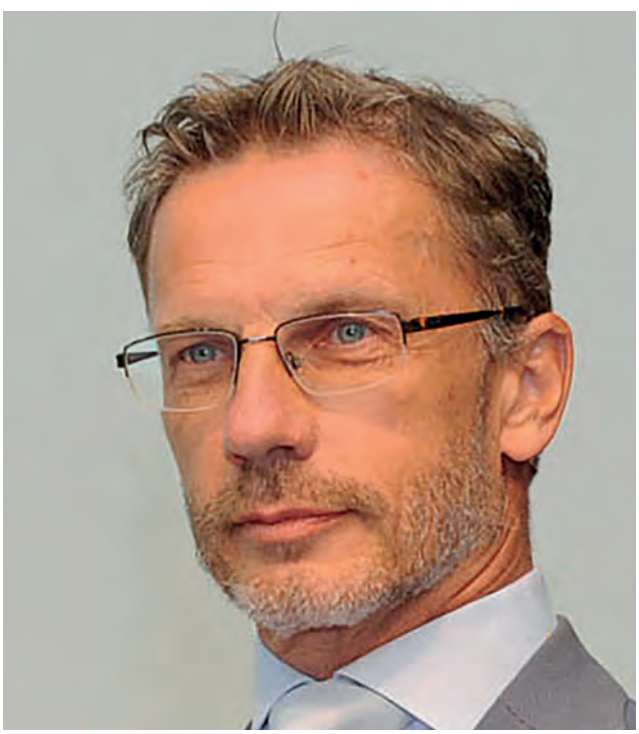
To conclude, I think that the obstacles the CEE countries are facing are well identified through the EU policy initiatives, however when creating specific measures to address them we have to make sure that no one gets left behind, or that they benefits only the parts of the EU with an already liquid and developed capital markets. "One size fits all" approach should be avoided whenever possible and those that propose and draft legislation have a responsibility to ensure that the legislation is fit for purpose, scalable, robust and proportionate. ●

Q&A

Boris Vujčić

Governor,
Croatian National Bank

How to make policy from home – challenges for economic policy-making of the "Great Lockdown"



Even before economic activity started to plummet in the face of the pandemic, and before stringent lockdown regimes were established throughout Europe and much of the world, the turmoil in the financial markets had prompted governments and central banks to act decisively. Economic policymakers have reacted as swiftly as health officials, and maybe even more rapidly as the greatest peacetime policy packages have been announced. Policy reactions have preceded information on the magnitude of the COVID19 related fallout from the statistical offices by weeks, if not by months. World's largest central banks have announced measures that will cumulatively exceed their responses during the global financial crisis within a much shorter time span. Ministries of finance raced ahead with tax reliefs, employment subsidies and loan guarantees. The big bazookas of the global financial crisis no longer seem so big.

In the face of the peril, few thoughts were given to the potential alternatives or the long-term consequences of the adopted policies. Their goal is not even to bring the economy back to normality, whatever normality may resemble these days, but rather to ensure a mere survival of the commercial fabric of our societies throughout the health crisis. Monetary policy cannot reopen stores that are closed due to the lockdown, or production plants lacking intermediate goods as their just-in-time inventory management systems collapsed with the breakup of the production chains. Neither can large fiscal transfers induce people to get out of their homes during the pandemic and spend beyond necessities – even if commercial facilities were to open. Policymakers have set their targets at preserving as many jobs and commercial entities as possible in order to enable a swift recovery once the pandemic is resolved.

At the moment, the side-effects of the adopted extreme policies seem to be few. However, we are still at an early phase of the crisis

and formulating policies might soon prove to be an act of balancing on a knife-edge. The major potential risk of exceptional stimulus is the perennial worry of a runaway inflation. Most analysts believe that depressed demand is likely to keep inflation at bay, regardless of the supply bottlenecks. Also, inflation expectations are to remain well anchored, even below the desirable level. Still, a few observers continue to believe that inflation is the most underpriced risk of all, as only a minority of active traders have a first-hand memory of runaway inflation. And this is all aside of the inflation measurement issue, which might be somewhat of a challenge at a time when households abstain from possibly a half of their consumption baskets – from airplane tickets and tourist accommodation to eating out and having a haircut.

While rising inflation could, somewhat paradoxically, be seen as a sign of success, more observers are worried about the excessive policy accommodation backfiring without providing much of a boost. Even as the specter of "Japanification" started to haunt Europe in late 2019, no one thought of the central bank balance sheet in excess of 100 per cent and public debt in excess of 200 per cent of GDP as even a remote possibility in Europe. The negative real and, in Europe, even nominal interest rates became a norm over the past decade, sparking research on the reversal rates where the costs of further monetary accommodation start to outweigh the benefits. Simultaneously, fiscal authorities have only partly used exceptionally low borrowing costs to rebuild fiscal buffers. Using monetary policy to maintain favorable financing conditions for the government could buy some time, but it will eventually render both the monetary and fiscal policies impotent. Leverage is not only high in the public sector, but many companies have also used cheap financing to return money to their shareholders, reducing the time period they could survive without a state aid. Thus, the most recent policy reactions come on top of a hangover from the global financial crisis that has weakened the ability of both the public and the private sector to cope with the shock.

Even if we manage to get macro policies right, by preventing economic activity from going into a tailspin and inflation expectations from de-anchoring, it will only be the easier part of the policy-making process. Once the crisis is, hopefully, behind us, the economic landscape may change to such an extent that maintaining the current, lackluster growth rates could prove challenging. Simultaneously with public and private debts testing the limits of sustainability and monetary policy approaching the frontier where net gains from further accommodation are no longer so clearly visible, policymakers might have to grapple with the reversal in globalization, the increased state presence in the economy and the "zombification" of much of the highly leveraged corporate sector. During the decades of a rapid trade growth, globalization provided a boon to productivity, while keeping inflation in check. As globalization languished since the global financial crisis, "the great lockdown" is likely to push it into reverse, with all the windfalls slowly leaking away. Wholesale bailouts planned to facilitate corporate recovery from the crisis could easily reduce corporate dynamism. The rise of the government presence in the corporate sector, either as a big lender, debt guarantor or outright owner, is going to make corporate governance more complicated as states may have different goals than the owners. Also, restrictions on dividends and the need to bring the state on board for major corporates could slow down the flow of capital between the different sectors of the economy. All these challenges are intertwined, might be feeding on each other and producing negative feedback loops. Taken together, they may prove to be of a different order of magnitude compared to structural reforms of the yesterday. Coping with them will require enhanced global cooperation and extreme caution on behalf of the policy makers.

Finally, spillovers and the contagion from the worst-hit countries are one free-wheeling element that could throw a spanner into the mechanisms of the already discordant economy. The emerging markets' weathering the global financial crisis relatively unscathed was a peculiar feature. This time round, the health crisis is more likely to morph into the traditional pattern of the financial crisis as indicated by the number of emerging economies seeking shelter under the IMF umbrella. Many of the emerging markets have little scope to stimulate their economies, with huge capital outflows putting pressure on exchange rates and financing conditions in general. The possible downgrades of their credit ratings might add to pro-cyclicality. Global governance needs to be enhanced, more resources mobilized, while procedures for debt restructuring should be streamlined. After all, the global financial crisis has taught us that severe financial instability is not reserved for emerging markets only. This time round, problems experienced by the emerging markets could be the "canary in the mine".

"The great lockdown" will test policy frameworks in different areas as policies move further into the uncharted territory. During the period of elevated uncertainty, financial policies will also have to deviate somewhat from the practices of the prompt recognition of all risks and the quick resolution of underlying exposures as banks look for ways to support the economy. Recent discussion about the consistent application of the IFRS9 and the IRB in the downturn reminds of the not so recent discussions. As we did not know that before. Forbearance could thus make a come-back, but we need to weigh it carefully and restrict such practices as soon as uncertainty subsides. The "great lockdown" possibly coupled with lack of policy space will eventually have to be reflected in the balance sheets of the financial sector and will have to be resolved by it. ●

I. VIEWS ON THE COVID-19 CRISIS IMPACTS

Issues at stake

We are experiencing with the Covid-19 pandemic an unprecedented crisis, pushing the global economy into the worst recession since the Great Depression. Central Banks and governments have taken a wide range of measures to sustain the supply of credit to the real economy, support financial intermediation, and preserve the resilience of the global financial system. But this exogenous shock is placing the financial system under considerable strain.

The Covid-19 outbreak is however more a powerful amplification factor of a latent debt crisis rather than a cause in itself of the current situation. Indeed, lasting zero – and even negative – interest rates have allowed businesses, States and leveraged investors to take on unreasonable debts, making them vulnerable to deteriorating economic and market conditions. The resulting excess liquidity in the financial system has generated bubbles of financial assets and their bursting, thus further weakening the financial system and hampering economic recovery.

Strong policy responses and international cooperation are required to tackle the unprecedented health, monetary, economic, and financial stability challenges posed by the Covid-19 pandemic. Fiscal discipline and solidarity will be needed in the euro zone, where the heterogeneity of deficits and public debt, and therefore of tax margins, is particularly marked.

Content

Views on the responses to the Covid-19 crisis

Interview of Jacques de Larosière conducted by Didier Cahen on 14 April 2020

How different is this sanitary crisis from the previous financial and sovereign debt crises of the years 2000?

The present crisis is far worse than the one of 2007 – 2008 because, this time, it threatens the lives of citizens worldwide. Covid-19 has disrupted our social and economic order at lightning speed and on a scale unseen in living memory, and the lockdown needed to contain it has affected billions of people. The common trait between the two crises is the unpreparedness of governments:

In 2007-2008, they underestimated the lack of sufficient equity in the banking sector and the vulnerability on the financial system in the face of huge asset bubbles

This time we are, except for a few countries, unprepared to cope with this massive pandemia because of:

- insufficient preventive and diagnosis devices, which are crucial to limit the confinement measures to people that are affected by the virus,

- insufficient availability of masks and the absence of an effective vaccine, or other medical treatments and

- the very limited capacity in terms of life saving respiratory units.

So, the difference is this: in 2008, the authorities swamped financial markets with liquidity in order to avoid total collapse of the banks and financial markets. This time, governments are closing very significant parts of economic activity because heath services are not able to distinguish healthy and non-healthy individuals and therefore have to lock-in most sectors of the economy in order to avoid any contacts between people.

This method is very inefficient compared to the practice of a few countries that have established systematic testing of all individuals and have kept most their economies functioning. This time it is the public authorities that have decided, given their unpreparedness, to create the conditions for a major depression unseen for 90 years.

How to assess the economic impacts of coronavirus?

The consequence of this global crisis and the lock down measures taken will be huge. Their magnitude will depend on how long it will take to overcome the health problems.

As a very approximative yardstick, if you assume that advanced economies are mandatorily closed at a level of 50%, that means that two months of confinement entails a loss of 8% of GDP. 4 months would amount to 16% of GDP.... Some countries will be far worse hit than others.

The collapse of economic output in the second quarter of this year will be the biggest in modern peacetime history. The impact of gradual exit from confinement is yet no forecastable. But the social and economic consequences of the pandemic are extremely serious and will be with us for many years to come.

The coronavirus crisis is developing at a time when the financial system appears weakened. Does monetary policy have a responsibility in this regard?

The minefield of the world economic and financial system is in a far worse state than we have been prepared to admit.

As a result of monetary policies that have been accommodating for too long, the debt ratio of states and corporates compared to GDP has surpassed all peacetime records. We witness that the growth in overall debt has been 50% since the last 2008 crisis. The asset bubble that was favoured by cheap debt - including the so-called risk-free government bond bubble - is now abating.

However, the rot has set in. Risk premiums had virtually disappeared in this environment of low or negative interest rates and we have lived with an illusion that assumed this situation would be timeless. As long as some growth was maintained, mediocre - or even downright bad - signatures of all forms and supposedly adequate ratings were considered by investors to be of sufficient quality and the search for a little yield pushed them to take unwise risks which are concurrently, undervalued by financial markets.

In this context, the risk of a serious crisis was dangerously close even before the virus struck; the slightest sign of economic slowdown was enough to instil fear in the markets that the "good times» were over and the storm was beginning. In fact, the first defaults were already appearing among the most vulnerable borrowers (e.g. issuers of high-yield securities and BBB-rated companies, which account for more than half of investment grade corporate debt - companies whose financial cost/income ratio has deteriorated considerably).

You have been warning of the dangers of monetary policies that have been accommodative for too long. Can you remind us of those dangers?

The impact of excessively accommodative monetary policy - with interest rates at zero or even negative for a long time - on the stability of the financial system is unfortunately too well documented: incentives to borrow more; weakening of the banking system; deterioration of the accounts of pension institutions whose liabilities remain subject to contractual obligations but whose fixed-income assets no longer yield anything; proliferation of zombie companies in an environment where interest rates no longer play their discriminating "quality signal" role that should be theirs; strong disincentive for governments not to undertake structural reforms since borrowing "no longer costs anything»;

Let us not underestimate the importance of this loss of benchmarks - zero interest rates blur risk premiums (one of the characteristics of the 2008 crisis).

What are the potential economic and financial stability consequences of the massive purchases of securities decided by the ECB and the Fed? Are the risks similar in the Eurozone and US?

The huge increase in public expenditures to maintain economies during this pandemic crisis will create a massive increase in public debts. This will inevitably raise questions on the sustainability of public debt levels of those countries whose figures are already very high.

The solution to the problem would normally be to raise more taxes and reduce less essential public expenditure. But given the monumental amounts in question, there may well be a temptation to expect central banks to hold them on their balance sheets thereby monetising public debt by monetary policies.

This is a new source of vulnerability and instability of the financial system.

Business survival justifies central banks' role as lender of last resort during the crisis. Central banks must do everything to support the needs of the people. But doing so should not be in conflict with the core purposes of monetary and financial stability. Increasingly using monetary financing will damage credibility and the role of money as well as weakening future control of inflation.

So the future looks very dark.

Both the US and Europe are pursuing the same policies. But the US has an advantage: they issue the international currency. It is less immediately exposed than other countries who do not benefit from this privilege. But, of course, in the very long run, even that US advantage will tend to dissipate, and the question of the fiscal sustainability of debt will arise even for the dollar.

Can this ocean of public debt on the balance sheets of central banks be reduced over time or are we entering an era of perpetual public debt, with maybe even further demands for State protection?

The answer will depend on the outcome of economic behaviour. If central banks and governments continue to forecast a very long period of low growth and zero or even negative interest rates, I do not see how central banks could start selling their accumulated bonds on the markets. The probability of even an increase for a very long time on central banks' balance sheets looks pretty high.

Consequently, a situation of persistently low interest rate will be very disturbing: in such a monetary environment, the market is no more in a position to discriminate among different types of assets due to the asset purchase of the central bank. Indeed, the universal buying of sovereign securities eliminates the normal functioning of market forces between savings and investment and brings interest rates to levels close to zero which, as we have already seen, encourages the holding of liquidity to the detriment of productive investment.

How can free markets assess value in these conditions? How do productive economic projects distinguish themselves from sheer financial profit opportunities in the search for investment capital?

Ultimately, by taking things to extreme, central banks would eventually hold most of the debt and even shares. But, by dint of being taxed, household savings could decline and central banks could become the main actors in the savings/investment equation.

Continuing such monetary policies is a cause of great concern for the future of our economies and our societies.

Are you concerned that this ocean of debt on the balance sheets of central banks will be a brake on the recovery of investment at the end of the economic depression we are experiencing?

Absolutely. The increase in public debt and unlimited money creation are a dangerous spiral for our economies. They will not only act ▶

as a brake on the recovery of investment but can also undermine the confidence of economic agents in the currency and the value of money.

The core problem of loose monetary policies is that it drives a preference for liquidity. Since investment by purchasing securities is taxed, investors tend to forgo illusory remuneration and retain liquid instruments which, at least, are not affected by the application of negative rates. But such a preference for liquidity (Keynes' "haunting») diverts savers away from long-term investment. They would be taxed if they invested long-term.

In the traditional investor trade-off between return, risk and liquidity, the notion of return loses its importance with low interest rates. The arbitrage is only between liquidity and risk.

Moreover, with lasting and huge asset purchase programmes, central banks are anchoring in the minds of the markets the idea that interest rates will remain low for an indefinite period. The expectation of low rates for a very long period has a "depressing» effect: economic agents conclude that the growth horizon will be low for a long time and therefore will refrain from making long term investments.

The accumulation of very high public debt, negative interest rates and massive repurchases of public and private securities against the backdrop of an accelerating ageing population has been experienced for many years by Japan (47% of outstanding public debt is held by the BOJ), which shows that it is inseparable from a sharp fall in potential growth.

What do you think of the European agreement of 7 April?

I think this is an excellent and fair agreement that provides for concrete actions. More than half a trillion Euros are now available to shield European Union countries, workers and businesses.

The European Stability Mechanism, the safety net for countries, will provide pandemic crisis support, in the form of precautionary credit lines not subject to macroeconomic policy conditionality. A member state that draws under these Enhanced Conditions Credit Line (ECCL) will commit to using the money only to cover corona-related costs. Each member state could benefit from this support up to the benchmark amount of 2 percent of GDP.

Second, a temporary solidarity instrument (SURE) will be established to support member states to protect workers and jobs in the current crisis. Loans will be provided to member states up to €100bn, building on the EU budget as much as possible and on guarantees from the member states

And thirdly, the European Investment Bank will implement its proposal to create a pan-European guarantee fund of €25bn to support €200bn of EU businesses, in particular SME's, throughout this crisis.

It has also been agreed to explore the setting up of a temporary Recovery Fund to facilitate a robust European economic recovery in all Member States. There was broad agreement to disagree on the financing of the fund, with mutualized debt issuance being favored by some and strongly opposed by others.

All this is still pending the agreement of the European Council.

Could the monetisation of public spending by central banks, if not accompanied by control of public spending by Member States, lead to a break-up of the euro zone?

What threatens the break-up of the zone is the disparity of the economic policies of the Member States and their lack of coordination. This heterogeneity is bound to increase with the further increases in public spending in this crisis.

If Member States whose public debts are already excessive do not make a more serious effort to reduce public expenditure not justified by imperative and urgent needs, the problem of the Eurozone' centrifugal forces will only worsen. We can see how much the policy, particularly in Germany, of reducing the public debt-to-GDP ratio to the level prescribed by the Maastricht rules, has paid off. Starting with 60% of public debt, compared to more than 100% in other countries, Germany has been able to embark on a massive programme of aid to the economy while its neighbours do not have the same margin for manoeuvre.

Moreover, the EU countries that have best managed the 2008 crash and the coronavirus epidemic are not those that have accumulated public expenditure and debt - like France, which is enduring a major shortage of gel, masks, screening tests and fans - but those like Germany - that have a modern state, healthy public finances, a powerful and reactive industry, a sustained research effort and strong social cohesion.

Furthermore, those countries that have controlled best their public finances are also those where research and reactivity have been better in terms of responding to the virus crisis.

How can public debt of the most indebted European states be reduced after the crisis? Is it possible to achieve primary budget surpluses?

Primary fiscal surpluses can be achieved to the extent that the debt-servicing burden would continue to be zero. Still, an effort must be made to reduce the least indispensable public expenditure.

Germany has reduced its public debt in relation to GDP from 80% in 2008 to 60% in 2019 (while Italy's has jumped from 126% to 136% and France's from 90% to 99% over the same period).

Countries that are still in primary deficit must take advantage of low interest rates to achieve a primary surplus to public debt over time.

What should be the characteristics of a renewed and effective Stability and Growth Pact once the crisis is over? Should new rules be added?

The first recommendation would be to apply the rules of the Stability and Growth Pact as they exist and as they were modified with more structural objectives after the 2008 crisis. We can always envisage improvements but the reality is unfortunately very simple: when the percentage of GDP devoted to public expenditure is too high, it must be reduced and brought closer to the average for the euro zone if we want to achieve a degree of homogeneity in budgetary performance, which is essential for the proper functioning of any monetary union.

It is all the more important to strengthen the common discipline that the system has put on the backburner during the crisis. Those rules are the cement that keeps together the Eurozone.

On the institutional front, since national budgets are vetted at the Union level, at one point, it would make sense to move toward a politically binding decision-making process with more substantial federal budget and tougher sanctions for non-compliance.

How can we encourage a return to healthy growth in a zero-rate environment, in economies that are often over-indebted, with populations, most of them ageing, asking for more protection from the State?

The first priority is to re-establish financial markets that function on the basis of market forces and not according to the prescription of zero-interest rates. The latter method, which has been practised unsuccessfully for the past decade or so, only encourages savers to hold liquid instruments such as bank accounts and to turn away from long-term securities with negative returns. This liquidity trap, feared by Keynes, largely explains the reduction in productive investment observed in recent years.

The national budget can also be used to promote infrastructure programmes, but to do so, it is necessary to have the means to do so, i. e. to reduce non-productive current public expenditure.

We must stop this psychodrama of so-called austerity, which is said to have weakened certain States of the Union. In fact, it is the fiscally virtuous countries that have best prepared their economies for the challenges of the crisis.

In countries with too much debt, decisions must now be made to stop "walking on their heads»; and to reduce unproductive and inefficient public spending. This is the only way to release the necessary resources to the productive sector. Such a fiscal policy requires a spirit of cooperation among the different political parties and on a bi-partisan basis, examples abound in the Northern European Member States.

Is this Europe's 'Hamiltonian moment'? What is your feeling about 'corona bonds' and /or a separate fund for dealing with the pandemic as suggested by the French government?

Alexander Hamilton understood that a nascent federal state needed a federal budget. Given the heterogeneity of economic performance among the 13 States of the Union, it is understandable that he had great difficulty in imposing this idea. But his vision was that of a federal state in the long term and not that of a group of individual states only weakly bound together only by legal concepts and human rights.

Is it possible to envisage that this American-style late 18th century vision could be born today in Europe?

One possible, Hamiltonian-inspired progress that is not revolutionary, would be to strengthen the Community budget. But the vision of the mutualisation of past or future national debts is of a different nature and is difficult to establish in a political system not united in fiscal terms.

Indeed without a fiscal Federation, it is very difficult to ask the best performers to guarantee the debt of the weakest members because this would be equivalent to a discretionary transfer of resources from some countries to others without the guarantors being able to influence politically the policies of separate states. This is fundamentally different from a fiscal authority. Moreover, Hamilton laid down the principle that the Federation was not responsible for the failure of the States.

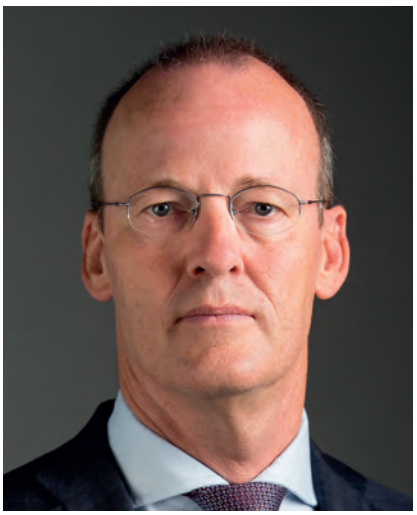
Finally a Fiscal Union would be a major political leap that must be explained to the public and which requires democratic accountability and the consent of citizens....

Given the critical situation we face, do you not think that some common, limited financial instrument issued by the Eurozone or the EU as a whole, would be beneficial to the Union?

What could be envisaged in these exceptional times with this huge, exogenous universal shock, is to mutualise exclusively the incremental part of public debt that has to be issued to fight against the pandemia. Indeed, this would not entail a transfer of resources from good performers to more problematic ones. It would just say that to fight this war all countries are in the same boat and that " l'appartenance européenne " counts.

In this regard, the Commission's proposal of the very significantly enlarged common budget is welcome. It entails a borrowing capability in the hands of the European Executive. This would be a "Hamiltonian" step forward. For the first time, such a major budgetary plan would imply a fiscal common entity in charge of issuing euro denominated debt. ●

Economic impacts of the Covid-19 crisis and policy responses



Klaas Knot

President, De Nederlandsche Bank
and Vice-Chair, Financial Stability Board (FSB)

A new impetus for international cooperation

Challenging economic and financial conditions are often a catalyst for stronger international cooperation. The whole history of the European Union is a clear example of this. The EU has faced many challenges in the past, but it has always found a way to overcome them, based on the principle of seeking constructive compromises and joint solutions. This approach of common interests and shared responsibilities has determined the international success of peace and prosperity within the EU.

Likewise, in the midst of the global financial crisis of 2008/2009, the financial sector faced existential threats. At that moment and in a unique atmosphere of joint global effort, the G20 developed a comprehensive international reform programme to stabilize and reform the global financial system. This was key to restoring confidence in the financial sector and global economy. It also led to the creation of the Financial Stability Board, to monitor financial stability and coordinate the implementation of regulatory reforms. Implementation of the post-crisis G20 reforms has made the core of the global financial system more resilient and in a better condition to face the unprecedented current economic shock of COVID-19.

The turbulence on financial markets and the effects of the economic fall-out from the pandemic confront us with new challenges. It reminds us that our economies and financial systems are closely interconnected and that developments in different jurisdictions have important contagion effects across the global financial system.

In this context, the FSB will have a coordinating role to share information, closely monitor risks and coordinate action to maintain global financial stability and keep markets open. In close cooperation with national authorities and the international Standard Setting Bodies, jurisdictions are encouraged to make use of the flexibility within existing international standards to provide continued access to funding and ensure that adequate capital and liquidity resources are available where needed within the financial system. This will preserve the financial system's capacity to support and finance economic growth. The FSB will focus on the critical nodes of the global financial system, including the functioning of funding markets, international capital flows and unintended effects in different types of intermediaries. The FSB will monitor the policy responses and report to the G20.

For Europe in particular, the current situation should be used as an opportunity to improve international cooperation. Now more than ever, progress towards completing the European banking union is essential to break the interconnectedness between governments and their domestic banking sector. The current unfinished agenda makes the European financial sector fragmented along national lines and vulnerable to idiosyncratic shocks. The unique characteristics of the European Union require further and well-designed steps to foster integration and strengthen the functioning of the single European financial market. In this context, additional measures are also needed to further develop the European Capital Markets Union to support open, integrated and developed capital markets to facilitate private risk-sharing and reduce systemic risks.

The unprecedented experiences of the dealing with the challenge of COVID-19 and resulting economic and financial fallout will test our dedication. Yet, as it has been in the past, it also creates new opportunities. There is ample evidence that policy responses are most effective when they are conducted in a joint and comprehensive approach, based on international standards.

In this spirit, I am convinced that the COVID-19 pandemic will provide a new impetus for international cooperation as the most effective path to ensure global financial stability. ●

Stipe Župan

State Secretary, Ministry of Finance of the Republic of Croatia

Towards a future-proof EU fiscal framework

Member states' fiscal outcomes ultimately emanate from domestic political choices across policy domains and from exposures to exogenous shocks. The financial and the sovereign debt crisis, pointed to the need for a closer coordination of national fiscal policies to address the risk of spill-overs within the Economic and Monetary Union. This resulted in a strengthened Stability and Growth Pact, a review process of euro area countries' draft budgetary plans, and the golden "balanced budget" rule of the intergovernmental Fiscal Compact.

These coordination tools have been instrumental in guiding member states towards sounder fiscal positions. In the context of the EU economic governance review and related public consultation, initiated by the European Commission in February 2020, a reflection has started on whether improvements to the common fiscal rules are necessary based on both a backward- and forward-looking assessment.

However, since the review was launched, the world has changed considerably in the wake of the coronavirus pandemic. The focus of fiscal policy is now squarely on facilitating the resolution of the acute health crisis and mitigating the socio-economic fallout of COVID-19, which has triggered the worst economic downturn since the Great Depression. Member states have acted swiftly and decisively by directing the necessary resources to health and civil protection services, supporting liquidity and credit for businesses, and protecting the incomes and jobs of workers.

As part of a broader European coordinated policy response to complement these national efforts, the European Commission, supported by the Council, activated the SGP's general escape clause to temporarily set aside the budgetary requirements that would normally apply, in order to tackle the economic consequences of the pandemic.

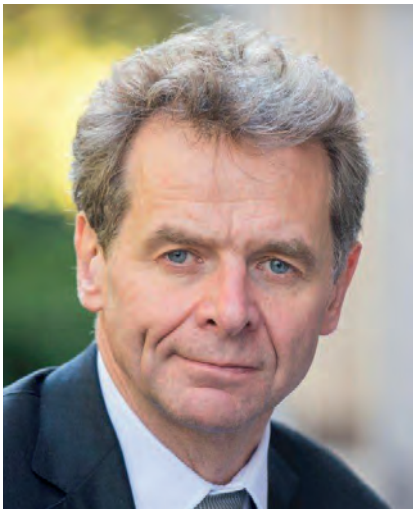
Large-scale national fiscal stimulus coordinated at EU level was undoubtedly the right response to avoid permanent damage to the economy's growth potential and ultimately, to debt sustainability. Nevertheless, it is clear that the public deficit and debt levels relative to GDP will be increasing significantly. These will have to be put on a downward path, which in particular for public debt proved difficult in some countries already before the crisis. At the same time, national fiscal policies should not become procyclical, but rather provide adequate support for rebuilding the economy. This is also related to the issue of the appropriate aggregate fiscal stance to increase the effectiveness of monetary stimulus. In addition, fiscal policy will have to cater for new priorities such as environmental sustainability and the digital transition.

Looking ahead, it will be important to achieve a common understanding on how to ensure that the EU's fiscal framework remains fit for purpose and is able to reconcile these different objectives. Striking the right balance will require careful consideration but should be feasible. If the fiscal rules were for instance to further promote public future-oriented investment, preferably in areas consistent with EU priorities such as environmental sustainability or the digital transition, this would not only be conducive to the economic recovery, but also constitute an opportunity for increasing the economy's growth potential and competitiveness. This would in turn benefit the long-term sustainability of public debt.

"Looking ahead, it will be important to achieve a common understanding on how to ensure that the EU's fiscal framework remains fit for purpose and is able to reconcile different objectives.

Possible trade-offs could also be eased by having a fiscal framework that encourages a more growth-friendly composition of national budgets. This could be achieved through a better prioritisation and targeting of national public expenditure as well as through less distortionary taxation. This in turn underscores the importance of pursuing fiscal and structural reforms.

Finally, it will be important to ensure that possible changes to address the above-mentioned challenges do not come at the expense of the transparency and predictability of the common fiscal rules, which should remain an anchor of confidence for markets and citizens. ●



Poul M. Thomsen

Director, European Department, International Monetary Fund (IMF)

Europe's Response to the COVID-19 Crisis

The COVID-19 shock is unprecedented in recent times, in both nature and size. About half of humanity is under lockdown at the time of writing.

Europe is particularly affected as it accounts for about half of the global total of confirmed COVID-19 cases at present. In Europe, nonessential industries closed by governments account for about one-third of output: that means that each month these sectors remain closed translates into at least a 3 percent drop in annual GDP. Consumer and business confidence are already deteriorating sharply: the composite PMI for the euro area fell in March to levels lower than in the global financial crisis. Financial conditions have tightened sharply, reflecting the extent of the real economic damage. A deep European recession this year is a foregone conclusion. Precisely how deep and how long remain highly uncertain.

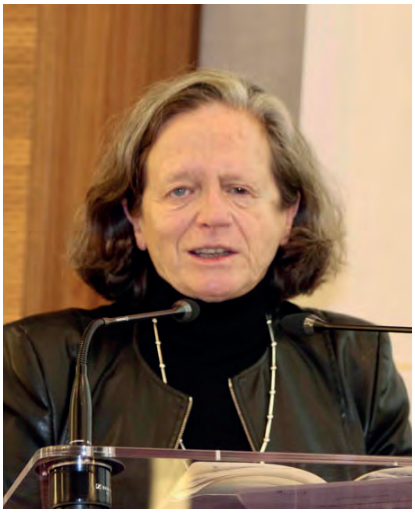
Policymakers in Europe have generally responded with speed and tenacity, deploying instruments tailored to both the specificities of the crisis and its scale. The most urgent priority is of course to save lives: a battle to stagger transmission and ramp up critical-care capacity to minimize the number of seriously ill patients that will be denied life support. This requires a massive investment in healthcare, on a war footing, accompanied by macroeconomic policies to ameliorate immediate hardships. Some of these actions will also help limit more persistent effects. In the near term, policies include supporting households and firms directly affected by the crisis, and providing abundant liquidity to offset financial stability risks. If there ever was a time to use available buffers and policy space, this is it.

But policy space for the response differs markedly across Europe. Advanced European economies have been able to launch large-scale fiscal and monetary support. EU fiscal rules have been suspended, bold monetary policy actions taken, and selected prudential norms for banks temporarily relaxed. Most countries in this group have announced large health outlays, employment subsidies, and guarantees, loans, subsidies, or capital to hard-hit businesses, while in some cases allowing tax payments to be deferred or cancelled. Fiscal deficits will balloon, and this is entirely appropriate. In the euro area, the large-scale interventions by the European Central Bank, and leaders' calls for the European Stability Mechanism to provide a supplement to national fiscal efforts, are particularly critical in ensuring that countries with high public debt will have the fiscal space they need to react forcefully to the crisis. The determination of euro area leaders to do what it takes to fight this crisis should not be underestimated.

> *Policymakers in Europe have generally responded with speed and tenacity.*

Emerging-market economies that are members of the EU but not the euro area should now use the buffers that they have cautiously built in recent years, through sustained reduction of fiscal and external deficits and a continuous strengthening of their bank systems.

Smaller countries outside the EU, however, will find it difficult to finance large budget deficits due to their limited access to external capital, less developed banking systems, and lack of potential access to EU financial support. Excluding Russia and Turkey, most of the nine non-EU emerging economies in Central and Eastern Europe have already applied for emergency assistance from a $50 billion pool available via the IMF's rapid financial support facilities. In this way and others, the IMF stands ready to help Europe and all of its membership. ●



Pervenche Berès

MEP from 1994 to 2019, European Parliament

The specificities of the Covid-19 crisis and how to respond

When the Covid-19 pandemic exploded, there was a temptation to refer to the Global Financial Crisis (GFC). But these two cataclysms may have little to do with each other.

The differences are huge. This crisis originates from a biological virus and not from toxic subprime mortgages. It is a health crisis and not a financial market one. This crisis spreads at a high speed and Members States or EU institutions have been reacting much faster than in 2007-2008. This crisis is a systemic one, with no place for a debate on moral hazard.

This crisis is deadly, it hits people first and its impact on the real economy is of a complete different magnitude, even though a big open question is its duration.

One way to fight this virus and its spreading is to enhance the surveillance of citizens' mobility. Advocates of full transparency of financial transactions should in democracy ask themselves more questions about the full tracking of individuals. Monitoring financial transactions and jeopardizing the freedom of movement of people are not the same.

But somehow, we observe the same mistakes and lack of solidarity.

Sub-primes were viewed as a US disorder against which EU fundamentals and automatic stabilizers were supposed to resist. This time, Covid-19, like Ebola or SARS, would not hit Europe; even when it arrived in Italy, there was some kind of condescending blindness. Like a reflex, the same group of Member States shot again first rejecting any strong EU solidarity and fiscal stimulus. On the front line a country, known for opposing reforms to rebuild a EU and Members States capacity through a fair corporate taxation regime, notably for platforms.

There is hardly any health coordination at the EU level even if this is mainly an area of national competence and that there have been few cross-border transfers of severely sick patients. But the trading of drugs and medical equipment remains a jungle with no internal market.

We would be much better off today if we had drawn all the lessons of the GFC and the legacy of the latter was a better-equipped EU to face crisis. This is true when it comes to have a revision of the Stability Pact to support long term investment, to establish a euro area budget to absorb symmetric shocks, even though up to now this crisis has no euro area specifying impact, to integrate the European stability mechanism (ESM) into the EU legal framework, to set up an unemployment benefit scheme acting as an automatic stabilizer or to issue Eurobonds. But, fortunately, one should also recognize that we have learned some lessons from the GFC. Some Members States have quickly put in place partial unemployment schemes, deferrals of tax and loan guarantees. Banks have much thicker liquidity buffers.

Mistakes vis-à-vis Italy were corrected, at least in the wording and after some hesitations, EU institutions reacted much more rapidly, the ECB with its 750 billion euro Pandemic Emergency Purchase Program (PEPP), the Commission with the suspension of the Stability Pact, decisions regarding state aids, structural funds, and the launch of SURE (Support to mitigate Unemployment Risks in an Emergency). While writing this paper, let's hope that Members States will demonstrate the same wisdom to commit to real fiscal solidarity.

What should we worry about for tomorrow? President Trump could for once be right! "We cannot let the cure be worse than the problem itself". In the short term, we need to have at our disposal a complete range of tools to tackle the different dimensions of the crisis, knowing that there is a dilemma: the more we are careful about people's health and smoothening the curb of hospitalized persons, the more we damage the economic situation.

For the future, to respond to the challenge of EU sovereignty and common goods, many EU policies will need to be reshaped; this is true for competition and industrial policies, trade, economy and taxation, notably of digital economy, but also for foreign affairs and development, having in mind the geopolitical implications of such a global pandemic.

No doubt that after this crisis the debt issue will be once more on the table, even though there are still two unknowns, the crisis duration and the debt level. This should only be evaluated at the end of the period as a one-off debt without making the same mistake made with the Greek debt.

Nevertheless, and on top of that, the question of fiscal tools and how to finance public services and public goods will have to be reopened.

The greatest risk would be to rush to restart the economy at any price, ignoring the still-valid urgency to lead the ecological transition. In the aftermath of this crisis, we will have no choice but to rebuild our economy around priorities for people, health and environment. This time, the main answers will not come from financial markets. One should make sure that they remain sustainable and contribute to collective preferences. ●

Andrew McDowell

Vice-President, European Investment Bank (EIB)

A pan-European response to a disease that knows no borders

Even as the spread of Covid-19 slows, and discussions commence on how to ease the economic shutdown, otherwise healthy European businesses are still failing by the thousands, suffocating from a lack of revenues and financing.

This pan-European pandemic calls for a pan-European economic response. This is why EU Finance Ministers have endorsed the European Investment Bank (EIB) proposal for EU Member States to create a €25 billion Guarantee Fund to enable the EIB Group to mobilise up to EUR 200 billion in funding for distressed sectors, as part of the wider EUR 520 billion package of EU crisis response measures agreed on April 9.

How the guarantee fund would work - The €25 billion guarantee fund will – subject to national confirmation and approval processes – be financed by EU Member States pro-rata to their shareholding in the EIB and/or other institutions. It is limited to addressing the Covid-19 shock, but could form a bridge between the crisis and the recovery periods.

With the benefit of a counter-guarantee from the Fund, the EIB Group – the Bank and the European Investment Fund (our specialist SME guarantee and equity subsidiary) – will unlock financing to the real economy by ramping up guarantees to local lenders, national promotional institutions and other financial intermediaries.

The products to be rolled out under the Guarantee Fund will likely be dominated by capped (first loss) and uncapped guarantees on portfolios of SME loans originated by local lenders and other forms of risk-sharing on new and existing corporate loan portolios. Some of these will provide regulatory capital relief.

Other products will also be considered, including participations in Asset Backed Securitisations to free up lending capacity, as well as equity investments in venture capital and private equity funds supporting innovative firms.

This fund should also allow EIB to counter-guarantee some national guarantee schemes already in place, thus sharing across the EU the risk of these schemes and increasing their firepower. The focus will be on SMEs, though it is proposed that mid-caps and larger corporates will also be eligible for support. All must be viable in the long-run and, in the absence of the Covid-19 pandemic, would meet commercial requirements for financing.

EIB and EIF have years of experience in these products, and through existing network of hundreds of counterparts can quickly channel financing to markets and sectors most in need. While there will be no quotas for any country, we have proposed upper concentration limits to ensure an equitable allocation of the firepower, always guided by EIB's usual assessment of economic and social impact.

A pan-European response to the pandemic - I see four key advantages of supplementing – at the EU level – the many national guarantee schemes that have already been rolled out.

Firstly, as with the Covid-19 health crisis, we need a co-ordinated approach to managing the economic crisis. No country will recover alone. Even the largest is influenced by what happens in terms of overall EU demand, intra-EU trade, intra-EU value chains, overall EU market confidence and financial market loops.

A study by the European Central Bank shows that 1% symmetric decline in the GDP of each Member State brings, after the initial mechanical effect, an additional 0.6-0.8% decline in the Euro-area GDP growth, due to the direct and indirect spillovers in trade. The EIB's own data shows that 40% of economic growth and growth in jobs from the operations we finance comes from cross-border spill-overs.

Secondly, by pooling credit risk across all of the European Union, the overall average cost of the fund could be reduced, compared to national schemes. Thirdly, the use of the EIB also means that guarantee schemes – and their SME and corporate beneficiaries – across the EU could benefit from the the bank's AAA rating, even in financially weaker Member States which lack fiscal space and a top credit rating. With the suspension until December 2020 of normal state aid restrictions, this can help to level the playing field for businesses across EU countries during both the crisis and recovery period.

Finally, Europe's venture capital and innovation ecosystems are trans-national by nature – no individual Member State has adequate incentives to fully protect them, calling for a pan-European perspective and policy instrument.

The broad product mix being proposed will ensure that in every country we will find a way to complement national schemes to best effect.

The economic and financial dynamics immediately ahead of us are approaching a tipping point: we have little time to put in place measures to safeguard the European economy from this unprecedented shock. By responding to this crisis with a spirit of solidarity and enlightened self-interest, we can start to strengthen confidence among markets and citizens in Europe's capacity to weather the storm. Together, Europe can emerge from this crisis even stronger. ●

Jordi Gual

Chairman, Caixabank

Europe's greatest challenge

We are experiencing a global health crisis unprecedented in recent history. The immediate priority must be saving lives: procuring all the resources the health system needs and taking the necessary measures to slow down the spread of the pandemic. In turn, the health crisis and the lockdowns that we are using to fight it have resulted in a deep economic recession that must also be faced resolutely. We have the capacity to manage both crises and lay the foundations for an economic and social recovery.

It is important to keep in mind that we are facing a public health shock that should be temporary if the epidemic is controlled in the near future. The goal of economic policy must be precisely to prevent it from having lasting economic effects, something that would happen if companies go bankrupt, if jobs are permanently destroyed or if companies and families emerge from this situation weakened by a heavy debt burden.

The response must combine policies that satisfy the liquidity needs of companies and families, favor temporary adjustment mechanisms for employment levels, and transfer public resources to companies and families to mitigate income losses. All European governments have already announced different measures in line with these priorities.

There is no doubt that the great fiscal effort implied by all these measures will suppose a significant increase in public debt. Such measures are essential to contain the economic and social impact of the health crisis. In their absence, the recession will be deeper and more protracted and the resulting fiscal costs from it, even higher. Moreover, some of the deterioration in public accounts this year should be reversed automatically with the recovery of economic activity.

These extraordinary times demand a shared fiscal effort by all Eurozone countries. It is not just, or even mainly, a matter of solidarity towards those countries that may end up being most affected. It is the most consistent approach with the fact that we are all members of a single monetary area.

By creating the euro, member countries gave up their monetary sovereignty and thereby gave up the support they could receive from their national central banks as lenders of last resort in exceptional circumstances. Certainly, the European Central Bank has shown its willingness to intervene in public debt markets to avoid an excessive increase in risk premiums, but this is not comparable, for instance, to the unlimited support that the Federal Reserve is providing the United States Treasury.

The Eurozone needs a single fiscal authority that can counter a shock like the one we are experiencing, an authority with the ability to issue a safe asset and that counts on the central bank as a lender of last resort. Indeed, lacking a fiscal union weakens our capacity to respond. This is the right time to take an additional step to strengthen the European Monetary Union and create it. In this regard, the Recovery Fund to be discussed soon by the European Council provides a unique opportunity to consider different options to start moving in the right direction. The stakes are high: the credibility of the European project in the eyes of the world and, most importantly, of its own citizens. ●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Bernd Spalt

Chief Executive Officer, Erste Group

Coronavirus has the power to transform Europe towards deeper integration

Without question, the coronavirus crisis is the largest threat to public health in living memory. Even though the real economic impact is not fully visible yet, most experts agree that we are facing an unprecedented hit on both the supply and demand side, with a lasting impact comparable only to such major disruptions as the global financial market crisis of 2007/08 or the oil crisis of the early 1970s. Above all, this crisis falls into the category of 'black swan events', which are hard to foresee and even harder to prepare for.

The sheer magnitude und unclear progression of the current crisis have the potential to stun the global economy far beyond the second half of this year, as is now commonly assumed. But there is one element of encouragement as efforts ramp up to address this challenge: despite the world's rather inevitable unpreparedness for this particular black swan, most economies were actually in rather good shape when the coronavirus first hit. Also, central banks and governments have reacted quite swiftly, which may be a lesson from the 2008/9 crisis, when the first round of reactions in parts of the world were too slow and faint-hearted.

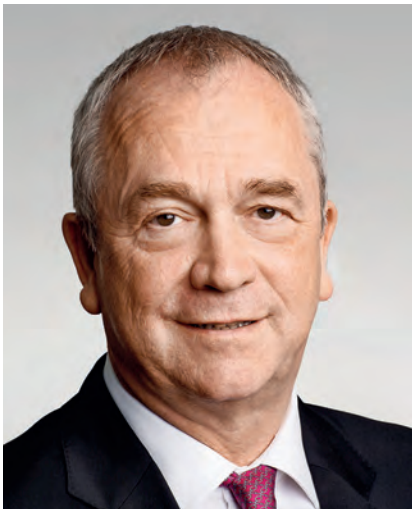
As the infection numbers start to peak in Europe and the US, the focus of public debate is shifting from protecting people's lives and livelihoods to restarting the broader economy. That is also why this is the right moment to take a closer look at what has changed in the economy and what this means for the banking sector.

Currently, governments are acting swiftly to keep their economies afloat. There is no doubt that they are guided by the right motivations, even as many details of these measures' implementation are still being worked out. All these measures have bought us some time, but we all know that the relief they offer can only be temporary and efforts to further strengthen the real economy will be needed in the coming months. We as the banking sector stand firmly by our commitment to support the customers and finance the real economy. Banks understand that they are key parts of the critical infrastructure on which societies rely (especially in such crises) and have undertaken massive – and successful – efforts to keep things up and running for their customers. Banks like Erste Group have been able to rely on their sustainable and resilient business model, with its digital offering and physical branch infrastructure. More generally, banks have shown that they are ready to support society by addressing the needs enterprises have in order to overcome their short-term difficulties. It is in the private sector that jobs are being created, where families generate their income, and where Europe produces its wealth.

> *Going forward we need a medium-long term framework to organize and coordinate the management of this crisis.*

Going forward we need a medium-long term framework to organize and coordinate the management of this crisis – a framework which takes into account the specific roles of politicians, banks and supervisors alike. In some markets we do see first signs of patchwork-like actions at national levels that fail to reflect the need for coordinated responses within the broader European context. We, as banks, need flexibility to be able to help. What is not needed are any additional obstacles to the free movement of capital or ring-fencing measures. What's more, governments should try to remove any unnecessary hurdles in the existing frameworks.

As a strategic investor in Central and Eastern Europe, Erste Group remains strongly committed to its home region. For this reason, we believe that a coordinated response involving all relevant stakeholders at the regional level makes sense and could draw on the successful model provide by the Vienna Initiative. It is astonishing that a virus that does not stop at any border has been treated – from an economic perspective – almost independently by all countries. This virus has the power to transform Europe, either towards more nationality or towards deeper integration. Going forward we remain committed to capital market development, support the European Banking Union and ultimately support any measures to foster deeper European integration. ●



Dr. Karl-Peter Schackmann-Fallis

Executive Member of the Board,
Deutscher Sparkassen- und Giroverband (DSGV)

Solidarity and Stability in Europe

The economic consequences of the Corona Pandemic are tremendous and rapidly deteriorating. After China and Europe, now the US, emerging and developing economies are hit most severly. In the US the initial response has been insufficient and inconsistent for a long time. An aggravating factor for the leading Western economy will be that it has less automatic stabilizers than most European countries.

There is hope that in many European Union countries the further spread of the disease can be controlled. Discussions about the appropriate exit strategy are beginning. Yet, the clear priority still has to be to limit new infections. If containment measures were to be withdrawn too early, a second wave could increase economic damages even further.

The Corona shock is symmetric, hitting the real economy with full force. Everything possible must be done to support and stabilise the economy. Capital stock and labour force potential must be maintained as much as possible. They form the basis for the economic recovery. Europe and the Member States have taken action: fiscal policies are delivering "whatever it takes". The rules of the Growth and Stability Pact are suspended for the duration of the pandemic, and rightly so. It is now important to make full use of all possibilities via the ESM and the EIB. The 500 billion Euro programme recently agreed by the Eurogroup is a fundamental sign of European solidarity.

A well-functioning financial services infrastructure will be vital to channel funds as quickly as possible to the real economy. That is why we are asking legislators and regulators to lower operational and administrative burdens for the banking sector now and to adjust implementation and application timeframes for all levels of legislation to the impact of COVID-19.

Within just 11 bank working days the German savings banks have had more than 704.000 conversations with their corporate customers. All systems are working to the limit of their capacities. In most cases these contacts involve general advice, utilisation of existing credit lines or fresh loans from the respective savings bank. In 20-30 % of cases it is a matter of suspending interest and repayment of principal or of loan applications to access public support programmes. In total, the savings banks have suspended interest and redemption payments for more than 200.000 clients already and the numbers are increasing. Thus, emergency measures clearly are transmitted via the locally active savings banks.

Once more this is proof of bank finance based on local banking networks being quicker and more efficient than capital markets-based finance.

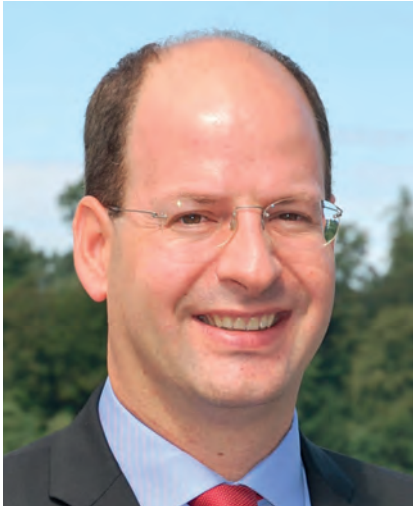
This crisis of the real economy could certainly become a problem for the euro area, if credit ratings of individual countries are lowered below investment grade, potentially leading to a further downturn of the European financial markets.

European solidarity will therefore be needed. Solutions must be balanced, acceptable and enforceable. A full mutualisation of public debt via so-called "Corona Bonds" does not appear to reach consensus. Without conditionality or other incentives, such a tool could indeed place too high a burden on all member states.

Yet, much more money will be needed. Innovative ways of financing those needs to avoid turbulences on the capital markets are necessary. Using the excellent credit rating of some member states could be made available via a guarantee, limited in time to EU countries with a lower credit ratings or countries having lost market access.

Such bilateral guarantee-relationships between countries of differing credit ratings could be a core element of the European recovery fund without the need of expensive equity. The default risk of such instruments would be lower than that of Corona- or Eurobonds. New or ongoing ECB purchasing programmes would also reduce risks for the guarantor of the bonds.

Based on these "Stability Bonds" solidarity on a European level could be provided. They would strengthen the crisis resilience of the whole euro area and have a stabilising effect on financial markets. The message behind those bonds would be that Europe stands together in times of increased financial pressure. But that Europe, unlike other currency areas, still keeps an eye on managing increased crisis-related debt levels, thus creating a solid foundation for renewed sustainable growth. ●



Dr. Jérôme Haegeli

Group Chief Economist, Swiss Re

Post-crisis recovery agenda: we need it now

None of us have ever experienced anything remotely similar to the ongoing situation, not even post-war generations. Governments globally face a unique health crisis which has seen no borders. Combatting it has meant taking a deliberate, difficult and delicate trade-off versus economic growth. As a result, the Covid-19 induced recession will be one of the deepest on record. The good news is that it may also be one of the shortest on record, however, there will be long lasting ramifications beyond the containment of Covid-19. Such ramifications will result in paradigm shifts that will take societies, policy making and the economic framework into a new era, including the following: 1) further innovation from the ECB, 2) monetary and fiscal policy coordination and implicit debt monetisation, 3) bigger role of governments in capital makets, 4) peak of globalisation and emergence of parallel supply chains, 5) possibility of a stagflationary environment, and lastly 6) accelerated digital transformation.

These paradigm shifts highlight the importance for the Eurozone to adapt and evolve if it wants to remain one of the major global economies. Even more importantly though, the challenges arising from Covid-19 have brought the euro area to a pivotal point where it will either "make it or break it", with the region at greater risk of falling apart now than during the Greek debt crisis. As such, it is vital for the euro area to witness an upsurge in solidarity if it is to survive. At present, already existing tensions amongst member states risk being exacerbated by the important disparities in the fiscal responses.

Although the massive global fiscal stimulus[1] is cushioning the blow to the economy, it will not absolve countries of all the challenges. This will result in governments not being able to take away the massive fiscal measures any more than they were able to after the GFC. Given the similar demographic profile to Japan, it is critical that Eurozone governments provide support to companies and sectors with strong potential for future growth to avoid replicating Japan's growth trap.

Governments around the world have so far focussed on attenuating the impact of Covid-19 on their economies. Although this is necessary, European leadership should also consider the ongoing disruptions as a window of opportunity to secure higher trend growth, ensure economic resilience and achieve political stability throughout the region. In addition, with Covid-19 being a temporary, albeit painful, disruption, persistent issues such as climate change will remain at the forefront of global dialogues. The Eurozone could position itself to spearhead the climate change dialogue. We therefore propose the following actions to policy makers:

1. **Common green innovation fund** – establishment of a euro area-wide fund to support innovative technology, with a special focus on low-carbon technologies to meet global climate change objectives all the while increasing productivity.
2. **Common resilience fund** – establishment of a common resilience funding pool that members can draw from in times of shock without the debt mutualisation aspect. The fund would include pre-defined trigger levels for fund access, with proceeds earmarked for targeted investments in alignment with Europe's economic and political ambitions.
3. **Digital alignment** – smoothing of the large digital disparities across member states and the creation of a digital single market. Europe is in some ways in a luxurious position as the Union can start from scratch without a pre-existing, institutional legacy on this front.
4. **Infrastructure spending** – emphasis should be on sustainable infrastructure, with spending done at a national and eurozone level. Transport infrastructure will be key to help the region transition to a low-carbon economy, while supporting the shift to parallel supply chains.
5. F**inancial integration** – improvement of the euro area financial system's capacity to channel surplus funds to parties in need of financing for consumption or productive investment. Better integrated asset markets should help smooth income and consumption growth, and hedge against country-specific sources of risk.

Ultimately, the European integration is a peace project which builds on solidarity and a joint future. The Eurozone therefore needs to act now while it still can and before what were once shared values drift further apart from each other. ●

1. Global fiscal stimulus will exceed 3% of world GDP in 2020, which compares to 1.6% in the GFC. This number only reflects stimulus that flows into the fiscal deficit this year, and excludes all loan guarantees

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Implications of the Covid-19 crisis for the financial sector

Michael West

President, Moody's Investors Service

Coronavirus exposes global financial market vulnerabilities

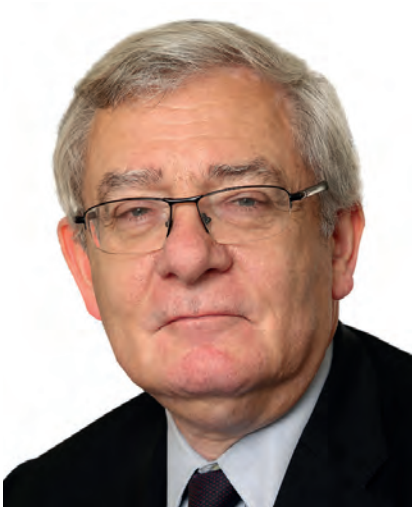
Global credit conditions are deteriorating because of the coronavirus outbreak and oil price shock, which will likely lead to an increase in rating downgrades and defaults in the coming months. The economic turmoil, along with significant financial market volatility, is creating a severe and extensive credit shock across many sectors, regions and markets. The combined credit effects of these developments are unprecedented. The sectors with the largest exposure to the coronavirus outbreak are those that are most sensitive to consumer demand and sentiment, including global passenger airlines, lodging and cruises, automotives, and segments of the oil and gas sector, as well as certain commodity exporters. Negative credit effects will be the largest for companies and governments with high debt levels, heavy reliance on external financing and weaker credit profiles. Speculative-grade companies and governments represented close to 40% of all Moody's-rated debt in 2019, up from 16% in 2009.Moody´s expects the G-20 economies to experience a major shock in the first half of this year and will contract in 2020 as a whole, before picking up in 2021.

Nevertheless, there remains sizeable downside risk to our forecasts given the significant uncertainty as to the length and magnitude of the coronavirus outbreak. The monetary and fiscal response has been significant and continues to grow, and we expect it to help cushion the economic and financial market impact of the shock. In some cases, these policy measures will allow for a faster recovery once the shock recedes. Fiscal stimulus will also lead to further increases in sovereign debt, which is already high in many countries, including in the European Union. Emerging market currencies have sharply depreciated vis-a-vis the US dollar because of safe-haven flows, increasing vulnerabilities for emerging countries that are dependent on external financing.

While the European Union has been slow to devise a coordinated response, one is emerging that may start to employ some of the policy tools devised during the euro area sovereign debt crisis. However, more broadly, global policy responses have thus far been disjointed, favouring more nationally focused approaches.

Even before the coronavirus, global economic growth was slowing as a result of cyclical and structural factors, including aging populations, weak productivity, global trade tensions and geopolitical risks. A lasting trade deal between the US and China will remain elusive, with disputes extending into technology, investment and geopolitics. The outcome of US-EU trade talks, potential auto tariffs and Brexit-related uncertainty also remain risks. Lower-for-longer interest rates also increase financial stability risks and weigh on profitability for banks and insurers. They encourage risk taking as investors reach for yield that may have contributed to high financial volatility and sharp asset declines in recent weeks. Low rates can encourage excessive borrowing as evidenced by elevated corporate leverage in the US and Europe.

Many high-yield companies took advantage of easy market access and have successfully weakened investor protections. The increase in low-rated companies with weaker credit profiles will likely lead to more defaults and lower recoveries even if the current downturn were to be milder than the one in 2008. High levels of Baa-rated corporate debt globally increases the risk of downgrades to speculative grade in a recession, although this risk in and of itself is not likely to disrupt the high-yield market. The market for leveraged loans and collateralized loan obligations (CLOs) has expanded significantly, which poses risks during periods of tight credit conditions. In Moody's view, junior tranches of CLOs would be at risk of significant credit quality deterioration under a severe downturn scenario. However, senior tranches would likely avoid impairments because of credit enhancement and other structural features. Investors are increasingly incorporating climate and cyber risks into their decision-making. Moody's expects these areas to become bigger credit considerations that in some cases will weigh on credit availability, putting further pressure on carbon-intensive sectors. ●



Jean Lemierre

Chairman, BNP Paribas

Covid-19: banks are part of the solution

The Covid-19 pandemia is a worldwide public health issue, which has brought a large part of the world's population and economy to a complete stop, leading the global economic activity to decline on a scale we have not seen since the Great Depression, with a drop of 6.1% in GDP for the advanced economies, as estimated by the IMF.

After the deep economic and financial 2008 crisis, and ten years of unprecedented regulatory and institutional overhaul to strengthen financial stability, the European Union is now confronted, with the outbreak of the CoVid-19, and its potential social, economic and financial consequences, to its first pan-european systemic crisis, affecting all Member States albeit with different timing and intensity, and all sectors of the economy.

Contrary to the sub-prime crisis, banks are not the problem, they are part of the solution. A prompt, coordinated and powerful response to this unprecedented challenge has been designed at EU and Member States level. Banks are called to support the economy, and are doing it in every geography and business lines.

> *Time will come to learn the lessons of the crisis, and to build the foundations of the recovery which is needed in the years to come.*

Banks are at the core of public policies, to avoid the massive bankruptcies that characterized previous crisis, with their dire consequences on job losses. Hand in hand with authorities, banks are the backbone of the financing of the economy, to support short term temporary liquidity needs, and to facilitate the recovery. Our staff is mobilized to address clients needs, every day, in branches, business centers, back-offices, risk management units, data centers. Banks are open for their clients, and the financial infrastructure works: payments, settlements, client orders, are processed in millions, across the globe so the economy can function. As an example, Swift transactions are close to their peak in March and April, with a 16% increase y/y. Moratoria and new loans are discussed with clients and granted with an accelerating process in most EU countries. In France, 3 weeks after the implementation of the State-guaranteed loans, 150 000 companies have received approval, for a total of 22 bn€, and the framework is ramping up quickly.

The massive financing that banks will provide to the economy is supported by the liquidity provided by the ECB, and by State Guarantees provided by Member States. Regulators are implementing the flexibility embedded in existing regulations, and, at the margin, adapting regulations to international standard setters guidance. This contracyclical approach is at the core of financial stability: build capital and liquidity buffers in good times, to be well prepared to weather bad times.

Time will come to learn the lessons of the crisis, and to build the foundations of the recovery which is needed in the years to come. Policy makers will also have to adapt the regulatory framework where rigidities may have dampened timely responses to the crisis.

But for the moment, our energy should be fully devoted to fight the virus and its economic consequences, hand in hand with the authorities. ●

José Antonio Álvarez

Chief Executive Officer, Santander Group

This time it's different. Let's keep it that way.

As I write this, many parts of Europe are in their second month of living with the COVID-19 corona virus. To many, the economic disruption and volatility in financial markets recalls the uncertainty and instability of the 2008-9 financial crisis and the Great Recession that followed it, or even the Great Depression of the 1930s.

But we know this time around is very different. In this crisis, triggered by a public health emergency, we in the financial community – banks and other financial institutions, monetary authorities, regulators and supervisors, our customers and employees and shareholders - are very much on the same side. We have all been rowing in the same direction. So far that has enabled us to mobilize huge resources for the economy. It will be very important in the coming months to maintain that shared vision and solidarity, which could come under pressure as the public health crisis wears on. So it is a good time to remind ourselves of some guiding principles as we go forward. We must always remember that our purpose is to support people and businesses, in difficult times as well as good times.

In the last two months, central banks and other authorities have been very quick to act in unleashing huge amounts of liquidity into the system. They did this through market operations and through prudential relief, eliminating the capital and liquidity buffers put in place while economies were growing to make banks more resilient when they are not.

Recognizing that monetary policy could not be the only answer, governments have put in place a series of fiscal and social measures that include direct support for SMEs and other companies, employment and wage protection and loan guarantees and moratoria. Banks, in most instances, are the transmission mechanism for these programs. All this happened in the first weeks of March. Not surprisingly, many of these initiatives took a few days to be activated, but they were mostly activated.

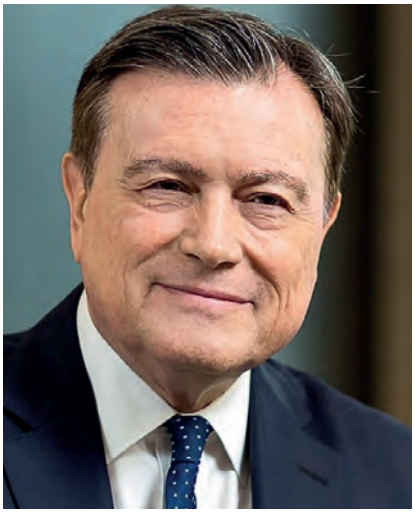
The close coordination among banks, supervisors, monetary authorities, governments and other key actors have led to quick preventive and corrective actions. On issues ranging from accounting and prudential flexibility the eligibility of collateral, I have seen authorities act quickly when the industry has raised concerns. In turn, banks have responded when concerns were raised over dividends and other measures to conserve capital.

Our collective learning curve has been steep. Here are some of the lessons we learned at Banco Santander, both for authorities and ourselves, which may be useful as we continue to navigate this crisis.

- **Be safe:** The first concern of any institution must be the well-being of its employees and customers. Working from home, protective guidance for branches and mental health support all help to keep people well. Maintaining their jobs is fundamental.
- **Be fast.** You can't rescue a company after it has gone under. Banks and authorities have had to work very closely together to get support where it needs to be, quickly.
- **Be big.** Monetary and fiscal measures work best when markets see they are of the scale required to address the problem. Make sure what you do is enough and the conditions are right. Half-way treatments don't work.
- **Be simple.** Applying for loans or benefits should be as paper-free and non-bureaucratic as possible. Include clawbacks and affidavits, if needed, rather than try to impose upfront conditions on support.
- **Be inclusive.** Guaranteed loan programs and moratoria should be for all types of loans and segments of customers, large and small, based on clear criteria.
- **Be ready.** Even as we are implementing the last measures, we have to look forward to the next stage – and the stage after that – to consider how the needs of our customers and governments and authorities may change and be ready.
- **Be open.** Fluid communications with our stakeholders, including authorities and governments, have been essential to our ability to manage so far. That will remain the case.

Going forward, the highest priority for banks will be to manage risk prudently to keep our balance sheets strong. Strong balance sheets will enable us to continue to support people and businesses. Banks must distinguish between what is near-term or transitory, related to the COVID pandemic, and what is not. This distinction, between transitory disruption and long-term unviability, is essential to make sure banks themselves stay healthy. Also, as the transmission mechanism for the public sector, we must assure that public resources are allocated fairly and justifiably, keeping in mind we are lending, not providing subsidies.

At some point, as we emerge from the lockdown phase - I hope in the near future - the financial community will need to work together to revive the economy and support people. This will likely be a gradual process, with many decisions and challenges, as some sectors and segments return to work faster than others. I am convinced that the close coordination we have maintained so far, with the private and public sectors working closely towards the same goals, will be crucial in making sure banks can perform their duty in the coming recovery. ●



José Viñals

Group Chairman, Standard Chartered Plc.

How banks respond to the crisis now is critical to the global recovery

The COVID-19 pandemic has triggered a global public health and economic crisis. Human and societal costs are already significant, and governments have taken unprecedented steps in an attempt to weather the economic impact. Many predict 2020 will see the worst peacetime performance for the global economy since the Great Depression. The International Monetary Fund projects a sharp global economic contraction of –3% in 2020, much worse than during the 2008–09 Global Financial Crisis.

The present crisis is like no other in the extent and severity of its shock, the uncertainty over its duration, and the strength and shape of an eventual rebound. Whereas previous crises required economic policies to stimulate activity, much of the present economic impact is attributable to necessary containment measures. Banks can and have been playing an important role in alleviating the immediate liquidity issues. By providing a reliable source of financing to corporates and individuals, and by being a conduit for delivering many of the public policy measures, we have been helping bridge the cash flow needs of our clients and communities.

In addition, many banks are taking their own initiatives to fight the impact of this virus. At Standard Chartered for instance, we've announced $1billion of financing at cost for companies that provide goods and services to help the fight against COVID-19. And we have launched a $50m COVID-19 assistance fund with $25m allocated to emergency relief in the most affected markets and $25m to help communities' recovery from the medium-term economic impact of the virus.

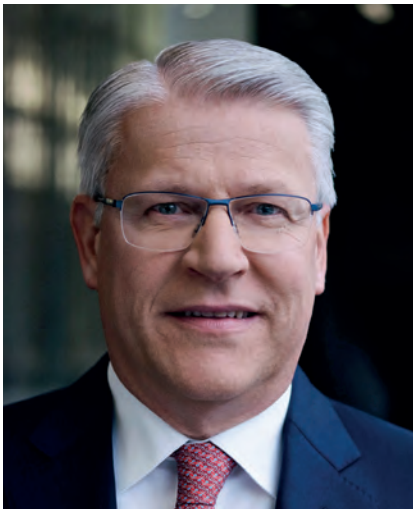
This crisis, however, has reminded us that financial markets can go through episodes of 'market illiquidity'. They quickly exhibit extreme volatility as some market participants must sell down their positions to meet their financial obligations. Corporates are also seeking to increase their liquidity buffers to manage their working capital needs, leading to an overall hunt for cash. The European Central Bank has decisively responded to those challenges, including unveiling the Pandemic Emergency Purchase Programme with an overall Euro 750bn envelope to buy government and corporate bonds. To address the global risk of dollar shortages the Fed has put in place, among other measures: dollar swap lines for a number of central banks; and, a special dollar facility for many central banks.

These measures are being used by banks to channel liquidity to the economy thus preventing a liquidity-driven crisis. While the magnitude of the impact of the COVID-19 crisis on financial stability in the medium term is difficult to assess at this stage, the dramatic fall in economic activity and the increase in both public and private sector debt will likely have a significant impact on the financial sector and on banks. For example, the fall in economic activity could contribute to the deterioration of asset quality of banks, leading to a vicious circle of reduced lending, poor profitability and negatively impacting the economy. This is not a new problem in the EU, which faced similar issues following the 2012 EU sovereign debt crisis, leaving banks at the periphery with high-level of non-performing assets and endemic lending. Yet European banks face the present crisis from a much stronger situation, reflected in substantially higher capital ratios, liquidity buffers and improved risk management frameworks. Low profitability nevertheless remains a concern and is likely to become even lower, at least in the short term.

> *We can look to the past for useful lessons.*

While the present crisis resembles no other since World War II, we can look to the past for useful lessons. In particular, few would argue against the idea that concerted and decisive action is essential now and to prevent the occurrence of a significant "second wave". International cooperation is required in the easing of lock-down measures to harmonise travel restrictions, enable supply chains to operate and facilitate trade. A coordinated global response is also key to adequately allocate protective equipment and medical supplies, collect funds for vaccine research and provide access to all once a vaccine is found.

There is a related, but equally important, need for a paradigm shift to one where we appreciate that no one truly wins unless everyone is helped. We have already seen some of this in the way governments have responded to the crisis. What risks we, as a society, choose to share, and how generous the safety net is that we choose to create for this and future generations, are, of course, some of the key questions that lie before us in the coming weeks and months. ●



Markus Ronner

Group Chief Compliance and Governance Officer,
Member of the Group Executive Board, UBS

Decisive action for a strong European banking sector

The COVID-19 pandemic is hitting the European economy and our financial sector at an already challenging time. Economic growth in many European markets has already been relatively subdued even before the pandemic, while sovereign debt levels in many countries are elevated, if not even at record levels, and monetary policy room to manoeuvre is limited due to low rates and quantitative easing. Authorities across the continent have nevertheless pulled off a remarkable set of economic stabilization measures to instill confidence to employees, corporations, financial markets and society at large. The current economic crisis is also an important test for the European banking sector. It's certainly too early to make a final call but there are some meaningful observations that can be made already today.

Strong and effective collaboration among regulators and authorities has been key to mitigate the effects the pandemic has on the economy to the extent possible. This includes temporary reliefs on capital and liquidity requirements to allow banks to serve the real economy. However, banks will need to demonstrate prudent lending practices and avoid adding on low credit quality. This is particularly important as many European banks are still struggling to adapt their business models and operate a sustainably profitable business, due also to structural issues as well as the expansive monetary policy, which has severely impacted a main income stream of the banking industry for a prolonged period of time.

In other words, the European banking industry enters the COVID-19 crisis period having not even fully digested the consequences of the financial crisis. The longer-term implications of the short-term stabilization measures need to be considered carefully. UBS research shows that only around 25% of the 40+ largest European banks would have earned their cost of capital if you were to adjust their 2019 return on tangible equity for the average loan-loss-provisioning rate of the years 2000-2005. And the 2019 ZEB European Banking Study forecast that, already in the baseline scenario which assumed that interest rates, profit margins and loan loss provisions would remain at 2018 levels, Europe's top 50 banks were expected to see their RoE halve over the next five years, mainly due to higher regulatory requirements.

Particular attention is therefore required in the following areas:

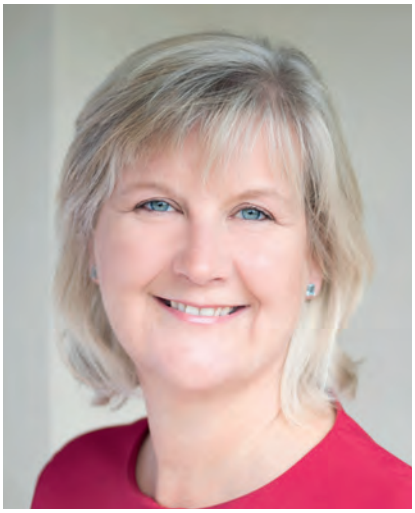
- Expansive monetary policy will add further pressure on the banking systems' Net Interest Income (NII) in an environment where Eurozone NII at the beginning of 2020 was already 45% lower than in 2007.
- Loan losses will be smoothed by public stabilization measures and some adjustments to accounting standards. However, banks, especially those banks with sizable non-performing loan portfolios, must avoid loading their balance sheets with low credit quality and associated future losses, which would further weaken their profile. There will need to be a fine balancing act between supporting the real economy and due risk management in such a highly uncertain environment.
- While central bank liquidity support is needed and welcomed, it should not be the main determinant of bank lending in the short- to medium-term. In an environment in which the ECB's term facilities have been funding around 15% of bank lending in some jurisdictions, this will require a significant broadening of funding sources for many European banks, potentially at a higher cost than that which is currently available.

> *Decisive action both by authorities and the banking industry will help to translate the threats of the crisis into an opportunity of building a stronger banking industry in Europe.*

In addition to these COVID-19-related factors which need to be addressed if and when the circumstances allow, a number of strategic measures by banks and policymakers can help enhance the resilience of the European banking sector in light of these threefold pressures.

On the one hand, banks will need to accelerate the adoption of new business models and, with the appropriate framework set by policymakers embrace the consolidation of the industry, focus on fostering critical size and enabling necessary investments in new technologies to support structural changes.

Decisive action both by authorities, including regulators and central banks, and the banking industry will help to translate the threats of the crisis into an opportunity of building a stronger banking industry in Europe which is crucial to foster a positive economic development in the post-COVID-19 period. ●



Susan Revell

Deputy Chair and General Counsel, EMEA, BNY Mellon

Thoughts on Covid-19 – the importance of people

When I think of the impact of the current Covid-19 crisis on the financial services sector, I think of three things, business continuity, lessons learnt (and to be learnt), and people. And of the three, the most important is people.

From the perspective of the financial services sector as a whole, one major conclusion from the past weeks is that the system has continued to work. In very challenging circumstances, financial markets, market infrastructures, and market participants have continued to operate, and have been able to manage unprecedented volatility and volumes.

This is highly reassuring, and even – despite the sad and tragic circumstances – satisfying. It shows that the enormous efforts that the sector has made in the past years to ensure business continuity have paid off. I think that if the virus had struck even three years ago the outcome would have been very different.

I have seen the view expressed that it is as if we are going through an enormous stress test. And as with every stress test, there are lessons that we can draw from the experience.

I think that once the situation – the humanitarian situation, as well as the financial market and economic situation – has stabilised, there will be many lessons that we can draw.

We shall look at the areas where frictions have occurred. We shall look at the actions of public authorities and we shall see what worked, what worked less well, and why. We shall need to think about how we can better prepare, and ensure that information is available to all. We shall have to look again at the conditions of access to the ECB's asset purchase programmes, and we shall see that not everybody has equal access. We shall say that fragmentation of European market infrastructure, and differences in market practice, are a problem that becomes more acute in times of market stress.

And there will also be broader lessons. We shall need to look at the resilience of the system as a whole, and at how to increase operational and technological resilience and inter-connectedness.

But the biggest lesson of all relates to people.

In the past weeks, the biggest source of resilience has been people. This is true in society as a whole, and it is also true with respect to financial services. Beyond systems and technology and procedures, all of which are, of course, important, the fact that over the past weeks the financial services sector has been able to continue to process payments, to support the financing of the economy, and to manage radical adjustments in prices and portfolios is due primarily to the adaptability, perseverance and dedication of our people.

> *In the past weeks, the biggest source of resilience has been people.*

As the crisis ends, and as we return to an environment that is closer to our past experience, we shall need to focus on our people. I do believe that the crisis will have shown that we need to focus even more than in the past on the agendas of diversity, inclusion and corporate purpose. ●

Alexandre Birry

Global Head of Research - Financial Institutions,
S&P Global Ratings

Covid-19 will expose many of European banks' strengths and opportunities

Beside its tragic human cost, the coronavirus' economic cost will very rapidly translate into substantially higher credit cost for European banks. And that is despite the substantial support provided by the authorities to households and corporates. But the capital and liquidity buffers built by banks over the past decade should, this time around, help banks be used as a conduit to support the authorities' monetary and economic policies to address the crisis. The flexibility granted by supervisors for banks to dip into these buffers will—as originally planned by the regulations—allow banks to contribute to minimise the depth of the crisis and build the foundations for a strong recovery.

That said, once the economic rebound takes hold, banks will not reap the financial benefits of their actions through the crisis. They will face customers that may be prone to deleverage, a cost of risk that will likely be well above pre-crisis levels, and the prospect of lower-for-even-longer rates. This will likely durably dent earnings that were already often feeble at the onset of the crisis.

> *The crisis may reveal the progress banks made after the last crisis in rebuilding their standalone strength.*

One of the longer-term questions that will need to be addressed post-COVID-19 is the extent to which regulatory requirements will again be tightened, and how rapidly. The earnings recovery for banks is unlikely to be as sharp as the GDP rebound. Time, and clarity as to the regulatory path ahead, will be required for investor confidence to be preserved. The crisis will also reconfirm how useful it is for banks and supervisors to routinely carry out stress scenario analysis based on non-traditional risks. Climate-related stress-tests—put on hold during the pandemic—may be revisited with a new vigour.

Also, performance pressure and evolving customer needs (for instance around sustainable finance and fintech to name just two areas) may strengthen the argument for fewer banks with greater scale in terms of size, geographic reach, product offering and technological capabilities. This may reignite the debate around consolidation once the dust settles – the main question being whether it will still lead to predominantly domestic consolidation, or whether we will finally see more cross-border transactions within the European Union. The emergence of pan-European wholesale banks could be key to the success of the Capital Market Union. But it is unlikely to occur in the absence of clear support for this from the national and regional authorities.

Finally, another question will be around the image of banks post-COVID-19, and the perception of their role in the economy. The crisis may reveal the progress banks made after the last crisis in rebuilding their standalone strength. Their resilience through this severe and abrupt crisis would be testament to the substantial transformation they've undergone since the global financial crisis. Their willingness to use it to support customers in times of stress will be scrutinised by many. Therefore, after spending the previous decade strengthening their balance sheets, banks' ability to demonstrate this willingness to support the economy through the crisis and to explain it convincingly will be instrumental in also strengthening their image in the public opinion. ●

Ksenia Duxfield-Karyakina

Government Affairs and Public Policy Manager,
Financial Services Policy Lead, Google Cloud

Resilient cloud: supporting the financial sector in a time of uncertainty with Covid-19

As COVID-19 continues to impact the globe, the financial sector is adjusting to the new reality, both in terms of migration of their own operations into the remote working-from-home environment, and sustaining to provide essential, now exclusively digital, services to their customers. Cloud technology has proved fundamentally important to support this transition in a number of ways.

Remote working

As organisations now rely on remote workforces to maintain productivity, using cloud tools is becoming a newly accepted norm for the industry.

The uptake of remote collaboration technology has been remarkable: Google Meet has been adding more than 2 million new users daily, and they're spending over 2 billion minutes together per day. We also made our advanced Meet video-conferencing capabilities available at no cost to all our customers until the end of September.

We introduced Meet more than a decade ago as a secure, easy-to-use collaboration and productivity service (now known as G Suite), as we envisioned a new way of working in the cloud. These tools have proved indispensable in the time of a pandemic.

Resilience of cloud infrastructure

The need for agile, scalable, secure, and resilient infrastructure is not new, but has been underpinned by the global pandemic. Hyperscale cloud providers that build infrastructure and systems resilient by design are well placed to support business continuity of the financial sector, the operational stability of which is critical to the European economy.

Google maintains comprehensive business continuity practices, and we have taken steps to ensure our readiness for COVID-19 from both a technical and personnel perspective. These steps are from our standard playbooks, which were written and have been tested for exactly this type of scenario, well ahead of the COVID-19 outbreak.

Network and compute resources are central to cloud services. At Google Cloud, we plan for these resources to accommodate normal demand fluctuations, long-term growth, and potential unanticipated shocks on supply or demand. The growth we've seen so far in response to the pandemic is within the headroom we've provisioned, and we don't face or foresee a capacity shortfall for either of these resources at this time.

Similarly, with personnel readiness, thanks to the collaboration tools we are using on a day-to-day basis, and with the distributed culture that we've built across the company over the past decades, our teams remain connected and able to execute in the work-from-home environment.

Impact on the use of AI and automation

During times of uncertainty, having access to insightful data is more important than ever. Financial institutions are turning to data analytics and AI to help them make smarter decisions, improve their business operations, and help their customers. Here are a few ways they're doing just that:

- Understanding data with analytics and AI tools to make better decisions in the trading portfolios during the market downturn, improve internal risk management, liquidity, and capital analysis;
- Using data and AI to streamline back office operations, such as trade processing and document management;
- Implementing AI-based agents in call centers to alleviate pressure.

There is a similar trend in the use of these tools by financial services regulators.

Thinking post COVID-19

It is expected that economic recovery will be a continuous process, with many lessons to be drawn across the industry and the regulatory community. These are just a few themes that we anticipate emerging:

- Infrastructure modernisation with public cloud in the financial sector will increase as a key enabler in improving sustainability and reducing operating costs.
- Remote work combined with broader reliance on online platforms are here to stay, encouraging innovative work cultures based on agility and flexibility.
- Today's end-to-end automation could lead to data and AI tools being further embedded in daily operations. This is a positive trend, but regulators would need to think through governance implications.
- Valuable, applicable learnings from other sectors will prevail, including the ability to scale on demand - similar to retailers, or tele-finance advice - similar to the advances in tele-medicine. Increased computational research, importance of data insights, and use of ML will be critical in this space as well.
- Financial services regulators have been increasingly looking into their own cloud-first and multi-cloud strategies, and the current crisis might also accelerate this transition.
- As financial services move online, it will be more important than ever to think about populations already underserved by banks and ensure inclusion. Reskilling, further investment in digitisation, and support for SMEs and innovative startups, will continue to dominate this agenda, which cloud can support.

This unprecedented period in our history gives financial institutions and technology firms the opportunity to work together to support our employees, customers and the wider community. ●

Cyril Roux

Chief Financial Officer, Groupama

Will the financial center hold in the current economic sudden stop?

After the Great Financial Crisis of 2008, the Financial Stability Forum turned into the Financial Stability Board, established as a permanent organization with a broadened focus reporting to the G20. In the European Union, the Barnier agenda was meant to address the multifaceted weaknesses of financial markets, infrastructures and intermediaries.

Dozens of directives and regulations were established, in an alphabet soup of acronyms: BRRD, MAD/MAR, SFTR, MiFID, EDIS, MMF, and many more. The ESRB worked with ESAs, Central Banks, national supervisors and the European Commission to measure financial stability risks, to design supervisory tools to address them, such as stress testing and remediation plans, and to develop macroprudential supervision.

In the US, the 2010 Dodd-Frank act introduced new federal agencies (CFPB, OFR, FIO and the FOSC) and a great many new financial regulations. The latter part of the decade saw a concurrent effort to roll back in part this recently increased regulatory burden.

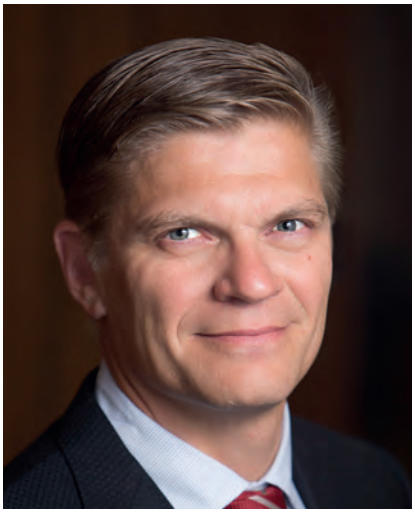
In Europe, this was the avowed focus of Commissioner Hill, while in the US, the impetus was given by the Trump administration and Republican Congress. This didn't prevent the completion of Basel III, however. All the while, low interest rates combined with the capital and liquidity requirements imposed on banks led to an increase of the indebtedness of public and private actors, and that of the size of non-bank financing over the decade. Although much was feared about the concentration of risk in CCPs, the strains and imbalances of the market and regulatory structures manifested themselves in the repo market from September 2019, especially in the US.

Then came the sudden economic and financial freefall which started in March 2020 after a decade of growth. It is a very stern test of the sufficiency, or otherwise, of the microprudential and macroprudential regulations and monetary instruments developed since the GFC. As in the GFC, money-market funds are among the very first to be hit by severe liquidity strains – but for reasons affecting the other side of their balance sheets. In the US, the SEC has moved swiftly to relax the prohibition of sponsor financing to enable money market funds to meet the large redemptions they face. In Europe, the ability to deploy swing pricing and redemption gates may be used, despite the stigma which may be attached to these measures.

The current crisis will also test the appropriateness of the CNAV and VNAV bifurcation of money market funds. So will the promise of liquidity underlying the growth of ETFs. ETF redemptions may be met with payment in kind, especially in credit, to the surprise of some subscribers. As in 2008, the CP market has seized, which is only natural when a wave of delinquencies is expected. The rise of counterparty risk in most of the economy, and accompanying credit downgrades, will stress fixed income funds, trigger loan covenants and increase margin calls. Banks would naturally be under critical stress were it not for the unlimited support of Central Banks, together with regulatory relaxation embedded in CRD IV – a relaxation that the European Union singularly failed to provide for under Solvency 2.

> *The economic freefall is a very stern test of financial regulations.*

More generally, the sudden stop of large swathes of the economy is likely to strain most markets and market participants, including corporates and governments. The least and last affected among financials are likely to be mainstream insurers. Provided they haven't invested unduly in riskier assets, nor taken aberrant underwriting risks (such as guaranteed investment returns or failed to exclude pandemic in their casualty coverage), mainstream insurers should weather the economic and financial storm, as long as governments do not default, notwithstanding broken measures of their solvency ratios based on point-in-time volatilities that say precious little about their financial standing. Should that be the case, as it was during the GFC, this would prove once again the futility of EIOPA and IAIS insistence to try to develop for and impose on the insurance sector an additional layer of systemic regulatory burden. ●



Bjørn Sibbern

President, European Markets, Nasdaq

Cooperation Prevails – Through and Beyond Covid-19

While no one with certainty can say when the human and financial impacts caused by the Covid-19 outbreak will start to subdue, it is my sincere belief, and also hope, that we will begin looking toward and discussing our future rather than contemplating our present questions. The financial community across Europe and the world plays an important role in not just mitigating the effects of the current economic downturn – but also when helping the global economy to get back on its feet. And it will get there faster if we work together.

Right now, in the midst of the Covid-19 outbreak, the focus of the financial industry, governments and others are on making sure we are taking immediate necessary actions. For Nasdaq, this means to ensure the health and safety of our employees and also that the markets that we operate stay functional in order to enable investors to get in and out of positions and to provide companies with a possibility to continue raising capital.

Exchanges will also play a key role in the efforts to recover from the effects of Covid-19, as market places but also as hubs for cooperation through our roles as integrated parts of the wider financial and societal ecosystem.

Exchanges are able to facilitate recapitalizing companies through financial markets. More than ever, market financing should be envisaged as a possible tool to solving financing issues. In the Nordics, where Nasdaq operates most of its European markets, many listed small- and medium sized enterprises (SMEs) have been funded through financial markets and have from this way of financing obtained benefits allowing them to grow. And growth is more important than ever before.

Post-Covid-19, we hope that the visibility we support public companies with will allow them to recruit back talent, refinance themselves and in the longer term continue to grow and create more jobs. It is important that the opportunities that exchanges create are fully leveraged to help remedy the adverse consequences of the Covid-19 crisis.

Exchanges can also support recovery by providing financing for initiatives more directly linked to healing the effects of the virus outbreak, for example Covid-19 recovery bonds aimed at recovering the immediate impact of the pandemic on economies and societies. Even in the current crisis, companies involved in Covid-19 research or hospital supplies may need extra capital.

We expect to also continue working together with governments and regulators to discuss actions to help economies recover. States are crucial to provide support for companies and employees affected by the Covid-19 outbreak, and we would also welcome a discussion on changes to the regulatory landscape that supervises the financial markets to remove barriers for recovery and capital raising for primarily SMEs. The unbundling of research and trading that was part of MiFID II and that has led to decreased visibility for smaller companies is one example of such hurdles.

This unprecedented moment in our history could also see already ongoing trends and shifts in our society accelerate. One such trend is sustainability. Today often discussed in terms of the environment, the social and governmental aspects of sustainability may have an enormous impact on companies' ability to recover and better support the societies in which they operate.

At Nasdaq, we try to do our part by enabling and encouraging companies and investors to make more sustainable choices by, for example, supporting sustainability reporting and data distribution, and also introduce initiatives to increase transparency and comparability between different investment products.

As we one day look back on this time in our history, I hope that we at least are able to say that we did our very best to come out of it as well as possible, and that we did it by working together toward a better and more sustainable future. ●

Marc Bayle de Jessé

Chief Executive Officer, CLS Group

Covid-19 and the importance of resilient financial market infrastructures

The current financial market volatility arising from the spread of COVID-19 has reinforced the need for adequate planning and rapid response by governments and central banks. Stress testing by global systemically important banks is the best example of such planning, requiring adequate capital to withstand sudden shocks while continuing to intermediate credit to households and businesses.

An overlooked lesson of this crisis is the system's reliance on strong, well regulated, and resilient financial market infrastructures (FMIs). Banks, fund managers, corporations and other users rely on FMIs for a variety of critical – if unglamorous – functions that are absolutely necessary to the functioning of financial markets: payments, custody, clearing, and settlement. Such services reduce risks for users (e.g., credit, liquidity) and offer operational efficiency. Simply put, financial markets could not operate smoothly without the key services provided by FMIs.

CLS settles foreign exchange transactions for the largest banks in the world on a payment-versus-payment basis. It thereby reduces settlement risk associated with FX transactions by ensuring that the final settlement of a payment instruction in one currency occurs if, and only if, settlement of the payment instruction for the other currency being exchanged is also final. The funding required to settle is determined on a multilaterally netted basis, reducing the amount of liquidity required for settlement by approximately 96 percent.

During the recent period of extreme volatility in March, CLS volumes increased sharply. The average value of payments settled daily totalled approximately USD7 trillion - about 20 percent higher than normal. CLS processed the added volumes with no issues or delays. As seen in the 2008 crisis, banks turned to CLS knowing their FX trades would settle on time and with finality.

The current crisis is not just a financial test, but also an operational, staffing, and resilience planning one. In the case of CLS, we took early steps to segregate key operational employees, direct other employees to work from home and use technology to maintain the high quality of service our users expect – while communicating regularly with employees, clients, vendors, and regulators.

This crisis is still ongoing, and deriving final conclusions is premature. But some tentative implications can already be drawn. Here are three:

1. Importance of resilience, redundancy and planning
FMIs must not only be operationally efficient, they must be resilient with multiple backups to diversify against a range of scenarios that might affect premises or staff. For example, CLS is diversified across multiple continents, but also has redundant capability. Diversification must be well planned with adequate testing and staff drills to help ensure the service can be delivered without any degradation of service users expect.

> *An overlooked lesson of this crisis is the system's reliance on strong, well regulated, and resilient FMIs.*

2. Introduction of new technologies
In recent years innovations such as blockchain, distributed ledger technology (DLT) and tokenization, among many others, raised the possibility of re-engineering the payments, clearing, custody and settlement space. As service providers and regulators review such technologies, they will want to assure that excitement about potential efficiency gains do not obscure or in any way degrade current levels of resilience and diversification. Indeed the recent environment will reinforce the need for new technologies to demonstrate at least the current level of resilience – and ideally enhance it – before FMI boards and regulators permit the introduction of such technologies for systemically critical services.

3. Expecting the unexpected
Banks typically plan for financial events or physical outages, but the current crisis is directed at human capital. The next crisis might be very different still. Hence, key financial market players, whether banks, asset managers or FMIs are likely to be pushed to plan for an expanded list of scenarios including some that may appear very, very remote. But then, a scenario that has shut down most of the global economy also seemed remote not very long ago. ●

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Monetary policy impacts

Ante Žigman

President of the Board,
Croatian Financial Services Supervisory Agency

It is time to expand macroprudential framework in the non-banking sector

In the view of many investors, the low and even negative interest rate environment (LIRE) has slowly become the most prominent risk that threatens the stability of the financial system in the EU. It has, perhaps, even become the new normal as depressed interest rates marked the entire decade. Although these developments are somewhat lagging in Croatia, as interest rates are relatively higher compared to other EU countries due to national idiosyncratic reasons, they are highly relevant because both banking and non-banking financial sectors are heavily exposed to domestic government bonds, whose long-term yields are rapidly converging towards zero. Insurance companies and pension funds are especially vulnerable to LIRE risks due to their business profiles, which are characterized by negative duration gaps, particularly those that issue products with guaranteed rates and defined benefit pension plans.

While direct risks that negatively affect stability of the financial system are notable, what is more important is the indirect effect that LIRE has on the system through its negative effect on economic activity, which continues to be subdued more than ten years after the global financial crisis. There is a growing consensus that current environment characterized by low interest rates and anemic growth is more determined by structural factors (declining productivity of companies and falling profitability that hinders new investments and contributes to the accumulation of the excess savings, increasing social inequalities, negative demographic trends and risk aversion) than cyclical factors (relaxed monetary policy, over-indebtedness of private and public sectors).

Therefore, the discussion regarding the LIRE should be broadened to emphasize its effect on real economic activity, which eventually impedes the profitability of financial institutions. In order to successfully restart the economic and financial progress in the EU, organized collective effort of all policyholders is needed, such that would focus on long-term and broad-based goals. More specifically, long-term view should take into account sustainability and environmental impact of long-term investments, while broad-based view should be socially sensitive and inclusive. Some steps in the right direction have been made to reach these goals, but majority of the road still lies ahead.

Since we are finding ourselves in uncharted waters, growing emphasis is, and will continue to be, placed on unconventional policy, more specifically on macroprudential policy actions. Therefore, policymakers should utilize the present relatively stable environment to further improve macroprudential regulation focusing on cross-border and cross-industrial harmonization of macroprudential rulebook. Even though macroprudential regulation in banking sector has made significant leaps following the global financial crisis, progress in non-banking sector is still lagging, which creates possibilities for regulatory arbitrage. The significance of closing this regulatory gap is even more highlighted by the rising importance of the EU non-banking sector as (investment and pension) funds and insurance companies are steadily increasing in size, are becoming highly connected (directly and, more importantly, indirectly) with the rest of the financial sector and are strengthening their relevance as a source of funding for the real economy.

> *We are swimming in uncharted waters and growing emphasis is being placed on macroprudential policy.*

In other words, policymakers should work proactively to improve their macroprudential toolboxes, following the banking example but also taking into account industries' specificities and the current macroeconomic and financial environment (LIRE), while simultaneously improving the resilience of financial system in order to support sustainable long-term investments. ●

Jean-Jacques Bonnaud

EUROFI

For a new Bretton Woods

The coronavirus pandemic beyond its health aspects, will profoundly disrupt the economies of the planet for a long time to come.

The brutal and widespread recession in the global economy this year will trigger a worldwide wave of public spending to limit the social effects of the recession such as unemployment or the disappearance of cash flow in many companies. It will however increase public and private indebtedness, which risks accelerating imbalances in indebted economies and slowing down structural reforms that have not yet been carried out, while new sources of imbalances are emerging with the violent fall in oil prices, the probable fall in the price of certain raw materials, the financing needs of an inevitable energy transition and the negative effects of geopolitical conflicts such as the Sino-American strategic conflict.

The European Central Bank and Member States have already implemented significant and timely monetary and budgetary measures to deal with this global crisis and to ensure there is ample liquidity across the EU. But Europe must fight the tendencies towards fragmentation accentuated by the national egoism visible in the health crisis. At the moment the EU is facing one of its biggest economic challenges, it needs to make a collective effort in favour of a " shared sovereignty" on the political, economic, industrial and health levels if it wishes to exist in the face of pressure from a China that is filling the void left by the American weakening that has been perceptible since long before the Trump mandate.

More generally, it is the entire system of international economic relations that needs to be the subject of in-depth review because the problems and solutions are cross-borders. Even if this perspective may seem optimistic or even utopian, this crisis is an exceptional opportunity to make progress towards the implementation of stabilization mechanisms that take into account the major challenges common to the entire planet. Fortunately, elements of such a consultation have already been initiated, particularly in the climate field.

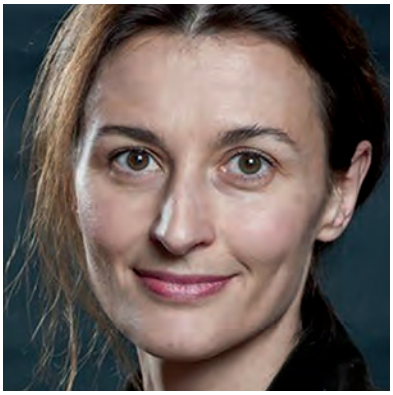
But if we want true global collaboration, we must also reorganize the international monetary system. Indeed, the "non-system"; in which we live has a great disadvantage: The absolute freedom that reigns in the exchange rate area raises suspicion. The easing of monetary policies by some countries is often seen as a disguised way of depreciating their exchange rates. In fact, since the end of the war, we have never been so close to the situation in the thirties ("beggar thy neighbour").

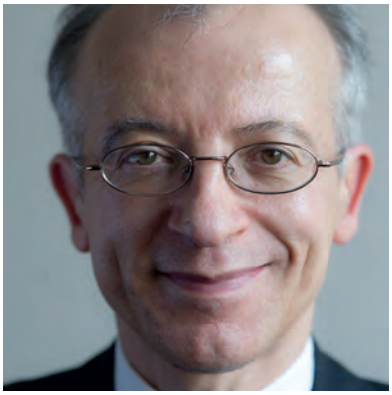
> *It is time for the major dominant economies to understand that a minimum of stability is in the common interest.*

Consideration must be given to the future pivot of the future system in order to stabilise exchange rates: should we envisage a return to gold, or to a revisable basket of raw materials - which would undoubtedly be better adapted to today's multipolar world, or to Special Drawing Rights additional to the rights stemming from a Monetary Fund with revised quotas? It is also necessary to work on the means of organising and monitoring, around the IMF, effective surveillance of the new system.

This work could be entrusted to a small 'Group of wise men" including experts and representatives of the major international financial institutions: BIS, IMF, Central Bank of China, Central Bank of Russia, etc. , in order to take stock in a forward-looking manner of the possible options and possible timetables.

It is time for the major dominant economies to understand that a minimum of stability is in the common interest. ●





Natacha Valla

Deputy Director General, DG Monetary Policy, European Central Bank (ECB)

Christian Pfister

Deputy Director General, DG Statistics, Banque de France

Helicopter money: Panacea, shell game or Faustian pact?

Since the GFC, proposals for economic stimulus through the recourse to helicopter money have multiplied. Recently, the measure has been associated with the issuance of a central bank digital currency or the fight against the Covid-19 epidemic. It is thus seen as a panacea. This piece is meant to be factual. It describes the concept and the advantages it is supposed to bring, to show that it is more akin to a shell game, if not a Faustian pact.

The concept of helicopter money

The concept of helicopter money is old. It already appeared in Friedman's essay *The Optimum Quantity of Money* (1969). Friedman describes it as a "thought experiment" in which a helicopter flies over a society that has reached a state of economic equilibrium and drops bills that are hastily collected by members of the community. He shows that the measure has no long-term effect on the level of output, only on the level of prices. In the short to medium term, output can rise or fall, due to opposite effects on demand (part of the helicopter money is spent) and supply (labour supply is reduced). Only much later did Bernanke (2003) suggest that Japan could combat deflation by pursuing a policy of public deficits financed by permanent purchases of public securities by the central bank. Bernanke (2003) stresses that the central bank's balance sheet is protected, since it holds a claim on the Treasury. However, this protection precisely prevents the measure he suggests from being regarded as helicopter money *stricto sensu*. Indeed, helicopter money is a gift on the part of the central bank: bills are dropped from the helicopter without the central bank acquiring a counterpart and thus correspond to a loss on its books. The gift approach has been rationalized by many, eg Caballero (2010), within a monetary and fiscal policies coordination framework.

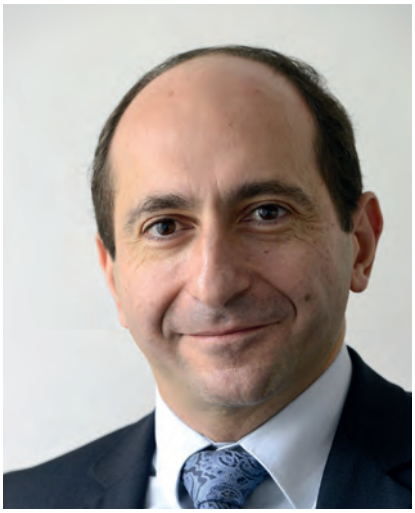
Helicopter money and public finances

On public finance side, public debt does not increase. In accounting terms, that is true but, since the aim is to have a public deficit financed by the creation of central bank money, it is the total made up of the general government and the central bank balance sheets that must be taken into account. Indeed, the increase in the Treasury's account at the central bank in the first instance, and the increase in banks' accounts at the central banks in the second instance, following expenditure by the Treasury, increases the liabilities of the central bank by the amount of the creation of helicopter money (Cecchetti and Schoenholz, 2016). The consolidated debt of the central government and the central bank thus increases. Furthermore, the money created has no cost for public finance. Again, that is accountingly true, at least in the very short term. However, the seigniorage of the central bank, and thus the profits it can pay to the State, are permanently reduced. Indeed, the increase in reserves held by the banks entail a fall in banks' refinancing and/or an increase in banks' excess reserves, which are remunerated. To do otherwise, the interest rate on the excess reserves (the deposit facility rate in the case of the Eurosystem) would for example have to be set permanently at zero, which would be tantamount to abandoning any monetary policy (Borio et al. 2018). It therefore seems that presenting helicopter money as having no impact on public debt and deficit boils down to a shell game. It is the "free lunch" where Borio et al. (2016) see an illusion.

Helicopter money and the central bank

On the central bank side, helicopter money would first circumvent banking intermediation. This seems self-evident but it would clearly be a "second best" compared to relying on the banking system. Indeed, banks have a better knowledge of their customers' finances than public authorities have of their taxpayers'. Second, helicopter money would have a substantial impact on demand. In fact, much would depend on how the measure is perceived by the public. In particular, if it were seen to reflect a diminished ability of public issuers to access capital markets, the public might become concerned and increase their savings. In this regard, Bernanke (2016) proposes that the central bank itself should decide, on a legislative basis, on the appropriateness and the amount of helicopter money. However, even under the difficult conditions associated with the Covid-19 epidemic, no government has considered establishing such a legislative framework, perhaps precisely for fear of damaging its reputation. Third, seen from an ex ante perspective, it should be easy to withdraw once the economic recovery objective is achieved. But its withdrawal should then produce the opposite effect to its implementation. If the measure were to become permanent to avoid this circularity, monetary policy and the central bank's balance sheet would be permanently affected. A Faustian pact would thus have been signed. ●

The views expressed in this article represent those of the authors and not of their institutions.



Didier Borowski

Head of Global Views, Amundi

That's one small virus for man, one giant leap for economic policy

The global economy has entered the most severe recession since the 1930s. But this is a new kind of crisis by its very nature. Comparisons with the Great Financial Crisis of 2008 or the Great Depression of the 1930s are misleading because at its source, this is neither a financial crisis (there was no bubble burst) nor a debt crisis (even though the world has entered this recession with historically high levels of private and public debts). The collapse in economic activity has not been triggered by the direct impact of the epidemic but by the global lockdowns, which have brought entire sectors of the world economy to a standstill. Half of humanity are confined to their homes, which is unprecedented in modern history.

Two essential things must be kept in mind. First, an epidemic is by its nature temporary. Second, given the characteristics of Covid-19 (low mortality rate in the labour force), potential GDP growth should not be affected in the medium run.

It was therefore necessary first to prevent the economic crisis from becoming a true financial crisis. Governments and central banks were equal to the emergency. Economic policies implemented on both sides of the Atlantic are unprecedented on both the fiscal and monetary policy fronts, with stabilisation plans equivalent to 10% to 20% of GDP (including loans and guaranties) and an expansion of central banks' balance sheets unseen throughout history.

Stabilisation programmes are being carried out in different ways on each side of the Atlantic, but the spirit is the same: the aim is to maintain macro-financial stability, compensate temporary unemployment, and avoid a full blown credit crunch with cascading corporate bankruptcies and defaults. The common goal is to protect the economy as much as possible during the recession in order to allow recovery once the epidemic is under control.

At the end of the day we are witnessing a de facto merger of central bank and Treasury balance sheets. Public debt will de facto be monetised. Debt securities will be purchased by central banks in order to keep bond yields at a very low level. The entire yield curve is now under control. Sovereign debt issuance (net of redemptions and central banks' purchases) will be negative in the major advanced economies in 2020. In the United States, it is the first time this has ever happened. Given the scale of the ongoing recession, public debts will rise very sharply, and bond yields would have soared without central banks' asset purchases. Subsequently, central banks' balance sheets will soar in tandem with public debts. Governments have become the buyers of last resort, while central banks are playing their role as lenders of last resort. Fiscal and monetary policies have become intertwined, and this is not reversible.

A crisis of this nature thus calls for a paradigm shift in terms of economic policy. Historically, economic and financial crises have always given the authorities an opportunity to equip themselves with the appropriate instruments to contain them. Indeed, it was following the crisis of the 1930s that the Fed adopted the statutes that enabled it to deal with the GFC in 2008. And it is thanks to the 2012 sovereign debt crisis that the ECB is today able to support (among other things) the guarantees provided by the governments. Most of the tools mobilised (or that could be mobilised today) in the Eurozone were put in place after 2012 to save the euro.

> *We are witnessing a de facto merger of Central bank and Treasury balance sheets.*

How long will central banks be able to monetise debts without causing a general loss of confidence? How long can interest rates be kept so low? Can inflation resurface? All these questions will likely remain unanswered for a while. The only certainty is that fiscal dominance has now become a reality among the major advanced economies. And whether we regret it or not, this process is not reversible.

For those who fear that a global debt crisis is looming, it should be remembered that debts owed to the central bank are unique in that they can be spread over time indefinitely, or even partially cancelled painlessly.

Ultimately, the policies that are put in place will inevitably shape the debate once the crisis is over. In Europe, leaders will at some point be forced to recognise that a single federal budget and a single financing instrument for the Eurozone would probably have been more efficient to manage this crisis. The birth of a European budget and a common debt will perhaps be the institutional traces that this crisis will leave in history: a forced march towards the "United states of Europe". ●

II. GLOBAL COOPERATION GOING FORWARD

Issues at stake

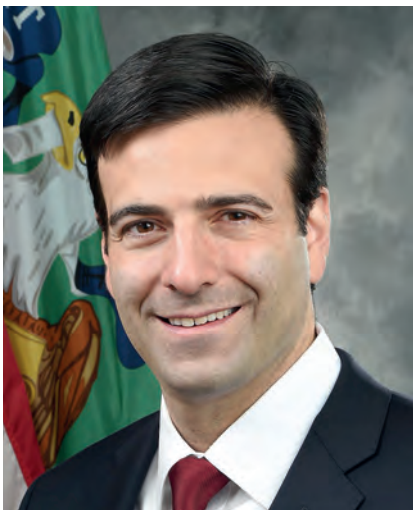
The effects of the pandemic and the turbulence on financial markets remind us that our economies and financial systems are closely interconnected and that developments in different jurisdictions may have important contagion effects across the global financial system.

The G20 reforms have produced a more stable international financial system. However, market fragmentation subsists (e.g. with an often differing implementation of global rules at a jurisdictional level), creating risks and hampering the resolvability of banking groups by trapping funds in their different components. Examples include measures relating to bail-in, ring-fencing, resolution and capital buffers. Internationally coordinated action to support a well-functioning, resilient financial system therefore remains a priority.

Brexit is creating further challenges. Although the terms of a potential trade deal are still to be defined, future EU-UK relations in the financial sector will most likely be based on bilateral equivalence. This may have significant impacts on the current dynamics of EU capital and wholesale markets in particular, which are highly integrated with the UK and use the City as a hub. Efforts have been made to improve equivalence determination processes with more transparency, but these will remain a unilateral decision for which no long-term commitment can be guaranteed (e.g. if rules diverge over time) and not all activities benefit from such arrangements.

Content

Addressing growing global financial fragmentation



Heath Tarbert

Chairman & Chief Executive,
U.S. Commodity Futures Trading Commission (U.S. CFTC)

A sustainable system of supervisory cooperation

It is almost tautological to say that our derivatives markets are global, something we witnessed before the 2008 financial crisis and in its aftermath. As a result, exposed deficiencies in those markets required us to find a solution that went beyond national borders. In that regard, it cannot be said enough that the post-crisis G20 reforms have produced a more stable international financial system. The benefits have been manifold, as evidenced by the resilience of the derivatives markets during the recent period of extreme volatility wrought by the coronavirus pandemic. Unlike in 2008, the derivatives markets are now serving as shock absorbers of systemic risk.

In many ways, the G20 reforms promote ever more globally-integrated derivatives markets. Agreed internationally and implemented locally, the reforms enable local regulators to address the nuances of their markets while adhering to common principles around the world. When regulators operate on the basis of comity among jurisdictions applying comparable regimes, it both strengthens the effectiveness of the G20 reforms and enables the derivatives marketplace to serve its important role of mitigating risks within international financial system.

Now more than a decade after the G20 reforms, we are increasingly witnessing a transition from a collection of disparate and sometimes conflicting national regulatory regimes to a shared regulatory paradigm underpinning the world's largest derivatives markets. This has made the possibility of regulatory deference more than simply aspirational for national regulators. For our derivatives regulatory landscape now holds the promise of fostering a sustainable system of cross-border supervisory cooperation.

Pre-crisis, the U.S. regulated derivatives market was primarily a cleared futures market traded on exchanges. It was a mature market with deep liquidity that permitted foreign participants to access its liquidity without adhering to U.S. laws. The U.S. futures regime entailed, and still provides, a great deal of deference abroad. Post-crisis, the G20 reforms set out a new regulatory approach for the swaps market. In the U.S., an early adopter of the G20 swap market reforms, the swaps market was open for business but the price of admission was strict adherence to American rules.

In 2012, CPMI-IOSCO's PFMIs catalyzed a new path in financial market regulation. With internationally-agreed baseline standards for market infrastructures—generally CCPs, trade repositories, and payment systems—supervisors now had a means to harmonize different local adoptions of the G20 commitments. Equivalence, comparability, and substituted compliance became modes of trust between authorities in the oversight of globally active FMIs.

> *We set our sights on a cooperative supervisory approach, grounded in comity and mutual respect....*

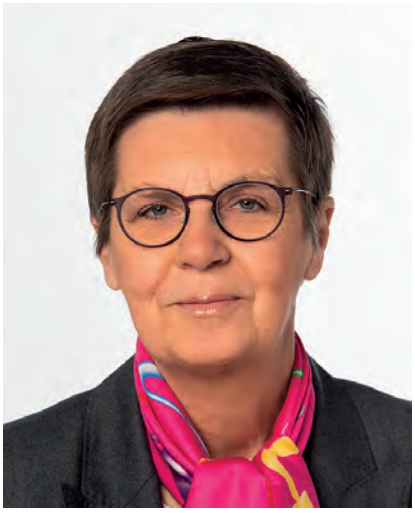
From recognizing the comparability of our respective regimes, we set our sights on a cooperative supervisory approach, grounded in comity and mutual respect, where host country regulators may rely upon a home country regulator when each has adopted comparable international standards, such as the PFMIs and other G20 reforms. When effectuated as a two-way street, this approach streamlines burdens and limits the risk of inconsistency in host jurisdictions while recognizing the accountability of the home jurisdiction's authority.

The CFTC has taken many steps to pursue regulatory comity with like-minded jurisdictions. In July 2019, the CFTC and Japan Financial Services Agency agreed to assess comparability ▶

for regulating certain derivatives trading venues in the U.S. and Japan, respectively, using an outcomes-based approach. In December 2019, we issued proposed rules governing the cross-border swaps market that recognize the importance of a substituted compliance process for foreign-based swap dealers. These rules also establish a framework for seeking comparability determinations for applicable foreign regulatory regimes. In February 2020, we proposed swap data reporting rules to harmonize our reporting system with relevant CPMI-IOSCO standards and those utilized by other regulators, including ESMA. And we continue to pursue supervisory cooperation arrangements built on mutual respect and comity.

Supervisors in Europe, Asia, and the Americas can cooperate in mutually beneficial ways to maintain vibrant and resilient global derivatives markets. The alternative could be a state of overlapping and conflicting rules that introduces complexity and risk to the international financial system.

We must strike a balance that respects the supervision of primary authorities while preserving the ability of host country regulators to oversee their markets as appropriate. A supervisory approach based on comity and mutual respect among regulators, grounded in international standards, will help ensure that our markets continue to thrive in the decades to come.



Elke König

Chair, Single Resolution Board (SRB)

Closer international cooperation as the basis for mutual trust

Resolution strategies for banking groups with subsidiaries in several countries can follow either a single point of entry (SPE) or a multiple point of entry (MPE) approach. For groups with centralized structures, resolution authorities (RAs) will likely opt for an SPE approach and apply resolution tools at the parent level, while groups with a sufficiently decentralized structure may be subject to an MPE strategy.

SPE relies on the concept that the parent, being the resolution entity, will be the subject of any resolution action. This allows for the efficient allocation of resources within a group in going concern; in gone concern, the upstreaming of losses and down streaming of resources from subsidiaries and maintaining critical functions must be secured.

By contrast, an MPE strategy would be considered if a bank's structure is based on reasonably independent - in particular "self-funded" - entities or sub-groups. This would result in multiple, operationally independent resolution entities within a group that may be resolved without affecting the other entities or sub-groups. The prevention of contagion entails a challenging trade-off between banks not being fully decentralized in going concern for operational or supervisory reasons, but entirely separable in a resolution event, as outlined in a recent article by Antonio Carrascosa[1].

The Banking Package strengthens the feasibility and credibility of implementing SPE, by requiring RAs to set internal MREL and TLAC requirements, which should facilitate loss absorption within a group. However, the new provisions also provide for a high level of pre-positioning of internal MREL, potentially leading to locked-in capital. It is too early to judge the consequences, but the SRB is concerned that this de facto ring-fencing within the EU might reduce substantially the needed financial flexibility at parent level.

Ring-fencing can increase risks and hamper resolvability, by trapping funds in different parts of the group, thereby not allowing for the optimal allocation of capital, resources and bail-inable liabilities within a group. In contrast, host countries fear that they might have to foot the bill if the subsidiary of a foreign banking group in their jurisdiction were to fail.

> *Trust among authorities is the main driver to overcome ring-fencing attempts.*

For this reason, we encourage policymakers to take forward concrete work on a legally enforceable group insolvency support mechanism for banking groups. These measures should apply to banking groups in Europe, but concrete solutions are also needed at FSB level. In the meantime, the SRB has made "bail-in playbooks" a priority of its work since 2018 and is focussing

on credible and executable plans to upstream losses and downstream capital within a group, if need be.

Moreover, the SRB strives to further enhancing mutual understanding among RAs in the Banking Union and beyond. We are dedicating considerable efforts to reaching joint decisions on MREL and involving not least NRAs outside the Banking Union with material subsidiaries in determining resolution strategies. Similarly, the SRB has enhanced cooperation with third countries through cooperation agreements, workshops and multilateral simulation exercises. We remain convinced that trust among authorities is the main driver to overcome ring-fencing attempts.

1. https://www.risk.net/comment/6787136/how-to-adapt-a-bank-for-mpe-resolution-strategy

Debra Stone

Managing Director and Head of Corporate Regulatory Affairs, JPMorgan Chase &Co.

Market fragmentation: through a different lens?

In June 2019, the FSB and IOSCO each published reports on market fragmentation and frictions in global financial activities. In particular, they focused on whether regulatory reforms adopted in response to the 2008 global financial crisis may have given rise to fragmentation.

The reports make it clear that certain types of fragmentation may be intended, but unintended fragmentation could raise issues for financial stability and the effective oversight and supervision of financial markets.

The current COVID-19 pandemic is a public health crisis with spillover to the real economy. The crisis should demonstrate that strong banks can prudently support households and businesses through lending, intermediation, and other activities to ensure the smooth functioning of the global financial system.

Both global standard setters and individual jurisdictions have quickly begun to address aspects of the current regulatory framework that could constrain banks' full support for the economy, such as lack of clarity around the use of buffers. Various recent announcements from the BIS, FSB and IOSCO are positive indicators of coordination at the global level.

Decisions by Basel to delay the implementation of Basel III, and by BCBS and IOSCO to extend the deadline for completing the implementation phases of the margin requirements for non-centrally cleared derivatives, should assist in avoiding the type of fragmentation identified in the FSB Report that results from differences in timing of national implementation of international standards. However, it remains to be seen as this current crisis continues, whether issues arise that make the case for further cooperative mechanisms among jurisdictions.

A type of fragmentation that has been recognized as most difficult to address is described in the FSB report as "jurisdictional ring-fencing." Prior to this crisis, the discussion focused on whether these requirements, if excessive, could impact financial stability by impeding the ability of firms to allocate resources where needed in times of stress.

> *It remains to be seen whether issues arise that make the case for further cooperative mechanisms...*

Now, tensions may arise if a firm's need to allocate resources to support lending and markets is not aligned with the views of regulators and supervisors as to the level of resources that should be maintained in a particular jurisdiction or legal entity. The COVID backdrop may highlight these tensions and how these types of requirements should or could operate in a stress situation.

The COVID-19 crisis may also shed light on other regulatory approaches that had not been a focus of the 2019

fragmentation reports, such as the development of standards and supervisory approaches around operational resiliency. This area may be informed by actual experiences from this crisis and further emphasize the need for a coordinated, rather than fragmented approach, across jurisdictions and regulators.

In the midst of this crisis, actions must be taken quickly to address the crisis; when the crisis subsides, there will be an opportunity for policymakers and financial institutions to look at the issues of fragmentation through a different lens.

Tetsuro Imaeda

Chief Executive Officer, Sumitomo Mitsui Banking Corporation Europe,
Managing Executive Officer and Head of EMEA Division,
Sumitomo Mitsui Banking Corporation

Regulatory fragmentation – potential approaches

Economic cooperation and international trade contribute to stability and wealth. Inconsistent regulation may introduce friction, reduce efficiency and use resources that could be put to better use. Through bodies such as the Basel Committee, FSB and IOSCO global policy makers have developed internationally agreed regulatory standards for the financial markets.

However, the stresses in the global financial system since the 2008 financial crisis have acted as a major brake on globalisation, partly because countries have focused on national legislative solutions and partly because detailed country or regional implementation of the post-crisis reforms has been inconsistent. Global policy makers have a central role in mitigating the effects of market fragmentation arising from financial regulation.

So, what are the factors which have contributed to market fragmentation?

Despite efforts by regulators to work collaboratively, implementation at a jurisdictional level often differs, sometimes in seemingly insignificant ways. However, the impact may be material. An example is the jurisdiction-specific implementation of the G-20 standards on trading, clearing and margining of over-the-counter derivatives. These standards were intended to make trading safer but have introduced friction and inefficiency in cross-border trading.

When combating crises, local policy makers tend to focus on protecting taxpayers and ensuring financial stability at a country level. Examples include measures relating to bail-in, ring-fencing, resolution and capital buffers.

The purpose is to insulate the national or regional economy from loss by ensuring firms' capital and liquidity is available at a local level. This comes at a cost to regulatory harmonisation and broader economic stability.

Fragmentation may also be driven by rules restricting the ability of non-nationals to access financial markets. Although the final stages of the UK withdrawal from the EU are yet to be played out, it is clear that the withdrawal will result in reduced access to the EU market for UK financial service providers and similar restrictions for EU firms accessing the UK market, giving rise to a patchwork of market access solutions across the EU.

How should global policy makers approach these issues?

It is crucial to develop a greater understanding of fragmentation. Policy makers can ensure that a review of cross-border regulatory issues becomes a regular item in their regional meetings, with detail of where and why fragmentation is happening, and at a global level they could add to their agenda an annual evidence-based report on the unintended consequences of fragmentation.

There should be a targeted expansion of the use of bilateral arrangements such as Memoranda of Understanding to gather information relevant to fragmentation.

Existing cooperation can be improved by making regulatory fragmentation a consistent topic in the work of supervisory colleges, examining topics such as resolution and the pre-positioning of capital and liquidity by international banks.

Finally, policy makers should use the emergence of the digital economy as a catalyst for enhanced international cooperation through the creation of a consistent cross-border approach to the regulation of new products and participants.

Wilson Ervin

Vice Chairman, Credit Suisse

Into the ring: Basel III vs. COVID Crisis

The COVID-19 pandemic is first and foremost a human tragedy. It is also wreaking havoc on health systems, social freedoms and economies. Will it do the same to the new Basel III (B3) regulatory regime? B3 was a powerful impetus for banks to strengthen their resources. But how will B3 perform when it leaves the training stage and enters the ring, for a real fight against a sharp economic crisis?

Round I – the initial shock: The last decade has been well used to address the glaring gaps exposed in the GFC and build robust capital and liquidity. Coupled with swift steps by central banks, the financial system has withstood the initial punch of the COVID Crisis. Unlike 2008 or 2012, banks are generally seen as strong and part of the solution. B3 has won the first round.

Round II – procyclicality: B3 is risk-sensitive, which is good for "point in time" risk assessment. But this creates problems for policymakers looking to smooth an economic cycle. In the last few weeks, economic and financial risk measures have spiked. This will push up RWA for existing balance sheets, as VaR models, credit downgrades, commitment drawdowns, counterparty risk rules, IFRS9, etc. roll into the calculation machinery of B3.

Estimates for RWA inflation range from ca. 10% to 30%+. This will cut capital ratios by 100 to 300 bps, eating into buffers when they're needed most. This will reduce banks' ability to absorb credit shocks or expand lending. Regulators have already leaned against some of the drivers, like IFRS calculations. More footwork is needed to parry this issue in the short term, together with a fundamental review in the longer term. The crisis looks to win this round, on points.

Round III – buffers: The capital B3 stack is a complex layer cake of minima and buffers. While the official minimum CET1 is 4.5% of RWA, few think regulators (or markets) would all allow all buffers to be released and allow a major bank to dip so low.

We don't yet know how much credit damage will be caused by the economic shutdown from COVID. If the credit cycle is harsh, some banks could see capital drawdowns on top of the RWA pressures noted above. This will force a tough tradeoff between two goals: supporting the real economy and supervisory comfort with lower capital levels. Round III will be close – it's too early to call.

Round IV – fragmentation. A fragmented banking market means that local COVID hotspots hit local banks, intensifying the impact in both financial and operational terms. An incomplete Banking Union is not helpful.

Home-host dynamics in the new regime are also untested. How will drawdowns be shared between nations: Will hosts release buffers to help a struggling home, or vice versa? Without cross-border cooperation (resource sharing), our research shows that bank risk can rise by 4x or more. Without clear rules of the road, local legal entity issues could create bottlenecks at exactly the wrong time. The FSB has identified fragmentation as a possible 'glass jaw' of the current system. Strong cooperation between homes and hosts is important to avoid a KO punch.

> *Pro-cyclicality, buffer flexibility and fragmentation were theoretical issues just a few months ago – now they are critical regulatory challenges.*

Europe could build on precedents like the successful 2009 Vienna Initiative (which addressed home-host tensions in the southeast region), perhaps via crisis-proof home host financial support agreements. Broader branching could provide another solution. Europe has often advanced in crises, and we hope it emerges stronger from this round.

Basel 3 – the new financial regime - won the first round but has several tough rounds to go. Procyclicality, buffer flexibility and fragmentation were theoretical issues just a few months ago – now they are critical regulatory challenges. A successful response to each is essential if banks are to both remain safe and support the critical needs of the real economy. ●

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Optimizing third-country approaches in the financial sector

John Berrigan

Director-General, DG for Financial Stability,
Financial Services and Capital Markets Union, European Commission

EU equivalence policy – a tool for regulatory convergence

The EU is one of the most open financial systems in the world, with very significant financial flows to and from the EU. There are hundreds of non-EU players in the EU market and EU players are present in all financial systems around the world.

The key instrument, with which the EU manages risks deriving from interconnectedness and exposure to third-country financial systems, is equivalence. Equivalence is about risk management - ensuring that financial stability, market integrity, and the protection of EU investors and consumers are safeguarded, even when there is a level of deference to a third-country authority.

The key questions before granting equivalence are: will the third-country authorities manage risks for EU firms the same way as they manage their own? Even more importantly, in case of a crisis, does equivalence ensure that we can really rely on third country authorities to manage risks for our own economic operators?

The Commission has an established practice of deferring to and cooperating with third-country supervisors; 280 equivalence decisions have been granted in respect of more than 30 third countries. With its Communication of 29 July 2019, the Commission has reaffirmed that risk management is the cornerstone of its equivalence policy. It has also reiterated that equivalence requires a risk-based and proportionate approach. This means that the higher the potential impact of a third-country market on the EU, the more thorough the equivalence assessment.

The Communication highlighted that trust is essential to underpin deference and that EU foreign policy priorities are relevant for equivalence assessments, including for instance anti-money laundering arrangements and/or tax governance.

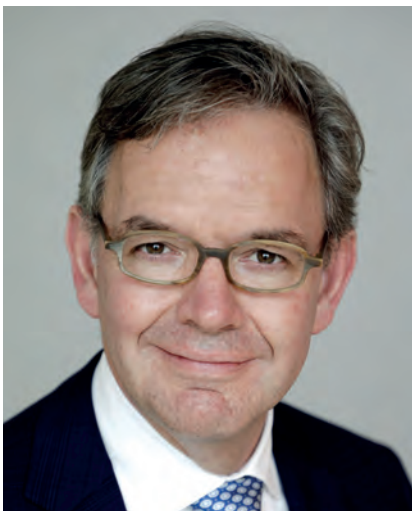
The Communication summarised recent developments, such as the targeted amendments to third-country regimes, in particular for Investment Firms, for CCPs and the enhanced role for the European Supervisory authorities, notably on monitoring equivalence decisions.

On process, the Communication detailed further transparency steps, e.g. through its better regulation practice of public consultation periods before adopting decisions. It presented plans to systematically monitor existing decisions. Normally, this would take place through dialogue with the Commission affording an opportunity for the third country to remedy any gaps identified. If gaps cannot be remedied, equivalence can be withdrawn as in the case of some Credit Rating Agencies decisions in July 2019. If conditions for equivalence were to change more suddenly, the process leading to withdrawal might become more rapid.

Equivalence policy is fit for purpose for the assessments of the UK, as for other any third country. It will be a key tool to handle EU-UK relations in the financial sector in the future. Irrespective of the outcome of equivalence assessments, UK-based financial institutions will lose their access to the single market based on their UK authorisation after the transition period. Those UK institutions that want to guarantee the provision of services to EU clients across the single market are aware that they will need an establishment in an EU Member State. Ultimately, it is a choice for each firm to decide how it organises itself and which clients it wants to serve.

On the risk of cliff-edge at the end of the transition period, the situation is different from the no-deal risk in 2019. The Withdrawal Agreement provides sufficient time for firms to take the necessary steps to cater for the change in their regulatory regime. Firms need to use the months left until the end of transition period to adapt their operations. Overall, counting from the day of the referendum in 2016, they will have had four and a half years to prepare. ▶

The Commission will constructively engage with the UK in all equivalence areas and gather facts, with the intention of concluding its unilateral equivalence assessments by June 2020. However, the deadline refers to the mapping, not to the decisions themselves. Further, the UK's stated intention to diverge from EU rules makes assessments more complicated. Equivalence is typically the outcome of a convergence process but, in the case of the UK, the Commission will need to consider the extent of possible UK divergence in its initial assessments. This implies a thorough and forward-looking assessment of how the UK regulatory and supervisory framework will operate after the transition period, and whether it will deliver similar outcomes as the respective EU framework.



Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

Enhancements to the EU equivalence framework

Effective cross-border regulation and supervision is an essential prerequisite for the development of strong, efficient and safe global financial markets. In this regard, open access to financial markets needs to go hand-in-hand with an effective supervisory toolbox for authorities, in both home and host jurisdictions.

The financial market regulatory framework in the European Union (EU) offers market access by market participants from third countries based on equivalence and recognition regimes. While not available to all sectors, these regimes still constitute, from a global perspective, the most extensive application of the "deference" principle agreed back in 2013 by the G20.

Internationally active market participants have benefitted in the past years from the aforementioned European approach, and market fragmentation has been kept limited in areas such as securities trading and clearing.

With the United Kingdom leaving the EU, which has Europe's largest capital market, the EU needed to accelerate the improvement of third-country arrangements as they were designed many years ago. In January 2020, a number of important changes in the EU equivalence and recognition frameworks became applicable, without, however, changing the main underlying principles of these frameworks.

Firstly, ESMA will continue to play an advisory role to the European Commission regarding the assessment of non-EU regulatory and supervisory frameworks in order to facilitate equivalence determinations. In addition, ESMA will take up the important task of monitoring relevant developments in those areas and jurisdictions where equivalence has been declared. To this end, ESMA will strengthen its ongoing cooperation with non-EU regulators and seek to better understand their domestic frameworks as well as their effectiveness. The revised ESMA Regulation requires ESMA to report on its monitoring activities to the European Institutions on an annual basis.

Secondly, in relation to CCPs, the EU introduced a more proportionate framework for the recognition and supervision of non-EU market participants. In particular, EMIR 2.2 sets out an enhanced recognition regime for systemically important third-country CCPs, whereby such CCPs will have to comply with EMIR requirements and be subject to certain supervisory powers of ESMA's. The current arrangement with ESMA's full reliance on non-EU supervision will continue to apply with regards to all non-systemic third-country CCPs. The final legal framework allowing ESMA to distinguish between systemically important and non-systemic CCPs has however yet to be established.

> *ESMA will take up the important task of monitoring relevant developments in those areas and jurisdictions where equivalence has been declared.*

Thirdly, enhancements were also introduced regarding non-EU Investment Firms (under the Investment Firms Review legislation), and here ESMA will receive improved monitoring and information powers as of mid-2021 in relation to firms from equivalent jurisdictions.

Fourthly, and finally, the revised ESMA Regulation contains a requirement for the European Commission to provide, in due course, a report regarding the need to enhance equivalence arrangements, with a possible supervisory role for ESMA, in relation to non-EU trading venues and CSDs.

Looking at these examples, it is clear that the EU equivalence regimes are changing. On the one hand, the equivalence frameworks will continue to be an important arrangement allowing to avoid market fragmentation while preserving open markets and a level-playing field between global market players active in the EU. On the other hand, a more proportionate approach to systemic and non-systemic non-EU market players is needed, combined with direct supervisory powers at European level, in the interest of EU financial stability and investor protection.

Shinzuke Toda

Managing Executive Officer, Deputy Head of EMEA,
Mizuho Bank, Ltd.

The longevity of the equivalence framework in a post-Brexit world

The enhancements proposed to the EU approach towards cross-border regulation and supervision of third country entities include a more granular perspective in respect of determinations of equivalence where there is systemic risk and ongoing monitoring of compliance with applicable standards by the European Supervisory Authorities (ESAs). However, the increased scrutiny and consequent increased risk of withdrawal of equivalence poses serious risks to business continuity for market participants and the wider health of the European economy as there is an inherent paradox where compliance with internationally agreed standards does not result in the maintenance of equivalence. This is particularly the case when equivalence is used as a political tool rather than to promote the integrity and resilience required for the financial markets to flourish. Outcomes-based equivalence, based on compliance with international standards (such as the Basel accords), should therefore be the preferred option and we urge policymakers to prioritise the principles of objectivity, proportionality and risk sensitivity.

There will be greater scrutiny of delegation, outsourcing and material risk transfers (such as back-to-back business) to third countries by the ESAs, which is welcomed to ensure effective supervision and enforcement in respect of third country players, provided that the regime is proportionate and the rules are clear as to what is permitted. The increased cooperation of the ESAs with third country regulators is welcomed; as seen in the Japan / EU EPA, regulatory cooperation should reduce the risk of regulatory arbitrage and ensure a level playing field for non-EU players. It is important to remember that although the enhancements to the third country regimes have arguably been motivated by Brexit, the changes will also affect any non-EU firms operating on a cross-border basis into the EU (including those in the US and Asia). This strengthens the argument that any changes in enforcement should be proportionate. For this reason, special consideration should be given to equivalence regimes between the EU and third countries to develop stable and resilient regulatory relationships that do not significantly affect financial links between the EU and these jurisdictions.

In relation to Brexit, both UK and EU financial markets will inevitably be harmed by the UK's withdrawal. Although marginally differing regulatory regimes may be necessary to respect sovereignty, material gold-plating of requirements may trigger third country banks to consider the extent of their presence and business model in Europe. Regulatory divergence would result in (i) operational inefficiency due to the need for greater investment to set up operations in each jurisdiction, losing the economies of scale of a centralised model (ii) higher transaction and compliance costs, caused by different procedures and documentation required under different regulations, (iii) reduced liquidity if, for example, investors in the EU cannot invest in certain UK markets, ultimately impacting investor demand and (iv) more restrictive market access, which is highlighted by the potential loss of an EU passport for UK incorporated financial institutions after the transition period. Specifically, we would welcome UK CCPs being declared equivalent after the transition period to ensure that EU participants may continue to use them for clearing. Another market concern seems to be that UK and EU derivatives trading venues should be declared equivalent so as not to adversely affect liquidity and to allow UK and EU market participants to trade on the same venue (known as the derivatives trading obligation under MiFID II).

Therefore, we would welcome the EU maintaining close cooperation and dialogue with the UK post-Brexit, to preserve a consistent regulatory and supervisory framework and to encourage investment in the region as a whole. The reduction of market fragmentation was highlighted as a key priority during Japan's presidency of the G20, as well as by IOSCO and the FSB. We hope there will be a move towards greater globally harmonised financial regulation through increased home state recognition of regulatory and supervisory frameworks.

Beatriz Martin Jimenez

Investment Bank Global Chief Operative Officer
& UK Chief Executive, UBS

Outcomes-focused equivalence is key to delivering the EU's Capital Markets Union

There is broad agreement among regulators, policymakers and market participants on the risks that market fragmentation present to financial and to some extent operational resilience. Last year, the G20 and the FSB recognised that a coordinated policy response is needed to address these risks while IOSCO acknowledged a role for deference in the regulation of capital markets, complemented by measures to strengthen regulatory and supervisory collaboration. Despite this recognition, we continue to observe divergent implementation of global rules, while mutual recognition of rules by regulators is not widely applied.

In the EU, the Capital Markets Union (CMU), which aims to broaden the funding base for European corporates and households, remains a key project. UBS and other global firms want to play a role in making the CMU a success by continuing to facilitate capital, liquidity and investment flows into Europe. The CMU is fundamentally about breaking down barriers to these flows in Europe's capital markets and as such is an important channel through which market fragmentation issues can be addressed. However, achievement of this goal risks being undermined by insufficient trust by host regulators of firms' home regulation, both within and beyond Europe.

The EU has developed an equivalence framework which could become a powerful tool to allow cross-border business to be conducted safely and to high standards, to the benefit of EU firms, households and the overall economy. In order to achieve this, equivalence decisions must be grounded in a technical analysis that focuses on ensuring that third country rules achieve the desired outcome, taking into account relevant international standards; and to deliver legal certainty, the process must be consistent and transparent.

The EU's financial sector is highly integrated with that of key third country partners, including Switzerland, which has substantially reformed its regulatory framework to align with MiFID II standards. Yet the absence of a reliable equivalence mechanism could disincentivise convergence towards the EU, with consequences for businesses, savers and investors both in and beyond the EU if financial integration is eroded. The lapse of EU equivalence for Swiss trading venues just over a year ago illustrates the lack of legal certainty third country partners face with the current system. A more structured and predictable process for equivalence, supported by robust regulatory and supervisory cooperation, would underpin market confidence and stability.

As we look beyond the current concerns with COVID-19, it will be important to deliver clarity on the regulatory framework that will apply at the end of the UK's Brexit transition period as a matter of priority. Even as firms including UBS establish additional EU hubs, the financial sector needs assurance that all relevant equivalence decisions will be in place on both sides and applied by the EU and the UK in a coordinated fashion well before the end of the transition period. Equivalence is key both to avoid any market dislocation and, given that London remains an important centre for liquidity and term funding as well as for European and international talent, to maintain the investment flows that support the functioning of Europe's capital markets.

Going forward, if we are to achieve the full benefits of efficient and safe pan-European and globally-integrated capital markets, any temptation to establish new barriers that could ultimately inhibit the CMU's ability to deliver increased competition, choice and innovation, such as disproportionate requirements on third-country firms wishing to provide cross-border MIFID services to wholesale clients, should be resisted. Building the CMU in a way that integrates an outcomes-focused, transparent and consistent equivalence framework must be a priority. It will lead to more legal certainty, lower costs and higher productivity for all market participants and customers.

III. FUTURE STEPS OF THE CMU

Issues at stake

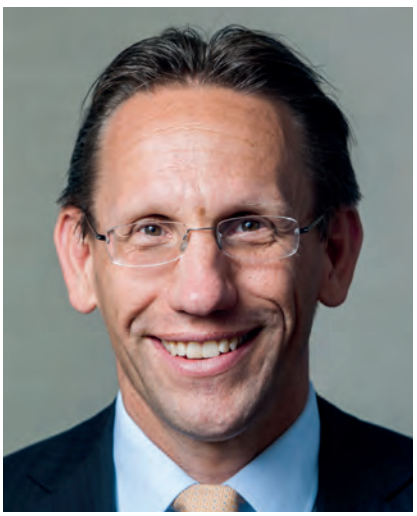
The EU capital market legislative framework has been significantly enriched with the two Capital Markets Union action plans put forward by the Commission (2015 and 2017), which have now mostly been implemented. However, the general feeling is that much remains to be done to achieve the CMU.

The Commission reaffirmed at the end of 2019 its commitment to the CMU and the Council set policy objectives for deepening the CMU related to the funding of SMEs, retail savers, the removal of structural and legal barriers to capital flows, the support to the transition to sustainable economies and technological progress and digitalisation.

A High Level Forum (HLF) set up in November 2019 by the Commission aims to propose by the summer of 2020 a set of concrete and targeted policy actions, likely to be "game-changers" for the CMU, together with the method and process needed to see them through. An interim report published in February 2019 outlined the key areas of work of the HLF going forward including measures for the financing of businesses, the strengthening of market infrastructure, retail investment, tax and insolvency procedures and supervision. The HLF also emphasized the need to have a clear delivery timetable that can be rigorously monitored and the importance of an upfront commitment from the EU institutions on a precise package of reforms.

Content

CMU 2.0: what is needed, by whom and when?



Jörg Kukies

State Secretary Financial Market Policy and European Policy, German Federal Ministry of Finance

A step-by-step approach will ensure best progress on deepening the Capital Markets Union

The corona pandemic and the impact of containment measures impede the access to capital markets for small and medium sized enterprises as well as for large corporates. This counteracts the significant steps towards the development of the Capital Markets Union, which the EU has taken over the last years. More than ever, we need to work on ensuring future-proof financial markets in the Union. Further steps are required to promote capital market-based financing, to integrate and strengthen the European capital market further and to make it internationally competitive.

Together with France and the Netherlands Germany has therefore taken the initiative and set up a working group of acknowledged European experts in the area of capital markets from various Member States to provide recommendations to deepen the Capital Markets Union (NextCMU).

In its final report, the NextCMU group has outlined some of the key issues we need to address. First, in order to further develop financial markets, in particular equity markets, the listing burden for SMEs should be reduced in a proportionate manner (this could be achieved, for instance, by review- ing the MAR), investments in Venture Capital should be promoted (e.g. through creating EU-wide funds-of-funds schemes) and retail investment in financial markets should be increased (e.g. through introducing a new category of semi-professional investor). Second, in the interest of long-term savers and investors, it needs to be ensured that a wide range of long-term financial products is offered – also in a low yield environment.

This objective should be appropriately reflected in the regulatory framework (Solvency II). In addition, savers should be further incentivized to turn into investors (e.g. through encouraging workplace equity investments and improving financial education), while at the same time ensuring adequate investor protection. Third, to ensure the free flow of capital between EU financial market places, remaining barriers in the internal market need to be removed (in particular in the area of post-trade), further consolidation of intermediaries and infrastructures should not be hampered and an EU wide Digital Finance Action Plan should be adopted. Last but not least, the EU financial markets will only flourish when they are liquid and competitive. To further develop EU financial markets, sovereign green bonds should be established, securitization markets need to be revitalized and a pan-European payment market should be created.

> *It is now up to the European Commission to translate the NextCMU recommendations and the ECOFIN priorities into specific proposals for legislative amendments.*

Building on the work of the NextCMU group Finance Ministers agreed at the ECOFIN meeting under the Finnish Presidency in December 2019 on key priorities for the Capital Markets Union. These include better access for small and medium-sized companies to Europe-wide, cost-effective, capital market-based sources of finance, improved Europe-wide range of diversified, long-term and sustainable pensions, savings and investment opportunities, increasing retail investor participation in financial markets, removing remaining barriers to cross-border financial flows and a digital financial market union. These priorities may not be implemented overnight, but require a step-by-step approach.

It is now up to the European Commission to translate the NextCMU recommendations and the ECOFIN priorities into specific proposals for legislative amendments. The European Commission has established a High Level Forum of ▶

European experts to provide further input into their work and to inform their Action Plan. An important first step to bring forward the CMU would be the short-term revision of the core regulatory framework for financial markets in the EU (MiFID II and MiFIR). A market consultation conducted by the German Federal Ministry of Finance last spring has shown a clear need for targeted improvements, which since then has been reinforced by the Brexit. The European Commission should therefore intensify its work on the MiFID II/MiFIR review and prepare a legislative proposal with high priority.

The incoming German Presidency is looking forward to appropriate legislative proposals from the European Commission to overcome the negative effects of the corona pandemic and the containment measures on the access to capital markets by deepening the Capital Markets Union. ●

Odile Renaud-Basso

Director General, French Treasury,
Ministry of Economy and Finance, France

A CMU rooted in the European economy

This article is written as the CoVID 19 health crisis is hitting European nations and their economies hard and in an unprecedented manner. No one can predict the consequences of the crisis but surely, immediately after the crisis, we will need to mobilize all the driving forces of our economies and, above all, we will undoubtedly need to act with redesigned economic tools. The day after the crisis will not be the same as the day before the crisis. The world will need even more cooperation between Europeans and a Europe capable of mobilizing its economy in a strong way to start rebuilding and reorganizing its economy.

The central contribution of CMU to the macro-economic stabilization of the European Economy is to provide a private risk-sharing mechanism. The CMU reflects Europe's design for its capital markets, both domestically and in relation with other markets worldwide. As Europe has the most open markets in the world, it is crucial to ensure the competitiveness of its financial services providers. The CMU will bring a decisive contribution into shaping the European sovereignty. It is clear, that in the long-term growth innovation and the green transition will require significant additional capital in the European economy. A significant part of this investment gap needs to be filled by equity rather than debt, in order to provide an adequate financing to these projects. As emphasized by the ECB, long term sources of financing are required as these investments have a long term or even very long-term horizon.

In a context of increased capital requirements for banks and taking into account the structural differences with their peers, relying on the sole channel of bank financing would limit our collective ability to raise the deeply-needed capital and would make us lag behind our peers. US banks benefits to a greater extend from the possibility to securitize and deconsolidate the mortgages on their balance sheet. Even if bank financing is the preferred financing mechanism in Europe, improving the functioning of our capital markets thus appears to be a necessity. In order to tackle this existential challenge for the European economy, it is paramount that the European Commission delivers on a realistic and proactive action plan as early as possible in 2020.

Based on the Ecofin Council conclusions from the 5th of December 2019 and on the numerous recent reports on this topic, in particular the Next CMU report, the High-Level Forum (HLF) still has to put forward concrete realistic proposals. If allegedly the previous 2015 action plan from Commission was somewhat watered down at the legislative phase, no one would understand that the Commission does not seize the opportunity to build upon the Council's ambitious conclusions.

As for concrete priorities, first the CMU must adapt to the green and digital transition, both in its means and objectives. Non-financial reporting and taxonomy require to build upon robust common standards to avoid market fragmentation which would arise from diverging labels and definitions. New technologies offer opportunity to revisit existing financial functions but need at some point a regulation based on the "same activity, same risk, same rules" principle.

Second, the CMU requires strong, efficient and demanding participants. On the one hand, we need capital on the ▶

European Capital markets. This means that there will not be any CMU without the active implication of resilient CIB, nor without the investment of insurers into equity. Thus, a careful transposition of Basel III and an adjustment of Solvency II are uppermost needed. On the other hand, companies and especially SMEs deserve to access this financing more easily. The increase of financial transparency and any measure to facilitate IPOs would be welcome here. Last, -and this, surely, will be critical in the post CoVID 19 context- we must improve the level of trust among market participants, so that the benefits of the retail flow to the markets remain. There is still room to enhance the training of financial advisors, deliver more concise and adequate information to the costumers and take advantage of new technologies to improve European customers' experience. ●

Harald Waiglein

Director General for Economic Policy, Financial Markets and Customs, Federal Ministry of Finance, Austria

Priorities and factors of success for the next CMU-initiative

Deeper integration of EU-Capital Markets should enable easening the access to capital and liquidity for EU companies as well as to diversified investment opportunities for investors in line with their risk appetite and needs. The Capital Market Union-Initiative 2015 - 2019 has shown that a comprehensive approach enables progress in capital market integration. However, further steps are needed to accomplish the ambitious goals of the initiative.

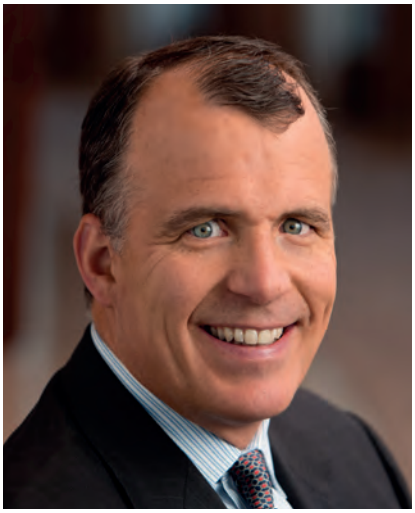
The Capital Market Union 2015 - 2019 was characterized by an evolutionary approach. Room for improvement was identified and legislative and non-legislative measures expedited by the Commission and adopted by Member States and the European Parliament. I anticipate that the Next Capital Market Union will again follow this approach thus moving forward towards a truly integrated, liquid and competitive capital market.

In my view, a holistic approach is needed thus addressing also obstacles outside the financial and capital market regulation, e.g. in the insolvency law to advance in the spirit of the CMU. Furthermore, it will be of importance to have a close look to some of the applicable legislation as well as on international standards to be implemented in due time. With regard to existing legislation we should change elements associated with excessive bureaucracy thus limiting the investment opportunities for customers and the competitiveness of EU-markets and enable up-to-date-solutions for existing and arising deficiencies. When transposing international standards, e.g. Basel IV, we should keep the supervisory standards achieved after the financial crisis but prevent competitive disadvantages by using a pragmatic approach which sufficiently respects EU-specifities and business models.

It is not the time to restrict priorities for the Capital Market Union. Additional game changers have arisen. Covid-19, BREXIT and climate change policies will have to compliment effective digitalization-policies within the Next Capital Market Union. We will have to mitigate the negative impacts of Covid-19 and BREXIT on Capital and Financial Markets and on the real economy in a decisive manner while not disregarding effective measures to address climate change and the transformation to a more digitalized EU. The next CMU has to incorporate reactions to game changers to achieve progress.

The reactions to the spread of Covid-19 throughout the EU has shown the positive effects of an advanced digitalized environment as well as remaining deficiencies to be overcome. We could all monitor to what extend Covid-19 hit financial and capital markets as well as the coordinated responses of EU-institutions. We are also looking forward to an European Union without the United Kingdom and the challenges to be overcome when the most liquid and progressive market stays outside the EU. Also in this regard we should aim for a pragmatic solution. Climate change remains one of our main and urgent challenges. We have to act to contain social and economic costs for future generations.

I am convinced, that the EU is capable of finding good and effective solutions to these challenges. In my view, it will be of key importance to demonstrate openess by acting and not only reacting to these challenges. In particular, the continent should learn from more advanced financial and capital markets and incorporate an open and progressive approach to ensure the competitiveness and efficiency of EU-markets also in the medium and long-term perspective. ●



Bruce R. Thompson

Vice Chairman and President, EU and Switzerland,
Bank of America

The time is now for a CMU for the businesses and citizens of Europe

Ever since its September 2015 communication, the European Commission has made it a top priority to develop a Capital Markets Union (CMU) in the EU. At the time, President Jean-Claude Juncker faced a Union struggling with high unemployment and in need of investments that could generate jobs. With a banking sector still under the constraints of both the financial and Eurozone crises, traditional funding sources had to be complemented to channel capital to all companies, including those that form the backbone of the European economy, SMEs.

While an ambitious Action Plan was immediately put in place, new challenges such as the departure of the largest finance centre from the Union, technological developments and the need to seriously tackle climate change make the project even more crucial for the future.

> *These challenging times should be seen as an opportunity to do things differently.*

This is why President Ursula von der Leyen made completing the CMU one of the cornerstones of her Presidency. One of the European Commission's first actions in this renewed impetus has been to create a High-Level Forum (HLF) composed of experienced industry executives and international experts and academics, with the aim of providing suggestions and guidance on future CMU policies; the sudden change in the economic outlook as a result of the COVID-19 crisis make this work even more of a priority – Europe needs its capital markets to be as large and liquid as possible to maximise funding sources to support citizens and businesses.

As a member of the HLF subgroup focusing on the development of European capital markets architecture, I am struck by the clear conviction among all HLF members that the future of the Union requires the development of a truly integrated CMU.

While many reports have been published on the matter, the HLF intends to set aside broad policy recommendations and focus instead on concrete policy measures as well as the method and processes needed to see them through. The HLF's recommendations, expected in May, will not target "low-hanging fruit", but instead aim for measures that will lead to tangible results, no matter how hard they are to achieve. These challenging times should be seen as an opportunity to do things differently.

While work is still underway, the final report will likely focus on a dozen or so recommendations centred around four broad categories:

- Financing for business: the HLF will consider issues such as enhancing the transparency and comparability of company data for investors, supporting the development of cross-border long-term investment vehicles, increasing the risk appetite of institutional investors, facilitating the listing of companies, and strengthening the tools available to financial intermediaries – such as securitisation.
- Market infrastructure: we are looking at enhancing the integration and efficiency of trading and post-trading, as well as improving the liquidity of secondary markets by strengthening the role of European intermediaries.
- Retail investment: conscious of current demographic and environmental challenges, the HLF will propose measures to steer citizens towards sustainable, long-term investment products through the development of adequate occupational and personal pension products. This will also require putting in place a strong financial literacy and equity culture in Europe.
- Cross-cutting issues: these are the pressing issues that are considered politically sensitive but must be tackled – issues around withholding tax for cross-border investors, the harmonisation of national insolvency proceedings, and the need for a true level-playing field for financial players across the Union.

While Rome wasn't built in a day, it is time for policy-makers across the Union to deliver on their political promises and boldly push for reforms that will make the EU a true global capital markets player. European citizens stand to gain significantly from an integrated and open CMU – a well-developed pool of capital that will not only enable wider household and retail access to capital markets but also finance the SMEs that drive the European economy forward. ●

Leonique van Houwelingen

Chief Executive Officer, BNY Mellon SA/NV

Capital markets policy – Incisive steps to make progress

I started writing this article about a week ago. In that week the world has become a different place. Some things seem much more important; other things much less important. Capital markets policy doesn't seem very important for the moment. But I do sincerely hope that when this article is published capital markets policy will have regained some importance. Lessons and challenges.

As we recover from the devastating personal, social, and economic impacts of the COVID-19 virus, it will be possible to reflect on some important lessons, and on some major challenges. Two key challenges will be how to make our societies and economies better prepared and more resilient for the next crisis, and how to recover from the current crisis.

Capital markets policy. In this context, capital markets policy has a role to play. One of the main justifications for the Capital Markets Union project has been that a greater role for capital markets, and for cross-border capital markets, improves the ability of an economy to absorb external shocks. The current crisis has caused major economic disruption, and financing problems for many corporates, including banks and SMEs. Improving the financing mechanisms of capital markets can help support the future financing of corporates.

Key principles. A week ago, I would have said that key principles for a bigger and more effective European Capital Markets Union are simplicity, developing market access, and encouraging diversity. Today, I would add the principles of resilience, decentralisation, and inter-connectivity. I see all these principles as having common elements, including the importance of common definitions, and a key dependence on the widespread use of standards.

Practical proposals Capital markets policy has few tools that can have a rapid impact. Other policy areas, such as monetary and prudential policy, and supervisory actions, have a much speedier impact. Capital markets policy deals with the structures and institutions that allow issuers and investors to use capital markets. But the slowness of their impact is precisely why we need rapid, clear and incisive capital market policy measures.

We need three things. We need measures to bring investors to the market; we need measures to bring issuers to the market; and we need measures that reduce cost, complexity and risk in the use of infrastructure and intermediaries, especially with relation to cross-border investment. Measures to bring investors to the markets should include the development of pension funds, and the use of investment savings accounts to encourage direct participation in capital markets by retail investors. Measures to bring issuers to the markets should in particular tackle barriers for securitisation and for SMEs. Measures to reduce cost, complexity and risk in cross-border investment are typically the most challenging, as they affect policy areas (for example, tax and insolvency procedures) that are deeply embedded in national law, and their benefits may be difficult to see. But they deal with the foundational building blocks of capital markets, and they are critical pre-conditions for progress. They include common definitions, for example, of a financial instrument, and of a shareholder/legal owner of a security.

> *Today, I would add the principles of resilience, decentralisation, and inter-connectivity.*

A Capital Markets Union will mean that investors in any European security are faced with common operational processes through the full life cycle of a securities investment, including common corporate action, and common withholding tax processes. This will require measures to facilitate cross-border and pan-European issuance, measures to ensure the harmonisation of core CSD processes, and a high degree of integration of tax processes. All these measures are desirable in themselves, but they have the additional benefit that they help build resilience in capital markets through decentralisation and inter-connectivity between capital market eco-systems. Report of the CMU High Level Forum. Despite the current difficult times, I am optimistic for the future.

I am confident that the final report of the European Commission's High Level Forum on the Capital Markets Union will contain some important transformational recommendations. And I am confident that the European Commission will take serious account of the recommendations in its future CMU Action Plan. ●

Deborah Zurkow

Global Head of Investments, Allianz Global Investors

What do we see as priorities for the CMU to have a good chance to solve the pension dilemma?

Written as of March 16th, 2020 - The Capital Markets Union (CMU) has the ambitious mission to align and integrate Europe's financial system. This is a challenging but critical task, as the success of the CMU may well determine not only the strength of the EU's economy and its financial sector, but also the ability of its institutions and companies to serve its citizens now, and in the future.

If the main CMU's goals are fulfilled, two imperative needs of citizens will be solved: maximise their current quality of life and their current income by mobilizing capital to invest in Europe's companies, while simultaneously putting savings to work to guarantee retirement income adequacy.

Our starting point is the EU's very fragmented capital market from a regulatory point of view. National tax, corporate, securities and insolvency laws, come on top of very different procedures and practices from country to country. In addition, Member States are on very different stages of their respective business cycles, which makes it hard to make that one solution fits all.

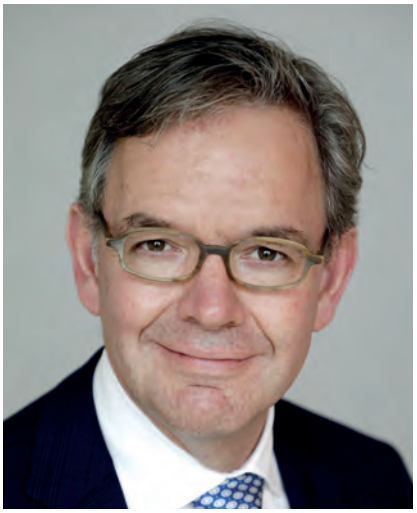
This diversity quickly becomes complexity and it deters market access and portability. Greater harmonisation across Member States will facilitate broader and more diversified investment opportunities for pensions funds and the ultimate savers they represent. In the absence of further alignment between Member States markets will be unable to play their role in maximising retirement income adequacy.

Cross border alignment and collaboration, as well as openness to change in favour of innovation, simplification and harmonisation will be key to solve the structural pension threat. Priorities in my view are 1) channelling long-term savings into financing entrepreneurship, 2) rethinking individual Member State approaches in favour of greater Pan European coherence, and 3) ensuring global competition of the EU in capital markets.

- **Channelling long-term savings into financing entrepreneurship;** A regulatory environment favourable to long-term investment would certainly help to enhance the offering of available savings products such as employees' savings schemes. Member States should work together and share best practices to undertake aligned measures that expand the amount of pension savings being invested. For this, unnecessary obstacles would have to be removed, and tax incentives would provide a much-needed support. One way to do this would be to recommit to a Pan European Pension Plan that allows citizens in all member states to direct their retirement savings into the capital markets in an aggregated and risk controlled way, with common regulatory and taxation principles that allow these savings to be transportable between countries in an efficient manner.
- **Rethinking individual Member State approaches in favour of greater Pan European coherence;** Member States should be encouraged to simplify and standardise withholding tax procedures and mutual fund taxation to encourage increased retail participation as well as greater cross-border asset ownership for institutional investors.
- **Ensuring global competition of the EU in capital markets;** Deeper and more competitive financial markets will contribute to growth through efficient allocation of capital. We need policy measures that balance market resiliency, market integrity and appropriate supervision with keeping Europe's capital markets sufficiently open and competitive in order to grow their capacity. This will promote further investment, continue to reduce reliance on banks and will create employment. There is also significant room to improve integration of financial centres, and to attract investors and companies from around the world.

> *The Capital Markets Union has the ambitious mission to align and integrate Europe's financial system. This is a challenging but critical task.*

In a nutshell, the investment challenge is well beyond the capacity of the public sector alone. Within the ambitious mission of the CMU, asset managers not only will help savers maximise their returns and mitigate investment risks, but also will be able to act as active stewards of capital, supporting sustainability through important extra-financial considerations such as ESG and climate, contributing to long-term health and sustainability of capital markets and society as a whole. ●



Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

The priority areas for the CMU

The imbalance that exists in the European Union between bank and capital markets funding makes the EU less competitive and less financially stable than it could be. Creating globally competitive markets takes time and we have yet to fully achieve that, but the UK's withdrawal from the EU reinforces the urgency of this goal: in the aftermath of Brexit, the EU will only be able to compete effectively with other major financial centres and reinforce its economic growth if its financial markets are sufficiently sizable – and further integrated. Moreover, in the context of the COVID-19 pandemic and its economic fall-out, stronger EU capital markets may play an important role in the recovery phase.

While the CMU is, in its current form, a relatively new project, achieving common capital markets is, more generally, a long-standing EU goal. Much progress has already been made, with successful market integration being observed in areas such as funds, trading venues, and clearing.

Looking forward, efforts should be focused on three priority areas which are essential to achieve a successful CMU: (i) Develop retail investor participation in EU capital markets; (ii) Improve capital market access for EU SMEs; (iii) Ensure effective consistent supervision in EU financial markets.

Looking at successful capital markets across the globe, a high level of retail participation should be an essential characteristic of a CMU. Some of the key reasons for scarce retail investor participation is their lack of trust in capital markets as a result of mis-selling cases, as well as limited financial literacy.

In addition, ESMA found in its 2019 and 2020 Reports on the performance and cost of retail investment products in the EU that costs associated with obtaining financial products are substantial and represent a significant reduction to long-term gains. Finally, due to a variety of disclosure rules applying, including on costs, it is not always clear to investors how different products compare with each other.

To address scarce retail participation in capital markets, several potential actions could be considered. Examples include: (a) further aligning disclosure requirements for investment products across different pieces of regulation and facilitating their cross-border distribution, (b) improving the distribution of financial products by looking into the incentives, like inducements, for advisors, and (c) reinforcing the role of pensions systems to stimulate retail participation in financial markets.

It is well known that EU SMEs tend to rely mainly on bank funding and that – when they access capital markets – they tend to privilege local markets due to easier access and lower information asymmetries for investors. For example, while venture capital funds can support the path towards IPOs, their presence is uneven across member states.

At the same time, it is fair to say that SMEs may pose increased risks for investors and it is challenging to develop rules that are appropriate for all types of SMEs at different stages of their development. The right balance should be found between making standardized information on SMEs available to investors across the EU, while the costs of such information to SMEs should be proportionate.

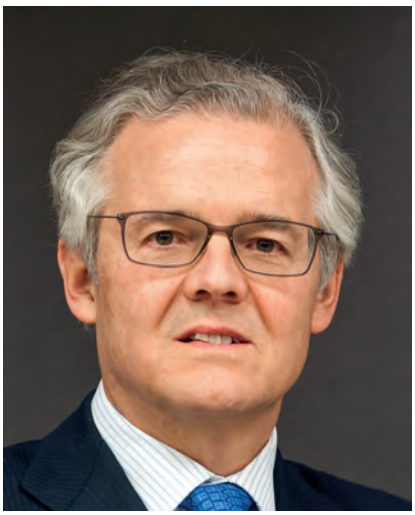
> *In the context of the COVID-19 pandemic and its economic fall-out, stronger EU capital markets may play an important role in the recovery phase.*

Other actions already taken in this area include the creation of SME Growth Markets under MiFID II. In this context, ESMA will soon launch a public consultation on an assessment of the functioning of the regime for SME Growth Markets. This consultation will include some suggestions to further promote the development of such markets in the EU.

Finally, regarding the role of supervision, it is well known that differences in supervisory practices increase the costs of doing business across the EU, and constitute a substantial barrier to cross-border investments. Over the past two years, the EU institutions have taken gradual steps towards expanding direct supervision at EU level. As a result, an increasing number of supervised entities will fall under ESMA's remit in the ▶

years to come. This concerns both EU and third-country market participants.

While the ESAs' review has introduced some useful changes to the supervisory convergence tools available to ESMA, these are less ambitious than those originally proposed. As such, there are further opportunities to enhance ESMA's supervisory convergence role further via a refined toolkit, especially regarding its ability to ensure the implementation of common supervisory practices. ●



Sebastián Albella Amigo

Chairman, Spanish Securities and Exchange Commission (CNMV)

Rethinking CMU: the importance of local markets

Although many of the specific objectives initially envisaged in the context of the CMU project have been reached, we are still far from achieving a truly integrated an efficient capital market in Europe. Additionally, there is a need to rethink and relaunch the whole project considering challenges arising from Brexit.

Therefore, it is time to propose additional actions. From my point of view, the key priorities for the next phase of the CMU should be three: increase the equity market share in funding, tax harmonisation and supervisory convergence.

Firstly, the need to foster market-based finance for companies is especially acute on the equity side. Being listed broadens the possibilities of financing, boosts the level of professionalism and rigour in management, is an incentive to grow, gives prestige, strengthens the brand, helps to attract and retain talent, etc. and, since it is compatible with maintaining control, is a very natural solution for successful family businesses of a certain size.

More listed companies also mean more transparent companies and even a somewhat more democratic society: it means that there are more companies within reach, either directly or through funds, for any investor. For these reasons, any restrictions on the capacity of firms to access capital markets should be removed and no extra restrictions or conditions should be imposed on companies associated with the fact of being listed.

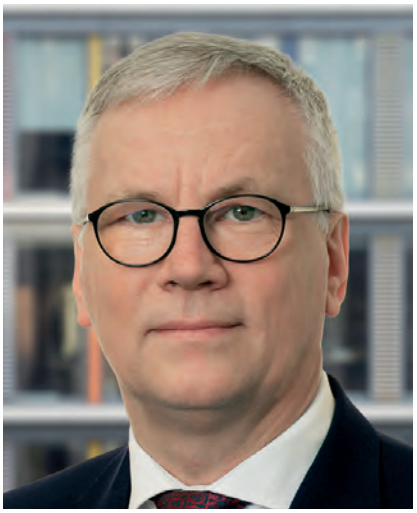
Secondly, there is also a need to make progress on tax harmonisation. Current different tax regulations distort financial decisions, reduce efficiency in capital markets and influence too much cross-border capital flows. There is room to reduce the vast differences across Europe in the tax treatment of financial markets' transactions and SME investments. Heterogeneity in this area creates too diverging distribution models for financial instruments (insurance, banking and securities products).

Finally, the CMU project needs to emphasise the convergence of supervisory practices. In order to homogeneously apply the European rulebook it is of paramount importance that ESMA intensifies its efforts in supervisory convergence by using in all appropriate cases the tools and powers granted by law. Regarding the home/host supervisory model in the EU, it would be an improvement if the host NCAs were provided with the appropriate information on the activities carried out in their jurisdictions. The establishment of formulas for cooperation between home and host authorities is essential in order to avoid a "race to the bottom".

> *Additional actions to relaunch CMU must coexist with strong local financial markets.*

This is especially relevant in a context in which there is certainly a need to create an integrated, competitive, deep and liquid capital market, but this should not imply the creation of a single or dominant financial centre or the weakening of the main European local markets, i.e. any additional actions to relaunch CMU must coexist with strong local financial markets.

They benefit medium-sized companies that are large enough to tap local capital markets, without preventing them from looking for capital across borders. Geographical proximity lowers transaction costs, helps to overcome cultural barriers of entrepreneurs and helps investors to understand the businesses that they are financially supporting. ●



Rimantas Šadžius

Member of the Court, European Court of Auditors

EU auditors call to address essential limitations of ESAs

The EU was plunged into a pool of uncertainty this year with regards to the financial sector as it continues to try and find tools to offset the massive economic fallout of the coronavirus crisis – which could likely require a global effort. The negative impact of the pandemic on the financial markets is evident, pushing to obscure transformations and making future structural changes inevitable (as of now). However, a need for sound supervision will surely stay instrumental, and thus, past lessons in building a harmonized approach to the EU-wide financial sector still need to be learned.

Common rules for the entire EU financial sector, or the single rulebook, are meant to ensure a more effective level playing field and prevent negative cross-border spillovers stemming from possible regulatory arbitrage. However, despite a large number of regulations and directives put in place since 2009, the bulk of direct supervisory controls and enforcement responsibilities still rest with national competent authorities and supervisors. As a result, even with more intensive coordination and approximation of national laws to reinforce the internal market, the rule framework remains fragmented due to different transposition or interpretation of rules, different supervision approaches, and most importantly, very limited EU level enforcement instruments.

So far, all three ESAs acting within their mandates can be praised to have indeed effectively contributed to a smoother functioning Single Market for financial services. At the same time, we can observe that in terms of the types of possible response to various developments in the financial area, the EU is constrained in its competences defined within the Treaties, although notably, EU legislators enjoy ample degree of flexibility in these issues. At present, strong national interest and a legally permissible degree of arbitrage (in setting national regulations, supervisory practices or enforcement approaches) related to the financial sector limit the possibility to take fully effective and proactive measures at EU level, because a difficult consensual approach in many cases has to be applied. Therefore, to overcome persisting strong national borders and to make the single rulebook work, ESAs should evolve from being "de jure" authorities to "de facto".

The mandate and role of ESAs as centralized bodies for capital markets and conduct-of-business supervision were discussed intensively recently. In its audits of EIOPA and EBA, the European Court of Auditors has identified a number of serious, systemic gaps in the supervision of the EU's banking and insurance sectors. In our work, for example, we pointed out a too limited role of ESAs, especially EIOPA and EBA, in supervisory colleges (for cross-border groups). The complicated functioning model of supervisory colleges and even the lack of proper arrangements concerning information exchange could bring about vast inefficiencies.

> *To make the single rulebook work, ESAs should evolve from being "de jure" authorities to "de facto".*

We called upon EU legislators to adjust accordingly the respective regulations and frameworks. We recommended, among other measures, to rethink both the governance and powers of the ESAs. Of course, another question is what should come first: whether it would be optimal to grant ESAs more powers before fixing identified issues in their governance and resources.

Along with the banking and insurance sectors, we also feel there are similar issues in the area of securities markets, investment funds, etc. Thus, we are about to start an audit of performance of the EU framework for non-bank finance intermediation to be able to provide a more detailed picture of it to EU legislators. ●

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J.P.Morgan

How can new technologies support the CMU?

Carlos San Basilio

Secretary General of the Treasury and International Financing, Spanish Treasury

EU leadership in Fintech. How can new technologies help develop the CMU?

Developed and integrated capital markets, especially in a monetary union, are crucial to ensure a good match between savings and investments and an increase in cross-country risk sharing, contributing to economic growth and financial stability.

In order to pursue these benefits, definite progress needs to be made in the project of the Capital Markets Union, launched 5 years ago.

New technologies can play an important role in developing the Capital Markets Union, helping overcome barriers to integration. Indeed, new financial technologies (Fintech) create an array of new possibilities for financial agents, instruments and transactions, by improving the efficiency of financial activities, making financial markets more inclusive and improving regulatory and supervisory capacities of the public sector.

The efficiency of different activities such as equity and debt issuance, asset management or corporate governance can be improved with Fintech, allowing for better access to capital markets, reducing barriers and transaction costs and therefore, enhancing financial markets' competitiveness. Some concrete examples of this are crowdfunding and alternative investment platforms, virtual vote tools for shareholders, supply chain finance and robotic financial advisory.

New technologies can also make financial markets more inclusive by enhancing retail investors' activity through low-cost digital platforms and more transparent and trustworthy products. Deepening the integration of financial markets at a retail level is key for a successful Economic and Monetary Union that takes into account the needs of its citizens. Retail investors are the main source of long-term financing of the economy. A broader participation of retail investors in the financial sector can help smooth asymmetric shocks that may affect individual countries.

Furthermore, new technologies can help improve public sector's regulatory and supervisory capabilities, through the so called Regtech and Suptech. However, new technologies may also present risks from a regulatory and supervisory point of view. Thus, policy initiatives should be directed to boost technology development while at the same time, ensuring that financial consumer protection and financial system stability are guaranteed.

The regulatory sandbox, which will be launched shortly in Spain, pursues both objectives simultaneously. The sandbox allows firms to test their innovations under appropriate supervision by the relevant authorities. This helps not only innovators and consumers, but also the supervisors and regulators themselves by having access to valuable information which could, eventually, lead to further improvements of financial regulation and supervisory practices. This initiative responds to the well-defined need to push innovation as a central element for sustainable and equitable economic development. Likewise, it guarantees that technological change protects users of financial services, maintains financial stability and market integrity, while at the same time preventing money laundering or financing of terrorist activities.

It is time to make significant progress in the deepening of the Economic and Monetary Union and turn the Capital Markets Union into a reality. For that purpose, we should make use of any means at our disposal. New technologies have undoubtedly a very relevant role to play. Spain is ready to contribute actively to this endeavor. ●

Mario Nava

Director Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

A digital Capital Markets Union

Digitalisation, new technologies and innovative business models hold great potential to support the objectives of the Capital Markets Union (CMU) by increasing efficiency, transparency and cross-border provision of services. The COVID-19 crisis shows that digitalisation may also be a safety net against operational risks, thus improving market resilience. The European Commission (EC) is thus taking the necessary steps to ensure the right conditions are in place to take advantage of and manage any risks stemming from digitalisation.

That is why digital finance has become a resounding public policy topic, as also reflected in discussions of the CMU High Level Forum (HLF) set up by the EC to identify and propose new targeted actions to further develop the CMU. Whilst it is too early to discuss the outcomes, these recommendations, including ideas on how digitalisation supports the CMU objectives, will be published later this year and will feed into the Commission Action Plan on Capital Markets Union. In parallel, ▶

▶ the EC is working towards a broader new Digital Finance Strategy promoting digital finance in the EU while adequately addressing possible risks. A digital finance public consultation was launched in April 2020.

Distributed ledger technologies/blockchain may improve efficiency in trading and post trading, reduce costs and make it easier to raise financing on public markets via Security Token Offerings and DLT bond issuances. In December 2019, the EC launched a public consultation on crypto-assets to assess if the existing EU legislation should be adapted for the issuance, trading, clearing and settlement of crypto-assets and how to ensure a level playing field between security tokens and other financial instruments. A legislative proposal covering all crypto-assets is expected in Q3 2020.

Recent EU policy initiatives recognise the importance of data-driven innovation and data flows such as GDPR's right to data portability and PSD2's Open Banking provisions. CMU objectives, in particular retail investor participation in capital markets, may also be further advanced through open finance. If broadened to include other types of financial data, open finance could benefit consumers by enabling the creation of new business models which would equip them with better tools to manage their finances and investments as well as foster competition between service providers. In February 2020 the EC adopted a Digital Strategy to enhance access and sharing of data within the EU. This horizontal framework will be complemented by a sectorial framework for the financial sector.

Financial institutions increasingly rely on third party providers of IT services, and in particular cloud services. While these solutions bring opportunities, they also expose the financial sector to operational risks and potentially systemic risks which need to be mitigated. The EC recently launched a consultation on digital operational resilience. A cross-sectoral act is expected in Q3 2020, harmonising rules across the EU to make the financial sector more secure and resilient.

> *The EC is working towards a broader new Digital Finance Strategy promoting digital finance in the EU.*

By improving access to finance for innovative companies, the CMU will deliver on its objective of supporting growth and innovation in Europe, and in turn further advance the digital transformation. ●

Björn Sibbern

President European Markets, Nasdaq

Artificial Intelligence + market surveillance = market integrity

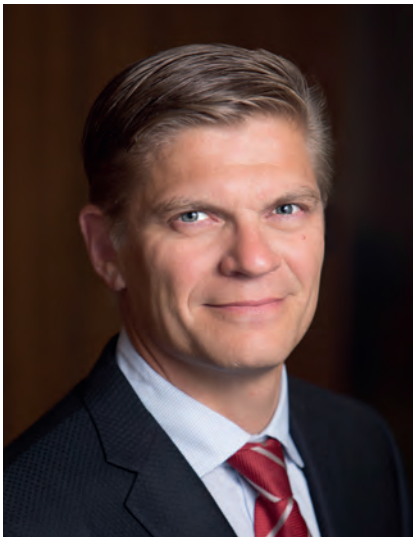
Artificial Intelligence is the defining technology of the 21st century that will upend industries, institutions and long-time incumbents. Modern artificial intelligence enables new, hyper-scalable capabilities which make otherwise bespoke or scarce solutions ubiquitous and accessible.

Machine intelligence is gaining deeper penetration at exchanges and clearing houses - we are using it to increase operational efficiency, create richer data products and provide better services to the market. Nasdaq reimagines capabilities such as alternative data research, trade surveillance, asset flow predictions, and investor relations and applies them to financial markets for institutional and retail investors.

Nasdaq was the first market to implement machine learning for market surveillance on the markets we operate in Europe and in the US, as well as providing such services to our technology clients. Nasdaq's European Surveillance team was the first surveillance team in the world that implemented machine learning into its surveillance technology and starting to use that in live production almost three years ago. When we are now also starting to use similar technology for our US market that will be helpful given that the Nasdaq's U.S. market surveillance team annually reviews 750,000+ alerts that flag unusual price movements, trading errors and potential manipulation.

> *...maintain the approach of not stifling but supporting innovation.*

The implementation for our European markets is benefiting from machine



learning to create a ranking score attached to new alerts from the surveillance system. In particular, it enable prioritization among incoming alerts in situations where work load is high, e.g. around opening of markets, it complements existing quality controls in relation to alert handling and it enables managers to identify outliers. This use of artificial intelligence enhances the ▶

▶ market surveillance functionality and transfer learning to improve detection of malicious activity. Machine learning provides better opportunities for surveillance specialists to focus on the right cases, ensuring market integrity is upheld at its highest level.

Nasdaq sees benefits for this technology for exchanges and regulators worldwide, not least in the European markets where trading is fragmented. We also believe it will be useful in sectors which are outside the traditional financial markets, such as cryptoassets and also in the gaming industry. Among others, it can help monitor bets and for instance detect possible money laundering cases.

Nasdaq continues within its Innovation Lab to research and build unique products that combine our proprietary and third-party data with machine intelligence capabilities. This allows us to work hand in hand with market participants to jointly build products that support investors' ability to build and protect assets today, and in the future.

Given the huge opportunities ahead, already under exploration or still to be detected, Nasdaq would urge policymakers to maintain the approach of not stifling but supporting innovation. As traditional business models are challenged and where regulatory intervention is considered, we also fully support the principle of 'same business, same rule', which has so far been guiding the regulatory development. ●

Adrian Poole

Head of Financial Services, UKI, Google Cloud

Achieving financial innovation through the cloud

Innovative banks who already understand cloud benefits are using this technology in a multitude of ways to understand risk, segment customers, track market movements, develop new instruments and ultimately gain a competitive advantage in an increasingly fierce market.

They are using the technology to process large volumes of information, reducing their time to market by rapidly creating and selling new and innovative financial solutions. Atom Bank is one example of an innovative bank turning to cloud to accelerate its digital transformation efforts. With cloud, the bank can provide more agility and scalability at a lower cost. The challenger bank operates in a very fast evolving environment and needs to take advantage of current innovation, whilst building for future speed by building more SaaS and creating an architecture that is resilient to future industry changes. Turning away from on-premise data centres towards the cloud has enabled Atom Bank to keep up with its tech savvy customer base by updating product app features or even creating entirely new services quickly and cost-effectively.

Other major players are also tapping the cloud to develop entirely new services. For example, Refinitiv recently launched its new Tick History database on Google Cloud Platform. The new offering allows Refinitiv's customers to access, query and analyse its extensive archive of pricing and trading data in much shorter timeframes, using Google Cloud's BigQuery.

Others leverage real-time market information streamed into large-scale, real-time databases and AI/ML models to quantify and cost risk. The time saved processing this information allows these banks to offer products at a much lower cost to their customers.

Traditional banks can also utilise the cloud to combat fraud and money laundering through AI and ML models, much like their challenger counterparts. Combining transactional and behavioural data can help more accurately detect fraud patterns and simultaneously avoid costly false positives. For example, using Google Cloud's BigQuery, Cloud Dataflow and Cloud Datastore to extract and store features for its model in real time, Monzo has already reduced its rate of fraud to an order of magnitude lower than the industry average.

Similarly, cloud-based technologies are being leveraged for banks' own risk-management to determine liquidity and exposure quicker, to carry out mark-to-market adjustments and for better accounting in general.

> *Conversations between technology providers and banks are now focused on what business problem the cloud can solve.*

HSBC is an example of a global bank - which is over a hundred and fifty years old - that is helping to better serve its customers using cloud technology. Using Google Cloud, HSBC can analyse petabytes of data in minutes. This allows the bank to calculate their liquidity position for scores of countries in a fraction of the time of their previous system. And HSBC can run much more complex financial crime analytics in a shorter time, while ensuring their data security and privacy.

It's not just banks and financial services companies that benefit from cloud-first banking, customers stand to gain the most. Cloud is transforming the technology ecosystem, and it's set to revolutionise the banking sector well beyond the core infrastructure. Now is the time for banks and technology companies to work together to take innovation of financial services and products to new heights for the benefit of consumers. ●

Chris Bartz

Chief Executive Officer & Co-Founder, Elinvar GmbH

A united Europe can become home to global leading fintech

Europe has the potential to establish itself as the ideal location and as an enabler for leading companies for fintech and the digitalization of finance, be it start-ups or established players. Digitalization and scalability are highly interdependent – so European policies need to enable both in order to ensure international competitiveness for European companies.

While it seems unlikely that, for example, another social network with global relevance will be founded and headquartered in Europe, there are massive opportunities in other sectors for Europe – particularly in fintech. Here Europe offers a unique combination of competitive advantages:

1) A proven track record in finance over many centuries and a high availability of talent with financial expertise.
2) A strong domestic market with a significant global market share based on volumes as well as on transactions, both key drivers for revenues.
3) Europe's outstanding reputation for trustworthiness and it's competence in data protection in particular, setting global standards in this area.

To leverage the potential for Europe and to become the major location for leading players in the fintech sector, the Fintech Council at the German Ministry of Finances proposed several key actions, published in the *Fintech Roadmap for Europe:*

1) Strengthening initiatives to eliminate obstacles to cross-border activities: we must ensure a single, strong and homogenous home market for innovative digital services to achieve the economies of scale needed to deliver customer benefits. Concrete obstacles to cross-border services like insufficient harmonization, gaps in the passporting system or discrimination against foreign IBANs, must be removed.
2) Establishing uniform European identification and authentication standards: user-friendly, uniform and standardised ID & KYC processes that are accepted in all countries without compromising on quality will provide customers with real access to the entire European market.
3) Creating a legal basis for comprehensive implementation of digital end-to-end processes: Digital identities and contractual agreements concluded digitally must be legally effective.
4) Harmonising standards and responsibilities to strengthen a single ecosystem: the financial market is turning into an ecosystem, where services are conducted through the cooperation of different market participants along the value chain. The historical principles-based approach needs to be developed further to meet the demands of an efficient ecosystem. Consistency between actual and regulatory responsibility, based on clear standards and interfaces, should be the core principle for all areas of the ecosystem. This must apply uniformly throughout Europe.

> *Europe has the potential to establish itself as the ideal location for leading fintech companies.*

5) Greater effort on the part of regulators and policymakers to promote innovation: successfully developing financial technologies will be underpinned by the pillars competence, networks, speed and security.
6) Enhancing customer confidence and customer responsibility with respect to data use: ensuring the data sovereignty of customers should be the primary consideration. The obligation to provide suitable interfaces should be extended to all providers across all industries and data management tools for customers should be supported.

Europe has the opportunity to actively shape the ideal framework to become home to global leading fintech companies. The moment to make this happen is now. ●

Does the EU have the players adapted to CMU objectives?

Philipp Hartmann

Deputy Director General Research, European Central Bank (ECB)

Financial structure, Capital Markets Union and Brexit

In this difficult hour for Europe and the world, it is challenging to still keep some focus on medium-term reform agendas. But as the corona crisis management has taken shape and as companies and households embrace the new ways of working and social interaction, we also need to get on with making our economies work better in the future. One European goal is to bring the Capital Markets Union to the next level. In fact, the corona crisis will create a lot of debt, so improving the functioning of capital markets is more relevant than ever!

The need for deepening capital markets in the European Union puts the spotlight on financial structure. Traditionally, bank-based and market-based financial systems have been distinguished, but more generally the financial structure describes the mixture of different financial markets and intermediaries. The March 2020 ECB report on "Financial integration and structure in the euro area" shows that the share of marketable instruments in total financing of euro area non-financial corporations stayed closely around 20 percent since 2002. In other words, securities market instruments, such as listed shares and debt securities, finance a much smaller part of euro area companies than non-marketable instruments, such as bank loans, trade credit or unlisted shares. The marketable part, notably public equity, is significantly smaller than in the United States or Japan, and not increasing. Private equity in Europe is large and rising. But compared to major advanced countries it is not helping many young and innovative firms to grow.

More dynamic equity financing would have at least two key advantages. First, equity investors tend to be more risk-loving than debt investors and finance more innovative companies. Second, recent ECB research suggests that economies with a greater equity share decarbonise faster. Hence, the next set of measures fostering CMU should have a particular emphasis on enhancing the share of public equity in company financing and on rendering private equity a more dynamic source of risk capital.

A number of public-sector policies would have sizeable effects on the demand and supply of equity in the EU. Pension reforms enhancing private retirement savings through diversified long-term investments would have the biggest impact. Second, improving financial literacy would be important, notably by introducing basic concepts in secondary schooling. Third, removing the tax advantage of debt would be very helpful. Fourth, stepping up public funding for life sciences and technology through universities and mission-oriented investments, respectively, could make a large difference. But also, adequate labour and product market flexibility and adequate levels of corporate taxation are important framework conditions under which equity-financed entrepreneurship flourishes.

At present global investment banks service about half of euro area companies' initial public equity offerings out of the City of London. Should regulatory equivalence with the United Kingdom not be ensured in the future, adequate relocations would have to take place or the EU to build its own capacity. It is important that the envisaged measures for advancing CMU take a forward-looking approach towards this and other implications of Brexit! ●

The views expressed are my own and not necessarily the views of the European Central Bank or the Eurosystem.

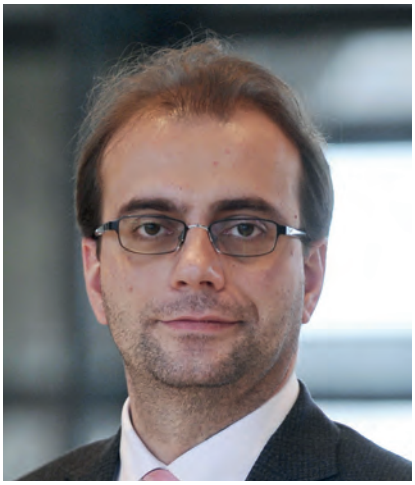
Sébastien Raspiller

Head of Department, French Treasury, Ministry of Economy and Finance, France

The EU needs strong players for achieving CMU objectives

As this article is being written, the Covid 19 crisis is hitting the European continent hard. It is above all a human tragedy and a terrible shock for the European economy. Europe has so far fed on crises in order to move forward. Hopefully it will also take advantage of this crisis to improve its functioning. It is also likely that in the aftermath of the crisis, a phase of economic reconstruction will begin, in which the problems of deepening the single market will become more acute.

As far as the Capital Markets Union is concerned, the Covid 19 crisis tends to demonstrate at this stage the difficulties to respond on a pan-European basis. Without going into an exhaustive review of the outcome of this crisis, several instruments are now sorely lacking to the European supervisory agencies (the so-called ESAs: namely EBA, EIOPA and ESMA). The 2018-2019 ESAs review will be reminded as a missed opportunity to prepare for this situation. Diverging views within the EU Council have prevented the ESAs from being given necessary supervisory tools. To quote only ▶



▶ two instances, no-action letter powers are today lacking to selectively suspend the application of certain rules and direct supervisory powers would have been helpful to simplify reporting or limit pro-cyclical effect of the supervision in a uniform manner across Europe. The fact that the only coordinated market supervision measure adopted during the crisis was to lower the threshold for short selling reporting speaks for itself.

As for European private actors, the crisis overall means that capital markets will have to bring their contribution to fill the investment gap, in a context where possibly the banking channel could be hindered by the incoming prudential requirement. Three strategic fields provide valuable examples: insurance, investment banking and private equity fund.

In this regard, insurers, which are long-term investors by nature, are key to foster equity financing for our firms, and could be mobilized for our challenges for the future, such as digital and sustainable transition. Beyond, we need such long-term countercyclical investors to stabilize EU capital markets. The review of Solvency 2 can bring a significant contribution to this objective allowing insurers to fully play their role in the economy. This review should be led consistently with a reform of accounting standards, which have an unintended negative impact on investment in equities for insurers.

In the same vein, the CMU will not succeed without thriving European CIBs. This is all the more true as banks will play a central role in the recovery. It is therefore desirable to ensure that the transposition of Basel III standards takes into account what other jurisdictions will actually do, in order not to put European banks at a competitive disadvantage. Similarly, the use of the European framework for Simple, Transparent and Standardized securitizations (STS) needs to be encouraged in order to facilitate the management of banks' balance sheet. To achieve this, a review of impediments to the development of STS products should be carried out.

Private equity has gathered momentum, but it should scale up in the field of venture capital. Europe needs more funds that can issue larger tickets. We need to invest much more to stay in the innovation race – on artificial intelligence, on space, on energy storage. Hence it is crucial to promote a single globally recognized European standards. As for today, the EU labels a few funds invested in non-listed assets. Among them, the European Long-Term Investment Funds ("ELTIF") appears to be in the best position to emerge as the European standard, in a UCITS-like manner for listed assets. To encourage the promotion of the ELTIF as the European standard, further work is required to ease its passporting, alleviate its fiscal treatment throughout Europe and enhance the applicable regulation in order to facilitate flows of investments and disinvestments. ●

Stéphane Boujnah

Chief Executive Officer and Chairman of the Managing Board, Euronext

A new CMU: building strong EU public capital markets to finance the real economy

The current sanitary crisis is unleashing nationalistic tendencies that go beyond what is needed for the coordination of health measures at national level. Everywhere, we observe the temptation of "my country first", "my banks first", "keep the cash in my country for now" and many other signs of eroding European ambitions. In contrast, the Covid-19 crisis actually underlines how important public capital markets and CMU will be for the recovery, once it comes. But this will need to be a fundamentally different CMU. It will have to factor in the consequences of Brexit, recent central bank interventions and fiscal stimulus measures, as well as the very real risks of fragmentation of our capital markets.

In order to mitigate these risks, we must structure the new CMU around two ambitions.

First, a competitiveness ambition. If Europe wants to provide citizens, businesses and society at large with the tools to turn these challenges into opportunities, it needs a vibrant single market for financial services.

> *Europe must be a continent of strong and competitive finance makers, not an open territory of finance takers.*

In this respect, Europe must be a continent of strong and competitive finance makers, not an open territory of finance takers. Therefore, every measure contemplated in

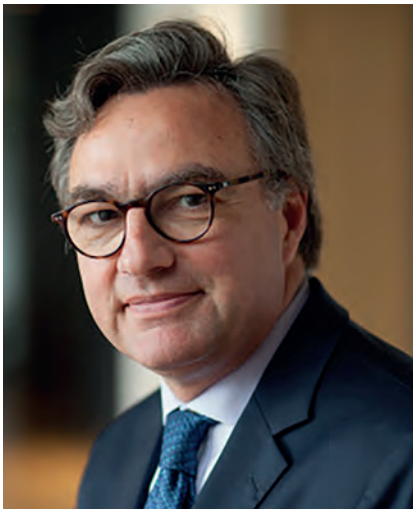
designing the new CMU must be assessed by a systematic "competitiveness test", which is more specific than the usual Commission impact assessments. This test should analyse - before new rules are introduced - whether they will make the EU's capital markets, financial institutions and infrastructure, stronger or weaker. If we want to unite capital markets, we ▶

need capital markets to be united. If this sounds obvious, then let's do it to stop the unilateral disarmament of the European financial system.

Second, a simplification ambition. Commission President Ursula Van Der Leyen has been clear that the regulatory philosophy of the Commission should be driven by the principle of "one rule in, one rule out". This simplification ambition is key to making the new CMU a success. Across the EU, investors, asset managers, issuers and all the other market participants need a pause in the continuous flow of incremental reporting obligations and operating constraints. Too often, such measures have a material impact on operations and profitability, without any tangible contribution to the unification of markets. Before proposing new rules under the new CMU, there must be a systematic assessment of what works and what does not work in MiFID II, MAR, Prospectus, Solvency 2, CSDR and the other pieces of regulation that have transformed markets over the past few years.

Many of the intended objectives of these regulations were not reached and some unwanted consequences have emerged, without the tools to mitigate the negative impacts on EU markets. This is a credibility test for the EU's regulatory ambitions. Either the new CMU will make all market participants' lives easier, with simpler rules, and trust in EU integration will grow. Or it will continue to add reporting obligations, follow a micro-regulatory approach, and market participants will turn to their national regulators and supervisors for more pragmatic solutions. Over-regulation will kill CMU and weaken Europe.

Euronext's ambition, by nature, is to be the backbone of the European capital markets. We want the new CMU to be a success. This is why we believe it is crucial that the new CMU be radical on these joint ambitions of competitiveness and simplification. ●



Jacques Beyssade

Secretary General, Groupe BPCE

EU competitiveness does include financial services

In Europe, banking groups are the main actors offering capital markets products to retail and corporate as permitted by the regulation. Banking and Capital Markets services are complementary and mutually reinforcing, each supporting the other by broadening the financing options available to their clients. The high level of financial regulation and supervision (AML, Prudential, Conduct, Anti-fraud etc.) is the result of a few crisis and 30 years of regulatory and supervisory efforts. Banks contribute to the collective interest while expanding their expertise and their range of services including capital market solutions to corporate and retail clients. Banks are helping clients to diversify their source of financing or investments as advisers, issuers, information providers, brokers, market-makers, asset managers, insurers and payment providers. Banks are naturally very well placed, with their strong client knowledge and the development of long-term partnerships to educate them, to help them adapt to all stages of their development, advise them on the best way to enter and use capital markets.

European companies need, in their immediate environment, stable and long-term financing partners to preserve their competitiveness, especially in case of crisis. It is becoming increasingly clear that EU needs a strategic financial autonomy: make bolder decisions, retain talents and their added value & profits, build on stable, reactive, and efficient financing channels, with decision centers located near European companies and key markets infrastructures. Regulation should support this need, especially in the context of the Brexit. EU is losing the UK's well-integrated financial center and its key market infrastructures (LCH, LME, LSE etc.). UK is intending to diverge while keeping access as much as possible to the EU market. It is time for EU decision makers to make the competitiveness of our financial industry one of the top objectives of all EU financial services regulation in addition to address financial stability and client protection needs.

For instance, the implementation of global standards (e.g. Basel) should not undermine our current strengths and specificities (e.g. infrastructure financing). The calibration of the EU market access is also crucial: an interdealer regime is needed to access worldwide liquidity, while all significant client activities should progressively be performed from Europe. Each equivalence should remain unilateral, granted after a thorough review, assessing competitiveness, financial stability and client protection, requesting an EU entity above a certain volume of activity.

> *EU needs strong European financial players to build an attractive and sustainable CMU.*

EU market attractiveness deserves more national and supervisory convergences, a prudential recognition of the Eurozone as a single jurisdiction and well-known measures to improve the quality of the client marketing/selling process (MIFID, PRIIPS). It also needs to foster an EU digital and green market: we would suggest creating an EU database to cover among others, NFRD corporate requirements, while maintaining reasonable costs for users.

To build an efficient CMU at the service of its economy, the EU needs to improve the attractiveness of its market for end-users as well as to preserve the competitiveness of its financial actors. ●

Laurence Caron-Habib

Head of Strategy, Market Intelligence and Public Affairs, BNP Paribas Securities Services

EU Capital Markets integration: be pragmatic and focused for real achievements

Today there is full consensus that the CMU project did not deliver enough during the previous European Commission mandate: even if some progress have been made in some specific, but limited areas, much still needs to be done.

In view of ensuring that right measures will be embraced, it is important to understand why integration of capital markets has still to be pursued despite huge efforts already produced. First, national specificities due to multiple cultural, economic and historical factors, still exist between Member States and are deeply rooted. Many regulatory initiatives to reduce this fragmentation have been launched but are stil to be effectively implemented (such as the CSD Regulation) to produce their full effect and reinforce capital markets integration.

At the same time, we still see diverging interpretations in the effective implementation and local transposition phase. This is typically the case for reporting requirements where national discretion still prevails. The insufficient cooperation between national competent authorities on this part, plus the absence of truly convergent supervision in many instances, harms the emergence of a truly single market and consequently the provision of cross-border services.

Complexity of the regulatory framework is another impediment to the effective capital markets integration. Due to heavy and costly requirements that may need to be replicated across jurisdictions, few players are ready and properly equipped to engage in cross-border investments or provision of such services.

In that context what should be the main priorities of public authorities to enhance the role of capital markets in completing the CMU? First reconsider the list of identified obstacles to this integration and select pragmatically which ones should be tackled in priority. The approach must be selective and realistic to ensure real progress will be achieved. As an illustration, whereas practices for corporate actions and withholding tax should be further harmonised, harmonisation of securities law should not be pushed forward.

Next recommendation is about addressing the current complexity of some EU measures that impede the developments of cross-border activities across the EU. Some regulatory regimes should be reviewed to simplify current requirements and introduce further proportionality when relevant. The revision process launched for MIFID2-MIFIR is a great news in this respect provided that it does not deviate from the initial target of limited and focused review.

> *The approach must be selective and realistic to ensure that real progress will be achieved.*

It is also crucial that there is an increasing cooperation between national policy makers and supervisors. In that space, additional powers should also be given to the ESAs where transversal approach should prevail across the EU.

This comprehensive set of measures should result in preserving and even strengthening the competitiveness of the EU financial sector. In parallel, leveraging new technologies to solve some persisting integration issues should be given the required level of attention. Fostering harmonisation and standardisation, while ensuring level playing field between all players, should prevail in this new space to ensure a real transversal framework will emerge and that errors from the past will be avoided. ●

Improving the funding of innovative and growing SMEs

Roger Havenith

Deputy Chief Executive,
European Investment Fund (EIF)

Navigating the twin transition: late-stage financing

With the coronavirus pandemic unfolding, there is little doubt that we are facing a health and economic crisis of unprecedented proportions in recent history. This comes against the backdrop of Europe's challenges related to digitalisation and the transition to a green economy.

As usual, it is the smallest actors in the economy that will find it hardest to cope. This is where public interventions need to help innovative European SMEs not only to navigate the transition, but also to lead it. With limited public resources, crowding in private funds will be key. Financial instruments have proven to be very effective attracting private funding and catalysing investment in support of European SMEs and midcaps. Research has confirmed that companies supported by EU financial instruments have seen greater growth in sales, assets and employment. It is now a question of using these instruments to target the industries of the future, secure Europe's competitiveness and harness them to support our values, policies and standards. This entails expanding established mechanisms to support innovative SMEs throughout their lifespan.

For many years, lack of sufficient early-stage funding was Europe's main equity market gap. Public measures aiming at catalysing private investments have successfully narrowed this gap. A second market gap, however, persists: when successful start-ups need funding to support further growth. In 2018, European VC-backed companies received just EUR 15bn in late-stage financing, compared to 24bn and 57bn for their US and Asian counterparts. In the absence of financial support in Europe, SMEs will relocate to more favourable financial climates. US and Chinese investments in Europe have been increasing and foreign investors – often government-backed – have been eyeing Europe's most promising companies, enticed by attractive valuations and driven by strategic interests. The recent CureVac case is indicative of this trend.

If we are to create global champions, late-stage support needs to be reinforced. The proposed SME IPO Fund would expand the range of EU support measures and help complete the VC ecosystem. The issuance of new SME stocks on dedicated markets in Europe has never fully recovered since 2008: amounts raised went from EUR 16bn in 2006 to less than EUR 3bn in 2018. Addressing this later-stage financing gap would significantly improve the exit environment for investors. In a recent EIF survey of more than 300 fund managers, 40% identified the poor exit environment as their greatest challenge.

In parallel, as we look to support key sectors such as AI, block chain, space, skills, climate and social impact, we also need to make progress in completing the CMU, strengthening the single market, and ensuring solid trade defence mechanisms and a competition policy framework fit for purpose. Faced with many challenges at the same time, Europe needs an ambitious and common Europe-wide response that addresses the immediate threats for the health of our citizens and needs of the real economy. A response, also, that is fit to address the longer-term challenges: sustainable economic recovery and maintaining the competitiveness and innovation potential of our companies.

Financial instruments are not a panacea. But they can be a critical building block of such a response, helping to fund the opportunities that will propel European businesses to the forefront of a sustainable recovery. ●

Carey Evans

Managing Director, Global Public Policy Group, BlackRock

A roadmap to an improved funding landscape for SMEs and innovative and growing companies

Despite the perception that Europe loses its highest potential companies to the allure of US venture capital and the US consumer market, many exceptional young companies do indeed choose to stay put in Europe. Furthermore, Europe is home to a significant number of more mature SMEs who are, in many ways, world-leading firms.

These companies can be exciting investment opportunities for many investors, and the companies themselves should be able to benefit immensely from access to capital market funding solutions in complement to bank finance. The refocused CMU agenda should ▶

▶ provide means to better-connect companies and investors.

We see three areas of focus for promoting a healthy ecosystem for financing these companies:

1) Provide companies with pathways to grow;
2) Facilitate and ease the listing process, and;
3) Promote a wider and deeper investor base for small companies.

The debate over incubating growing business tends to focus on the 'funding escalator' – a linear path through various stages of specialist venture and growth financing, ending with an IPO. This path is increasingly out of sync with how many companies grow from a financing perspective. Companies can stay private or go public, depending on their needs, but the crucial point should be providing the opportunities for companies to grow as businesses.

The untapped potential for the Single Market to help firms grow into a pan-EU marketplace beyond their own national borders is significant. Working capital is a key ingredient for helping small companies of all growth aspirations and trajectories thrive, but it is often overlooked in the policy debate around supporting SMEs. Promoting additional sources of working capital to complement bank finance – such as non-bank lenders, or ABCP programmes – would help companies meet a range of ongoing financing needs.

> *The refocused CMU agenda should provide means to better-connect companies and investors.*

When it comes to the companies for whom listing can be an acceleration of their growth and funding aspirations, improvements to the listing process can be made. Since 2013, 40% of European IPOs have failed – largely due to pricing expectations not being met. Promoting direct listings where a firm lists without raising capital is a positive intermediate step where firms can build a track record as a public company, and investors can deepen their familiarity before the firm looks to raise capital. In a limited sample size in Europe to date, direct listings have resulted in companies finding it easier to eventually meet capital raising goals than they had previously attempted in their IPO processes.

In the medium-term, it is imperative to grow a specialist investor segment focused on small companies. Widening the investor base by exploring whether policy can bring in new investors or accommodate increasing interest from larger institutional investors is critical. For example, looking closely at structural barriers like accounting issues for insurers and pension funds that keep them under-allocated to strategic long-term asset classes like early-stage equity should be a key focus for policymakers. We see exciting possibilities as well for bringing investment strategies focused on exposure to a range of growth companies at different points in their growth trajectory – from early stage providing continuous investment through to their development into more mature listed companies – to certain types of retail investors with long-term investment outlooks. The ELTIF provides a unique platform to grow this market; targeted amendments to the framework could help facilitate this further.

A roadmap to grow sources of funding for many SMEs is more necessary than ever as Europe faces recovery from the economic impact of the current pandemic. The CMU High-Level Forum is looking at closely these issues and we are hopeful that the range of recommendations result meaningful benefit for European companies and investors. ●

Henry Erbe III

Global Head, Strategic Relationship Management and Public Policy, Fidelity International

Financing sustainable innovation in the EU with an Electronic ESG IPO Exchange

With the start of a new decade, the EU Commission needs to take bold action to relaunch the European Capital Markets Union (CMU) initiative with stimulatory policy and stakeholder engagement to drive SME capital formation in the "real economy". Since 2015, the core aim of CMU remains the same - strengthen capital markets, finance SME innovation and create jobs. In 2020, Europe also finds itself as the world leader in promoting Sustainable Finance and Environmental, Social & Governance (ESG) initiatives - a position that Europe must maintain.

Fidelity International recommends that the EU consider establishing a dedicated electronic ESG IPO exchange (ProjectE3) to power SME innovation, European economic growth and job creation. The time for the EU to innovate and differentiate is now. In non-EU markets around the world, SMEs have historically pursued initial public offerings (IPOs) to access growth capital they need to hire new employees, develop products, drive growth, ensure governance, as well as to expand their businesses in home markets and globally.

> *The time for the EU to innovate and differentiate is now.*

In addition, IPOs also provide pension funds, other investors and employees who receive long-term equity incentives,

an opportunity to share in the upside of successful companies (studies show that 90% of job and revenue growth occurs after a company's IPO). The EU has not yet delivered on CMU and one negative result has been an 85% decline in European equity new issuance since 2005. The development of a dedicated electronic IPO ▶

exchange focused on sustainable initiatives will tackle multiple policy objectives of the Commission. It would enable SMEs access to growth capital, while putting into practice the objectives of the European Green Deal, Sustainable Finance and the CMU. With online issuance and electronic secondary market trading, an IPO exchange would also showcase Europe's evolution in the Digital Age.

In practice, we envisage a consortium of EU exchanges and market participants - bank underwriters and asset managers - developing an electronic IPO platform for ESG and sustainable SMEs with distribution to both institutional and retail investors as well as pension funds. In practice, SME eligibility for the ESG exchange would be determined using the EU taxonomy framework for the "Environmental" - and social, labour, tax and other policy frameworks for the "Social & Governance". A centralized ESG exchange and IPO platform would also encourage EU research excellence, market making, liquidity and attract non-EU issuers as well. Inspiration could be found with global regulatory initiatives for young emerging SME companies e.g. the US Emerging Growth Company IPO Reform, UK Alternative Investment Market (AIM), Hong Kong Exchange Innovation Lab & New Listing Regime - as well as many of the successful online financial lending and investing platforms.

EU regulators have an important role to play both in terms of overseeing the development of the platform as well as ensuring prudent governance and future supervision. With strong Points of View on IPO Reform, Sustainable Finance, Investor Education & Protection and FinTech Innovation, Fidelity International is ready to play an active role in creating an EU IPO Task Force to further develop this idea and others. ●

Oliver Gilvarry

Head of Markets & CMU,
Ministry of Finance, Ireland

The importance of European retail investors & SMEs for European economic growth

The development of our capital markets will support the growth of our SMEs at different stages of their development, which in turn will ensure Europe has a dynamic and growing economy. In order to achieve the objective of developing a strong and deep European capital market to support our SMEs, we need to have the pools of monies to invest in such markets. The potential for increased participation of retail investors in EU capital markets is significant. In the EU, 30% of total household financial assets is held as cash and bank deposits, with wide differences between Member States.

To gain the maximum from increasing the level of retail investor participation in our markets, we need to ensure they can invest in products that support our SMEs along their growth cycle, from start-ups to becoming large corporates able to raise financing via global capital markets. This means ensuring that we have the range of financial instruments that SMEs can use to raise financing, such as through venture capital or private equity or debt issuance or IPOs. This will also benefit investors by allowing them to diversify their risk by investing in SMEs in different sectors, but also allowing them to diversify via investing in SMEs at differing stages of development.

Under the first phase of CMU we have made a number of amendments to enable our SMEs access additional sources of funding, we have amended the Prospectus Regulation, Market Abuse framework and EuVECA/EuSEF. We need to ensure the changes we have made across these different pieces of legislation, and others, are sufficient and are working in tandem with one another.

At the same time we need to consider, are we providing the correct amount and quality of information to investors to enable them make investment decisions? MiFID II has provided significant transparency to investors in the area of fees and we are seeing a change in behaviour as a result.

We need to build upon this by ensuring we are providing the right information in an understandable way for investors, along with aiming to reduce the burden on entities providing this information. By achieving these two objectives, we will help make access to our capital markets more efficient. The introduction of an additional class of investor under MiFID may be a way forward, but it must be designed in a way so as not to add more layers of regulation on firms or investors or lowering investor protection too far.

> *Another initiative could be to examine what needs to be done to improve take–up of the ELTIF structure.*

Another initiative could be to examine what needs to be done to improve take-up of the ELTIF structure. Its objective is to invest in debt and equity of non-listed companies. Therefore, it should be the ideal vehicle for Europe's SMEs during the early stages of growth. In the last phase of CMU we have made changes to the EuVECA/EuSEF structures; we should now do the same for ELTIF to help promote early stage investment in our SMEs.

To conclude, Europe has a growing and vibrant SME sector and we need to continue supporting it. This is even more important due to the impact Covid-19 will have on all our citizens and economies. Therefore the changes we need to consider in the next phase of CMU is how we increase retail participation, ensure we have the appropriate mechanisms for them to invest in our capital markets and that they and SMEs can invest and raise capital efficiently. ●

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Western Union WU
Zurich

Enhancing transparency in securities markets

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

Less complexity, more transparency

Market transparency is a central pillar of the MiFID II framework and its effective application is critical for the development of competitive markets, ensuring informed investor decisions and allowing efficient allocation of assets. After two years of application of MiFIR, ESMA is assessing how transparency in EU markets has evolved and whether the new provisions have delivered on their objectives. In line with the review mandates embedded in MiFIR, ESMA published two Consultation Papers with analysis of the transparency regime applicable to equity and non-equity financial instruments and proposals for potential adjustments of the regime.

One important achievement of MiFIR is that national competent authorities and ESMA have more data at their disposal to check on market developments and assess how the law is working in practice. ESMA has made extensive use of such data in its consultation papers and the policy proposals entailed are based on in-depth data analyses.

Those analyses indicate that significant margin for improvement remains in many areas. For instance, on the equity side the majority of trading is not subject to pre-trade transparency (between 50 to 70% of trading in turnover), including on-venue trading where a large proportion of orders benefits from a pre-trade waiver (30% of turnover for shares and 50% for ETFs).

Regarding non-equity instruments, the level of both pre- and post-trade transparency appears to remain limited. This low level of transparency is partly due to the market structures prevalent in many non-equity markets but, in ESMA's view, also due to the way the MiFIR transparency provisions are designed. On the pre-trade side, MiFIR offers a broad range of waivers which, allow to be exempted from the transparency obligations under many circumstances resulting in real-time transparency being the exception rather than the norm. On the post-trade side, a complex deferral regime that is subject to national discretion has led to a patchwork of different rules applying in the Union.

Against this backdrop, ESMA is consulting on proposals reducing the complexity of the regime. As some examples, on the equity side, ESMA is considering to turn the double volume cap into a single cap, to simplify the applicable liquidity tests and to reduce the number of waivers.

For non-equity instruments, the main proposals include reducing the number of waivers and deferrals and establishing a streamlined deferral regime without national discretion.

Following the consultations, ESMA will analyse the feedback received with a view to aim at sending its final recommendations to the Commission in Q3 2020. ●

Anamarija Staničić

Head of Division, Policy and International Cooperation Division, Croatian Financial Services Supervisory Agency (HANFA)

Taking the long view in the equity market transparency debate

Now could be a good time to take a step back and asses if the transparency rules in the EU equity market would benefit from a larger overhaul, not just one that is Brexit related. Technology is distorting the application of MIFID/MIFIR rules, and data challenges in post-trade transparency will only get more demanding. Two years is not enough to assess if MiFID has led us in the right direction or not, but in the Brexit context, there is no question that a focused review is needed. Many of the requirements and thresholds in the current framework were calibrated to accommodate UK data. Consequently, rules like the double volume cap (DVC) cannot remain unaffected by the UK's departure.

The extraterritorial scope of the trading obligation carries its own pitfalls, with the potential to fragment liquidity and drain it away from EU venues. It is also difficult to assess how the systematic internaliser (SIs) regime will look like without the UK. It is a very fraught time to be a legislator, or ▶

an interpreter of rules, such as ESMA. So far, ESMA has concentrated on fixing the perceived failure of MiFID II to reduce trading on "dark" venues; through the use of waivers, the DVC, SIs, as well as on issues such as the trading obligation, and the (lack of) consolidated tape (CT). This is the technical side of the equity market transparency debate. And that is important – it truly is. However, we also need to look ahead, to the market as we want it to be, twenty years from now. Brexit is taking away what was a significant and integral part of the EU equity market for decades, but, at the same time, it is an opportunity for us to redefine what remains.

The real review of MiFID II should focus on the long view – how do we structure our equity markets to bring the most benefit to the real economy? How do we want our retail investors to predominantly access that equity market? Do we want to incentivise direct access, access through a financial product like an investment fund, or do we want to push a balance of both. This choice has an impact on the optimal structure of the transparency rules. We are currently trying to occupy the middle ground, which implies trade-offs in between types of access, as the optimal structure will at times conflict, favouring one type and penalising the other. Funds will benefit from a different set of rules than individual retail or even other institutional investors.

Waivers, thresholds, frequent batch auctions, SIs – they all have their benefits and drawbacks. Instead of focusing on the details, we should first ask how a rule or exemption incentivises our preferred policy choice. If a waiver or a venue of execution is justified in that context, then it should be permissible. The MiFID II framework also banked on being able to centralise all the data provided by Approved publication arrangements (APAs), but there is currently no CT in sight and one may be unlikely to emerge without some form of public sector backing. However, the viability of a CT may depend on legally obligating APAs to provide free data to the CT, or for a symbolic nominal fee. If so, a privately owned CT could be problematic, and a public infrastructure CT has its own challenges.

There is no doubt that we need to fix what Brexit broke, but we also need to acknowledge that some issues have not yet matured enough for long term policy decisions. ●

Stephen Berger

Managing Director, Global Head of Government & Regulatory Policy, Citadel

Achieving post-trade transparency in the EU non-equity markets

MiFID II laudably aimed to shine light on the historically opaque non-equity markets, including for both bonds and OTC derivatives. Regrettably, the post-trade transparency framework is not working as intended and has yet to deliver concrete benefits for investors. As the EU proceeds with the MiFID II review, addressing implementation shortcomings and establishing post-trade consolidated tapes for non-equities are necessary course corrections that will materially benefit EU investors, capital markets, and the broader economy.

Benefits of Post-Trade Transparency

Post-trade transparency, in the form of real-time public reporting of transaction prices and sizes, yields significant benefits. Myriad academic studies demonstrate that increased post-trade transparency in non-equity markets narrows bid-ask spreads and enhances liquidity. First, real-time public reporting empowers investors to accurately assess execution quality, demand accountability from liquidity providers, and obtain best execution. Second, real-time public reporting removes information asymmetries and allows all liquidity providers to better manage risk, and in turn, more confidently quote prices, commit capital, and warehouse risk across all market conditions. Third, real-time public reporting makes markets more resilient, especially in times of stress, by ensuring that new information is efficiently assimilated and reflected in current price levels.

Addressing Implementation Shortcomings in the MiFID II Post-Trade Transparency Regime

Unfortunately, to date, the accessibility and timeliness of the scarce EU non-equity post-trade transparency data that does exist is poor. First, very few off-venue transactions are subject to post-trade transparency requirements. For example, only approximately 5% of off-venue trading activity in OTC derivatives is currently subject to post-trade transparency requirements. Second, across bonds and OTC derivatives, even for on-venue transactions, four-week deferrals from public reporting are the norm, not the exception, primarily due to inaccurate liquidity assessments or excessively low size thresholds for trade deferrals. Finally, trading venues and APAs are not publishing post-trade transparency data free of charge after 15 minutes, as is required. Each of these shortcomings can be remedied and doing so will help set the MiFID II transparency regime back on course.

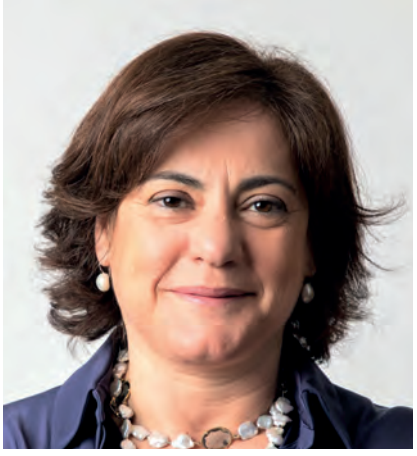
Establishing EU Post-Trade Consolidated Tapes for Non-Equities

In parallel with addressing the above issues, establishing real-time post-trade consolidated tapes for non-equities will ensure that EU investors can efficiently access and benefit from transparency data. The US post-trade consolidated tapes in each of the corporate bond, municipal bond, mortgage-backed securities, and OTC derivatives markets provide empirical evidence of both the value and viability of implementing post-trade consolidated tapes for non-equities. These consolidated tapes are each comprehensive, require mandatory contribution, disseminate information immediately upon receipt (both freely to the public via websites and via real-time data feeds at a reasonable cost), and feature targeted and limited deferral regimes for larger size block trades.

Conclusion

The MiFID II review process provides a critical opportunity to remedy identified implementation shortcomings and to establish post-trade consolidated tapes that together will put the MiFID II post-trade transparency regime for non-equities back on track, strengthening EU financial markets and improving conditions for investors. ●

Increasing retail investment in capital markets



Gabriela Figueiredo Dias

Chair, Comissão do Mercado de Valores Mobiliários (CMVM)

Retail investors are key to relaunch the CMU after the Covid-19 crisis

European capital markets development urgently needs a significantly wider engagement by retail investors, to equip the European Union (EU) with a financial system that can cope with the huge challenges we will be facing in the coming years. This is even more true given the deep, temporary, and hopefully short economic and financial contraction imposed by Covid-19. The flexibility and diversification of savings and credit alternatives offered by financial instruments to families and SMEs, but also to institutional investors, constitutes a significant advantage in supporting the recovery after the crisis, particularly in the context of a banking system under strain.

From a regulator's perspective, it is clear that, moving forward, financial supervisory and regulatory policies cannot focus mainly on market instruments and its infrastructure, as it has been the case in the first years of the EU's Capital Markets Union (CMU). More emphasis is needed on policies aimed at improving investor confidence in the capital markets, as there is no sound market without a wide investor base.

We should therefore focus on three dimensions: stronger financial literacy and investor protection, as retail investors are less prepared against bad market practices and have less capacity to recover from losses; fierce adherence to the highest quality and ethical standards among managers, especially in the financial sector; and on adopting a horizontal and cross-sectoral policy approach to markets, products and supervision that promotes a real single European financial market.

Regarding financial literacy, European initiatives have not been very expressive or effective. In what concerns investor protection, more has been done, and while trying to avoid overregulation, one should keep improving the legal framework and its application, as it being done regarding MiFID directive and legislation. Having said that, measures taken by ESMA, CMVM and other regulators to restrict CFD trading and binary options, or the use of its powers of product intervention, are part of the contribution we have given in this field.

When it comes to strengthening culture and professionalism of supervised entities and executives, the powers enshrined in MiFID, UCITS, AIFMD, EMIR, BMR and the Shareholders Directive allow regulators to assess and act on boards' culture, effectiveness and integrity and they should be strictly enforced. We should not refrain from acting.

Finally, to ensure a thriving European market for banking, investment, insurance and pension products, one should also level regulation and supervision accordingly, namely by aiming at a strong harmonization of the regulation across Member-states, including rules on ownership, insolvency and taxation of financial products.

The relaunch of the CMU after the Covid-19 crisis must be a priority, if we aim to regain our economies to full potential as soon as possible. For this to happen, the financial community as a whole needs to strengthen investor confidence in the capital markets by being more transparent and clearer regarding instruments, fees, rules and procedures; by being more focused on investors' needs; and by improving professional and ethical standards. ●

Niels Lemmers

Head of Public and Regulatory Affairs, European Investors/VEB

Never waste a good crisis to improve investor protection

The first few months of 2020 have been unique in the recent history of financial markets because of the speed of the correction. Almost all markets saw widespread sell-offs: equities, corporate bonds, commodities, gold and structured products. In the midst of promoting equity investments, the market turned south and had its worst performance in decades. And what years of legislative measures have tried to achieve happened in prompt reaction to the turmoil. In several countries more households started investing in equity. The WhatsApp indicator has arrived. Family and friends ask in WhatsApp groups how to start investing, because now you can get in relatively cheaply. And FinTech initiatives have made it even easier to start. If even the big drop do not keep households to invest for the longer term, then the tide may have turned. A proper, healthy equity culture is emerging. But at these junctures of market turmoil, unsuitable financial products are still being offered to households. Consequently, European Investors urge the reinforcement of investor protection rules. ▶

▶ Regulation has been implemented to ensure investors are advised on the benefits of equity investing with a long-time horizon. Unfortunately, investors are also buying complex structured products because they have been told that this would be a safeguard. Such advice is also based on regulations. Before the drop, the market was quiet and the delta was low so structured products were als quiet and reassuring. Then markets plunged precipitously, structured products fell even harder and their delta increased. The markets became more volatile and structured products were carried along with them. As soon as the barrier in the structured product is crossed, it is transformed from a capital-protected product into a unconditional loss. When unwinding the structured product, the issuer also needs to unwind the derivative hedges that were necessary initially. As derivatives markets became particularly illiquid, the cost of unwinding hedges increased, resulting in lower unwind prices for the structured product. Was this potential risk and painful scenario also properly explained to the end investor?

> *Was this potential risk and painful scenario also properly explained to the end investor?*

Never waste a good crisis, they say. Retail engagement in capital market is important to build that proper, healthy equity culture in Europe.

Understanding the trade-offs in the market is just as important, however. If anything, the ongoing reviews of the MiFID II/MiFIR and PRIIPs regulatory frameworks need to address two issues. First, investors should always receive clear and unbiased investment advice, giving them a realistic picture of how financial markets and products function.

The financial education of households will take time, maybe decades, but it all depends on the information given before entering the capital markets. Second, some products are hardly suitable for investors. Certainly not in volatile markets like those we are currently seeing. Without wanting to diminish the investor's choice, we need to be cautious.

We can only have these products on the sales board if investors were told about the risks and returns of these products. Strong and enforceable regulation is needed in this area. Preferably steered by ESMA. European Investors calls upon the European Commission and Parliament to act swiftly.

Retail investors don't need a new 'CMU part 3'. They need reinforcement of the current regulatory framework and investor protection rules. ●

Javier Hernani Burzaco

Chief Executive Officer,
Bolsas y Mercados Españoles (BME)

Boosting the flow of retail investment into capital markets

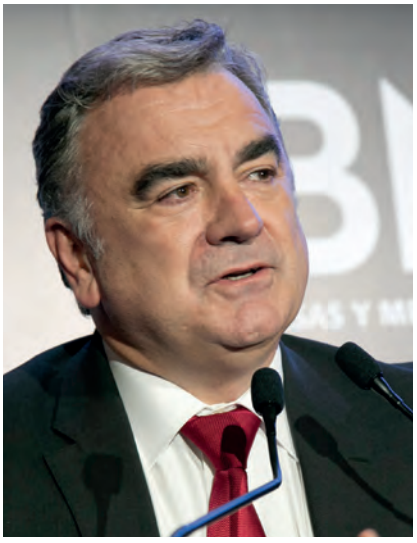
I head a financial group that has traditionally been proud of attracting high levels of retail investment.

Delving into my old papers while I was preparing this piece, I found that in 1998 a stunning 35,1% of our total market value of shares was in households' hands, ranking second after non-residents with a 35,9%, being the rest of holders banks, corporates, UCITS and public sector.

Unfortunately, the tune has changed since then, and in 2018 the figure had fallen to 17,2%, three points below ten years earlier. But there is always a silver lining: this figure shows a convergence with the rest of the continental exchanges –where direct retail investment has been lower– and almost 2,5 million Spanish households hold listed stocks within their portfolios.

There are several reasons that account for this trend. The most evident is the growth of investment funds. They provide fiscal benefits and are easily marketable by banks and, therefore, are a competitor difficult to beat. While 5% of the households' savings is directly invested in listed stocks, 14% is invested in funds. Market behaviour –particularly in sectors that whet retail investors' appetite, like banks–, also discouraged direct retail investment.

Finally, like the rest of Europe, Spanish financial sector is predominantly driven by bank products.



I mentioned above that there is a low level of retail investment across Europe. If we agree on the importance of retail participation in financial markets in order to release financial resources to fund companies' growth, we must admit that there is a European problem. ▶

If retail investors do not find easy ways to channel savings to productive investment, something is not working well in the Europe of the CMU.

In the CMU Green Paper, five years ago, the Commission stated that the development of capital markets in the EU required, among other measures, boosting the flow of retail investment into capital markets to diversify funding sources, which only could be achieved by enhancing the confidence of retail investors in capital markets and its intermediaries.

However, in the Midterm Review, four years later, the Commission acknowledges that engagement by retail investors with capital markets remains low, even though European households are amongst the highest savers in the world. The diagnose remains unchanged: most of the savings are held in bank deposits and accounts.

> *CMU must promote initiatives to increase levels of retail investor participation in public capital markets.*

So, the measures have been insufficient and extra efforts are needed.

Maybe we should think carefully about the design underlying our European financial markets and particularly, financial regulation. Blue chips squeeze less liquid stocks out. Big issuers leave no room in the marketplace to small and medium companies.

Investment advice limitations also contribute to make SMEs invisible. Small intermediaries are disappearing, cutting the links with the local financial ecosystems. Costs and lack of transparency throw retail investors out...

Daniel Kapffer

Member of the Management Board, DekaBank Deutsche Girozentrale

CMU on the tipping point – retail investments are key for sound economic development of the EU

Participation of retail investors in capital markets is absolutely crucial for two reasons. On the one hand, households and other retail savers are the main source of long-term funding for the European economy. Without sufficient retail investor engagement, the high dependency on bank loans will persist. On the other hand, pension schemes will not provide enough retirement benefits to maintain living standards.

Retail investors need to build a significant component through capital markets investments. That's why the CMU aims to foster greater participation from retail customers.

There is no doubt – investor protection rules are fundamental to a healthy development of retail investments in capital markets. However, if they result primarily in significant obstacles, they will only prevent investments.

European regulation seems to follow the idea that the client should be able to have a deep understanding of his potential investments similar to that of his investment advisor. This results in a significant complexity even for a simple investment in a plain-vanilla instrument. Consequently, it not only scares the retail investor but also denies a fundamental principle of modern economies – specialization.

Short and easy to understand information is fundamental for investor confidence

The recent EU regulations Packaged Retail and Insurance-based Investment Products PRIIPS and MiFID/MiFIR have aimed at reducing complexity and helping retail investors better understand the key features, risks, rewards and costs of different products through a short key information document. However, MiFID and PRIIPS have not been harmonized, particularly as costs are concerned.

Another issue that has already been taken on by regulators are the performance scenarios that might lead to very misleading information on returns. Also, the high degree of standardization (for example SRRI) has replaced qualitative descriptions of the key risks. In the end retail investors receive less information that might even be more confusing.

> *...investor protection rules are fundamental to a healthy development of retail investments in capital markets.*

Convenience stimulates confidence and reduces obstacles

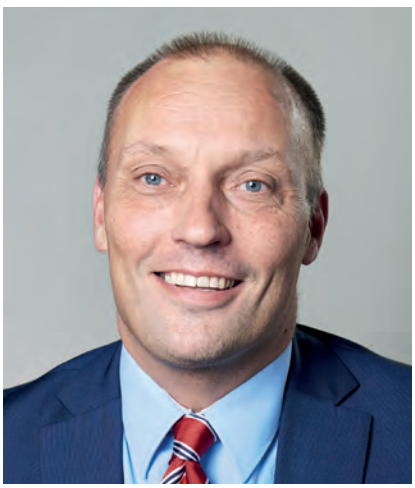
In order to achieve the two goals retail clients, need to invest on a regular basis into the capital markets. A one-time investment will not provide enough benefit. However, the rules set out especially in the MiFID/MiFIR for retail clients do not make a difference between different levels of retail investors. For each single transaction the whole set of requirements applies as it did for the last one even if this was in the same financial instrument.

▶ Product information documents, ex-ante and ex-post cost statements and other complex regulatory rules are difficult to digest for retail investors and so discourages them from investing in financial markets. The lack of convenience leads to a lack of confidence, which affects not only direct retail participation in capital markets, but also the indirect forms of investment available through the variety of collective investment vehicles, like investment funds and pension funds, because it lowers the general investors' demand for access to capital markets.

In addition, the requirements regarding a timely provision of ex-ante information are a significant obstacle for investments via distance communication channels – in the age of digitalization a major channel. To ensure that these clients can use a means of distance communication effectively, and to ensure the timely conclusion of transactions, more flexibility is required.

The need to record phone conversations should be deleted especially because of privacy concerns for customers and the potential to impair the confidentiality of communication between investment firm and client.

Overall the regulatory approach has increased obstacles for retail clients to invest in capital markets while generating extremely high implication cost and increased cost of service for investment firms. The CMU can only evolve with investors who feel convenient and comfortable with their choices. ●



Paul-Willem van Gerwen

Head of Efficient Capital Markets Division and Trade Decisions Supervisor, Dutch Authority for the Financial Markets (AFM)

How a strong CMU could help reduce the fall-out of the Covid-19 crisis

In 2020 we saw global disturbance, as a result of the outbreak of Covid-19, resulting in markets being in turmoil. The current situation makes the case for a CMU even stronger – the need for highly integrated markets, with deep liquidity and available unlocked capital flowing freely. Facilitated by an appropriate set of rules this will offer companies various financing options by different types of market participants and financing providers.

A recurring key element to strengthen the CMU and increase funding options for companies across Europe is in achieving stronger participation among retail investors in capital markets and to provide them with more cost effective, simpler financial products and fair advice.

In relation hereto, building adequate and sustainable pension systems will help the retail investor to indirectly enter the capital markets by savings for his or her retirement. It would be worth exploring both public and private sector options to improve pension adequacy in member states with less developed pension systems.

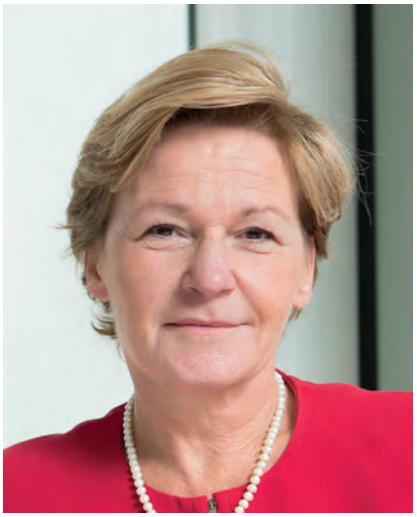
Also, further improved investor protection on EU level is required to achieve retail participation suitable for cross-border activities and open, transparent capital markets. In light hereof, the current EU passporting system, while being a cornerstone of the internal financial market, still faces challenges with regards to its implementation in the respective EU countries, as NCAs might hold different views on how to operationalize different EU legislation. This in turn can lead to 'jurisdiction shopping' where financial services companies seek the jurisdiction that applies specific requirements less intrusively.

Another key prerequisite for the CMU to become successful is the availability of transparent, integrated, standardized and highly liquid secondary markets covering various types of financial instruments such as equities and bonds.

As recent events have shown, market liquidity is essential in times of severe stress conditions as demonstrated during the current fall-out of the Covid-19 crisis, particularly for firms to retain access to funding. While the equity markets remained open and liquid (though highly volatile), the European bond markets came to a near-standstill with liquidity all but completely evaporating, particularly in the corporate bond market.

> *A fully integrated CMU is essential in avoiding future market collapses of any kind.*

In light of the strengthening of the CMU, it would be worthwhile to trigger a discussion on further improving the foundations of the EU-bond markets, particularly allowing for more open equity-like transparent market structures enabling cash-strapped companies with more direct access to retail savings. As the current primary and secondary bond markets are highly dominated by banks and the volumes of new issuances make bonds almost illiquid by nature, a necessary prerequisite would be further standardization of eligible instruments. This would enable access and liquidity provision by a more diverse landscape of market participants ranging from banks, professional trading groups, institutional and retail investors. Fundamentally, rather than central banks purchasing bonds of the balance sheet of banks to trigger the provision of credit, a more sensible approach could be offered by a strong CMU enabling firms to seek funding through a multitude of sources. ●



Judith Hardt

Senior Advisor, Better Finance

Retail investors are the key to the completion of the Capital Markets Union

There have been several attempts to build an integrated and resilient Capital Markets Union. From the perspective of Better Finance, the CMU project still lacks a solid individual retail investor base. 50 years ago, households were the primary owners of European stocks[1]. Today, foreign investors hold 32% of Eurozone listed equity, while households' ownership represents merely 11%. EU savers who have financial investments[2] gain exposure to the EU economy mostly indirectly, through packaged products (insurances, pensions, etc.), while listed shares account for only 4% of their financial balance sheets[3]. This is because investors are being "sold" packaged investments which are unfortunately often quite expensive and fee-laden products. They are very rarely offered 'plain vanilla' shares.

This development had a negative impact on Europe's capital markets. The market capitalisation of listed equities in the EU is almost three times smaller than in the US. SME fund themselves to a large extent through bank loans. In addition, dark trading increased despite the double volume cap introduced by MiFID II. About 60% of equity trading now takes place over the counter, versus 20% -40% before MiFID I.

To integrate capital markets, you need to integrate investor demand and retail user's perspective into the equation. Household savings are the foundation of any capital market. The first sentence of the Interim Report of the High-Level Forum on the capital markets union notes the following: Demographics clearly show that pay-as-you-go pensions will increasingly need to be supplemented by life-long intelligent saving and investing. If low interest rates persist in the long-term, savings accounts will no longer be a mechanism to increase the value of one's savings. This will only be achieved through a large-scale switch to equity investments.

It has become increasingly clear that the CMU must provide real investment opportunities for citizens to help them prepare their long-term needs, such as retirement, health and education.

To achieve this, investors firstly need easier access to specialised and truly independent expertise. The MiFID 2 and IDD reviews must eliminate inducements, at the very least for execution-only services, regardless if the investment products are insurance-based or not.

Secondly, Better Finance believes that it is paramount to develop and incentivize Employee Share Ownership. This could be the single most powerful driver to develop equity markets and culture.

Thirdly, the PRIIPs framework must be reviewed as popular "retail" bond markets decreased by 70%, due to the new KID requirements.

Finally, individual investors need free and easy access to pre and post trade information on the listed securities they buy. All "retail" trading, must be brought back to regulated markets. ●

This article has been co-writen by Stefan Voicu, Research & Policy Officer of Packaged Investments, Pensions & Insurances, Better Finance

1. Didier Davydoff, Daniele Fano, Li Qin, 'Who Owns the European Economy?' (August 2013) Observatoire de l'epargne Européene, Insead Oee Data Services, p. 86, Annex 5, Table 3.
2. A survey in 10 large Eurozone Member States shows that, on average, only 43% of citizens do have financial investments, which speaks a lot about both households' participation in capital markets and financial inclusion; see European Commission, 'Study on the Distribution
3. See BETTER FINANCE's CMU Assessment Report 2015-2019, https://betterfinance.eu/wp-content/uploads/CMU-Assessment-Report-2019.pdf.

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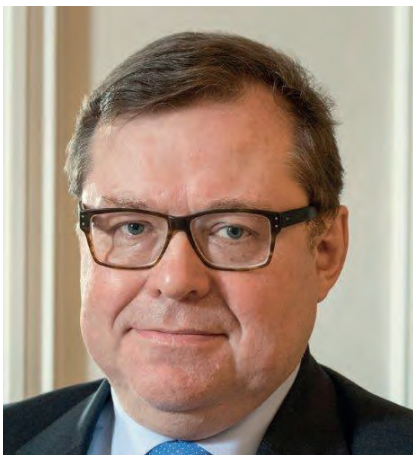
Challenges and priorities of the EU fund sector



Jean-Paul Servais

Chairman, Financial Services and Markets Authority, Belgium (FSMA)

Asset management regulation challenged by climate change and digital developments

Asset management in the EU is embedded in robust regulatory frameworks, including the UCITS Directive and AIFMD, to the benefit of the market operators and the investors. The success of the UCITS label is recognized both in the EU and abroad. Broadly spoken, AIFMD has worked well. Therefore, at this moment, there does not seem to be a need to launch a thorough AIFMD review, even if in some areas are welcome (e.g. in the area of segregation duties in case of delegation of the safekeeping of assets by the depositary). It is in the interest of the EU to have a stable framework for funds, while at the same time be responsive to new challenges, and this against the background of a prolonged low rate environment and of the corona crisis.

Firstly, asset management has a role to play in the European ambitions to achieve sustainable finance and, ultimately, the ambitious EU climate goals. In this respect, the EU should take a leading role, but should engage as well at a global level to contribute to the adoption of standards and practices that are internationally adoptable. Mobilizing sufficient private investment will not be possible without efficient capital markets and an important role for asset management. In this respect, enhanced transparency of sustainable features of financial products allows investors to identify viable sustainable investments. However, this evolution can give rise to investor protection concerns and can lead to greenwashing, especially given the risk of confusion about existing terminologies. Adequate disclosure and a harmonized taxonomy should address the risk that investors end up buying products, which are marketed as sustainable when in reality they are not.

Asset management also has to keep pace with digital developments in finance. Among the relevant developments are online digital services, robo advice, artificial intelligence and machine learning, each of which entail risks, benefits and opportunities. Regulators' strategy in relation to technological developments can be summed up by three actions: facilitate, monitor and supervise. Innovation hubs are possible channels to facilitate the contacts at an early stage between Fintech players and supervisory authorities and allow for better monitoring of the innovations. Supervision should ensure that innovation happens smoothly, so not to endanger consumer protection, fair and efficient markets or financial stability.

The increasing volume of the assets under management has finally led to a greater focus on asset management from a financial stability perspective. The FSB has issued recommendations intended to address financial stability risks from structural vulnerabilities associated with asset management activities that could materialize in the future. IOSCO has operationalized these recommendations concerning possible liquidity mismatches and fund leverage. Both aspects merit close attention at EU level. Although existing tools in the EU already address many of the macroprudential concerns, it is recommended that the relevant authorities review their existing regimes and consider making adjustments as appropriate to ensure potential financial stability risks are addressed in a forward-looking and internationally consistent manner. ●

Marco Zwick

Director, Commission de Surveillance du Secteur Financier (CSSF)

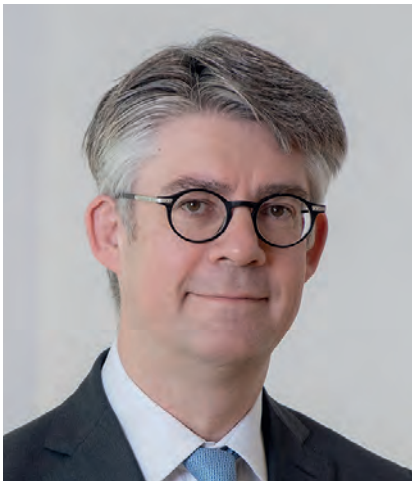
Key supervisory priorities for asset management

2020 key supervisory priorities include:

- Liquidity risks of investment funds, with a focus on UCITS;
- Cost and performance of funds, e.g. performance fees, closet index trackers;
- Data quality, availability and usage in relation to AIFMD, SFTR, EMIR;
- Review of AIFMD and related impact on UCITS;
- Sustainable finance and ESG;
- Anti-Money Laundering and Counter Terrorist Financing.

This article focuses on two of these key priorities: liquidity risk management and cost and performance of investment funds, which both are essential to maintain the highest degree of investor protection.

1) Recent isolated issues concerning liquidity risk as well as the strong growth of total net assets in funds have raised concerns with securities regulators. Hence, a closer look at the liquidity position of UCITS and AIF by investment fund managers and their supervisors is warranted. Having said that, we believe that the currently existing regulatory framework, which is based on international and European rules, overall provides for a solid basis to address liquidity risks in investment funds. Therefore, the primary focus for investment fund managers ▶



should be on adhering to those rules. Compliance with the rules is key to ensure financial stability, investor protection and the orderly functioning of financial markets.

With this objective, ESMA, together with National Control Authorities, has recently launched the Common Supervisory Action (CSA) on liquidity risk management. The CSA is a two-stage process starting with a data-driven screening on a large set of asset managers followed by a risk based, in-depth analysis on a smaller sample of managers, whose objective is notably to verify adherence to liquidity rules, to assess the existence of potential vulnerabilities and possibly suggest future improvements.

> *We monitor stability and the conditions under which the respective investment fund product and management passports continue to function effectively.*

2) Work in relation to costs and performance of investment funds is being performed at various levels:

- ESMA will soon publish its second annual report on costs and performances of retail investment products (including investment funds), produced under the EU Commission's Capital Markets Union Action Plan and aiming at facilitating increased participation by retail investors in capital markets by providing consistent EU-wide information.
- EU work in 2020 will also encompass the implementation of the forthcoming ESMA Guidelines on Performance Fees in UCITS and retail AIFs, which notably apply to actively managed UCITS.
- Work will continue on so-called "closet index trackers" which, according to their official documentation, claim to be managed in an active manner while in fact staying very close to a benchmark and, by doing so, overcharging for their investment management services. ESMA published a related statement in 2016 and at national level, and closet tracking remains a key issue for the CSSF in 2020. Following the initial investigations in 2016 / 2017, the CSSF thereafter continued work with a particular focus on enlarging the scope of the investigations.
- Finally, we monitor that, from a legal and regulatory perspective, the investment fund regimes remain stable and verify the conditions under which the respective product and management passports, which have contributed to the investment fund success story, continue to function effectively. ●

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

ESMA's priorities for asset management in a changing world

There is no shortage of exogenous stress factors for the asset management sector currently, from the COVID-19 pandemic and its economic fall-out, the prolonged low-interest rate environment to the shift of money associated with the emphasis on sustainable finance. In addition, the asset management sector is facing evolving customer preferences, pressure on fees, and the growth of the passive asset management business model.

ESMA is monitoring these trends as well as the potential risks that may flow from them. As a result, one of ESMA's key priorities is liquidity risks in the asset management sector.

> *There is no shortage of exogenous stress factors for the asset management sector currently, from the COVID-19 pandemic and its economic fall-out, the prolonged low-interest rate environment to the shift of money associated with the emphasis on sustainable finance.*

ESMA launched on 30 January 2020 a Common Supervisory Action (CSA) with national competent authorities (NCAs) on the supervision of UCITS managers' liquidity risk management. NCAs will assess simultaneously whether market participants in their jurisdictions adhere to the UCITS liquidity rules in their day-to-day business, on the basis of a common methodology developed together with ESMA.

The CSA should be seen in the context of ESMA's broader work on stress testing. In July 2019 ESMA published Guidelines on Money Market Funds' stress tests, followed by Guidelines on liquidity stress testing (LST) in

UCITS and AIFs in September. On 5 September ESMA also published a stress simulation framework for investment funds, simulating a large redemption shock affecting investment funds and the subsequent impact of asset sales on financial market.

Regarding sustainable finance, ESMA recently issued its strategy. ESMA will promote ESG transparency by issuers and market participants to help investors to better understand the ESG impact on their investments and improve transparency on investments' contribution to a sustainable economy. ESMA will do this by:

- drafting technical standards and advice to the Commission (such as the Joint Committee technical standards under the Disclosure Regulation),
- providing guidance to market participants, building awareness, ensuring a common approach to supervisory activities on ESG,
- supervising transparency and application of relevant ESG requirements (relevant for credit rating and benchmark in the future); and
- developing risk identification of ESG factors, monitoring market developments of products with ESG characteristics and adjusting stress tests to incorporate ESG.

ESMA's renewed strategic orientation for 2020-2022 has emphasised the need to actively promote retail investor engagement in the European capital markets. Essential to these aims is ESMA's ongoing work on costs and performance of retail investment products, including the work on closet indexing and the technical work on the key information document for packaged retail and insurance-based investment products (PRIIPs).

Finally, the European Commission's process to review the AIFMD should not be forgotten. The AIFMD has formed an essential part of the European asset management sector legislation since it came into application in 2013. ESMA will ensure that lessons learned from the years of NCAs' practical experience supervising AIFMs are considered as the primary legislative framework is under review. ●

Simon Janin

Head of Public Affairs, Amundi

Key priorities and opportunities ahead for the European asset managers

While representing the second largest region in terms of assets under management, the EU still substantially lags behind the US. In 2020, the American asset management market size is expected to be roughly 52 US$ trillions, outperforming that of Europe[1], that barely exceed 29 US$ trillions[2]. Certainly, the mere quantitative comparison has its limits, as it does not take into account structural differences (notably the importance of pension funds in the US). This being said, a number of well-known reasons including the absence of a fully integrated market, the lack of supervisory convergence along with a burdensome regulatory environment, are some of the challenges to the development of asset management in Europe.

Proportionality, stability and predictability should then definitely inspire the EU regulation applied to the asset management industry. We need European players able to compete with the rest of the world in order to fully address the funding needs across the single market. Together with a strong focus on the importance of preserving a real level playing field with other jurisdictions, it is essential to ensure that we are properly mitigating market fragmentation and avoid as much as possible supervisory divergences orchestrated by various NCAs. In this respect, the forthcoming AIFMD review should be the opportunity to recognize the notion of EU group as a way to strengthen European asset managers' competitiveness and take the full benefit of the single market. This would definitely facilitate the exercise of the delegation or outsourcing of management between two entities belonging to the same group - provided that they are both subject to EU legislation. The AIFMD review could also allow for a clear recognition of AIFs that are UCITS-like and only address material shortcomings without reopening the directive's overall framework. Furthermore, great attention should be paid on the suitability of the current reporting framework.

The needs in terms of retirement savings and preference for the long term can also make the difference in the future. There is a tremendous opportunity to channel EU citizens' savings into long-term investment products. To achieve this goal, a balance has to be reached between risk-mitigation techniques and the need to invest in illiquid assets in order to achieve returns. Our industry together with policy makers must find solutions that certainly include a better consideration of the time horizon of investors.

> *The AIFMD review should be the opportunity to recognize the notion of EU group.*

Having all this in mind, the EU asset managers should be able to seize decisive opportunities in order to play their cards right. In this respect, sustainable investing has become a must-have for the asset management industry. The regulatory framework is evolving quickly, with the European Action Plan launched in March 2018 already taking effect, notably through the taxonomy, disclosures and benchmarks regulation. In parallel to the upcoming NFRD review, that should extend access to more comparable and reliable data, it is also essential to provide a European Ecolabel based on a scientific based taxonomy that properly includes transition activities. ●

1. Europe refers to the EEA + the UK + Switzerland.
2. The Cerulli Report, Global Markets 2019, p 40.

Jarkko Syyrilä

Head of Public Affairs, Nordea Asset and Wealth Management

Recovery from COVID-19 turmoil has to be EU's top priority in financial services

EU's short-term top priority in financial services needs to be supporting the economy to sustain and recover from the coronavirus crisis. Governments, central banks and other authorities need to do whatever it takes to overcome the economic impact of the crisis. New regulatory initiatives/ requirements should be delayed to help the financial industry to recover its operations and support its customers in full.

Looking beyond the current crisis, moving towards a carbon-neutral economy is a fundamental challenge facing the EU economy the next decades. The devastating economic impact of COVID-19 pandemic will add to the challenge. Both public and private capital will be needed to achieve the transition and asset management can be a key channel to convey private investments in a sustainable way. There is growing client demand for this and also lot of regulatory action.

What asset managers need in support of this development is clear standards and harmonization that will support the growth and mainstreaming of sustainable finance. Avoiding labels and frameworks becoming too niche and hindering product development is key. Regulation needs to be meaningful, requirements clear and non-duplicative and implementation schedules realistic. Key is also to have clearer ESG data standards so asset managers can assess the investee companies properly and fulfil all the new requirements.

EU asset management regulation is very mature and successful in global comparison, especially UCITS has become a global gold standard which has to be preserved. No major overhaul is needed. The planned reviews of the UCITS and AIFMD should be evidence-based, carefully targeted and aimed only at addressing material issues that cannot otherwise be addressed through supervisory convergence.

Lot of focus has in recent years been devoted by the stability regulators on liquidity of investment funds. The COVID-19 market turmoil is now stress testing the current rules in real life. EU regulation already provides a proper toolkit for asset managers to manage the liquidity of their funds, but these tools are not evenly allowed by the national regulators. A big step forward would be ensuring that these liquidity tools are available in all EU jurisdictions.

Many EU regulatory measures have in recent years been adopted impacting indirectly asset managers, most prominently MiFID II which is having key impact on distribution models. With the review of MiFID II now commencing EU has the opportunity to correct the problems that have arisen for the industry to be able to serve its clients properly. There are certainly pressures to amend the client classification framework to create a category for semi-professional investors and to simplify the costs and charges disclosures.

EU action is needed to establish a proper framework for long-term investment for retail investors, allowing them to commit a greater part of their savings into less-liquid investments. It seems we will be in the low yield environment for long so Europe needs new kinds of products to give retail investors adequate returns. ELTIF was a laudable idea but has not been taken up by the market. We need to analyse carefully what went wrong and how to create a workable framework on less-liquid assets for retail investors to ensure they have all the means they need to achieve a proper asset allocation for their savings.

The European economy faces many short-term and long-term challenges. By working in constructive dialogue policymakers and the industry can ensure that asset management continues to help economies and citizens to overcome the challenges they face in current crisis and in the future. ●

Stéphane Janin

Head of Global Regulatory Development, AXA Investment Managers

How circumstances should lead to asset management regulation adaptation?

At the time of drafting of this article, it is difficult to anticipate what the market situation will be when it is published. However, some lessons can already be drawn – possibly leading to practical actions by policy-makers and regulators.

First, the prompt spreading of a natural virus and its consequences were difficult to anticipate. Since the 2008 crisis, the work carried out by supervisors was mainly targeting the risk of re-occurrence of a similar event. The actions were not so much taking into account externalities such as sanitary risks and their impacts on finance. Probably no one can be blamed for that, as by definition a crisis occurs where you have not anticipated it.

So the point is not to anticipate any crisis for ever – which would be ▶

pure utopia – but more to set the right tools to manage in practice the consequences of an unpredictable shock.

The current EU legal requirements work well. AIFM and UCITS Directives require fund managers to be licensed, monitored and if needed sanctioned by NCAs. The role of ESMA to facilitate the coordination among NCAs is also positive to facilitate convergence at EU level.

However, the current exceptional context demonstrates the insufficient requirements applicable to other players in the value chain or the uncertain application of best practices and rules among Member States.

First, regarding risk management, fund managers are currently lacking information from distributors on the detailed profiles of fund investors. ESMA identified the need for fund managers to anticipate investor behaviors, through its "Guidelines on liquidity stress testing in UCITS and AIFs" issued in September 2019. But to date, distributors do not provide on a free-cost basis for such investor profiling.

Still regarding risk management, many Member States have not introduced the complete set of fund liquidity management tools available in other Member States, e.g. swing pricing. This is regrettable as already 2 years ago, IOSCO issued a report recommending NCAs to introduce the widest range of tools: « IOSCO expects that authorities will actively promote the implementation by responsible entities of the 2018 Liquidity Recommendations".

> *Set the right tools to manage in practice the consequences of an unpredictable shock.*

The fund industry reminded such issues to EU authorities in two AMIC/EFAMA public reports on fund liquidity, already in 2016 and more recently this year. We wrote: "We note that the operational tools listed, such as swing pricing, for example, while not mandatory under the AIFM or UCITS frameworks, are useful liquidity management tools for fund management companies. ESMA could encourage the NCAs in certain EU Member States to consider broadening the range of available tools, thereby ultimately contributing positively to the management of liquidity risk."

Last, the Commission should use its powers at Level 4 to ensure the application of existing EU rules across Europe. For instance, we are still lacking the first ESMA report on AIFM measures and sanctions, although required by the AIFM Directive almost ten years ago.

These practical actions by ESMA and the Commission towards Member States should be taken as top priorities, in the general interest of financial stability and investor protection – before deciding to launch any legal revision of the AIFM rules. ●

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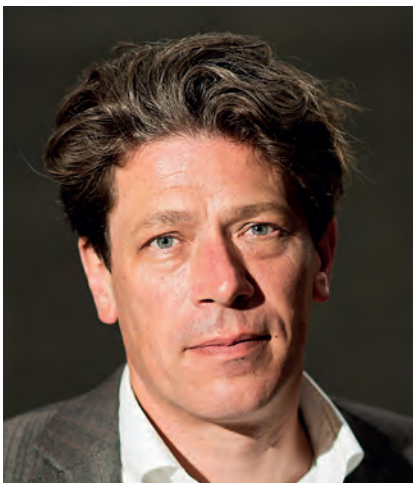
Relaunching securitisation in the EU



Paul Tang

MEP, Committee on Economic and Monetary Affairs, European Parliament

Securitisation done right

Securitisation done right has benefits for lenders and institutional investors alike. Securitisation done wrong, however, can amplify economic crises and bring the global economy to its knees. The EU's securitisation regulation created a standard that allows for the benefits of securitisation, while avoiding the pitfalls. Under the right economic circumstances and with the endorsement of regulators, securitisation can play a pivotal role in recapitalising banks in the post-COVID, Basel III regulatory environment.

Pooling illiquid assets into tradable securities allows lenders to increase lending capacity while transferring risks to investors according to their preferences. It is important however, that these risks do not remain in (the systemic part of) the financial sector, so that overall stability is guaranteed. Besides, when low trenches of asset-backed securities are repeatedly packed in collateralised debt obligations, it quickly becomes impossible to analyse the product's creditworthiness. Since such CDOx products helped propel a US housing crisis into a global financial meltdown, it is only right that a certain stigma is attached to – complex – securitisation.

When, after the financial crisis, European securitisation remained subdued, the European Institutions reset the market through a regulatory framework for "good" securities. It set rules on due diligence, risk retention and transparency for all securities, and enabled the identification of simple, transparent and secure (STS) products. With level-2 measures published, we now see the first early results. In 2019, 143 transactions were notified to ESMA as STS. In the first two months of 2020 over 30. STS is thus a workable standard, allowing the reaping of securitisation's rewards, without suffering its drawbacks.

Expansionary monetary policy means the use of securitisation to increase lending capacity is limited. Why pay fees to a range of credit rating agencies, underwriters or credit enhancers, when you can secure cheap capital with the ECB? But, with EBA estimating that banks need over €100bn to fulfil Basel III requirements, securitisation can help reduce risk and improve one's capital base. Given the sector's efforts during the current COVID-19 crisis, this amount is only set to increase. Securitising outstanding loans will be essential to reach Basel III standards.

However, the EU regulatory environment means that using STS securities is not yet fully rewarded. For example, the standards for other financial products have not caught up with those for securities. Products such as covered bonds lack securities' transparency and due diligence requirements. With ambitious regulation on these products, the EU can set off a race to the top while guaranteeing a level playing field.

As EU we can be proud to have eliminated the most stringent risks associated with "bad" securitisation while creating the global standard for the "good" kind. Yet, the combination of expansive monetary policy with an imbalanced regulatory environment means the EU is not fully capitalising on this standard. With lenders seeking the capital base increase that securitisation provides, this is something to set right. Upcoming reviews of financial legislations provide a good opportunity to do so. ●

Martin Merlin

Director, Banks, Insurance and Financial Crime, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

The STS label has kicked off to a good start, but fine-tuning needed

Securitisation plays a key role in the Capital Markets Union (CMU) creating a bridge between bank lending and the CMU objectives. Overall, it is expected to contribute significantly to unlocking the benefits of the Single Market for EU businesses and households by providing more innovative, sustainable and diversified sources of funding. When soundly structured, which was one of the aims of the overhaul of its legislative and regulatory framework, securitisation allows banks to transfer assets to institutional investors and free up capital for new lending, while providing markets with a broader scope of investment opportunities.

The EU securitisation market got off to a slow start in the beginning of 2019, ▶

in the first months of application of the new framework, but activity picked up thereafter. The authorisation of third-party verifiers seems to have had a very important positive effect on the STS market, helping operators navigate the new framework. The first STS deal, a private RMBS securitisation, was notified to ESMA on 22 March 2019. Thereafter, originators started 'taking the plunge' and nearly 200 STS deals were notified to ESMA by mid-March this year.

It is early to make definitive conclusions about the state of the market and the impact of the new framework after just one year of application. The take-up of the STS label does point to strong demand among investors. Thus, the new label has helped to reduce the stigma among investors. However, the fact that we have not yet seen a broadening of the investor base and, more generally, a significant rebound in the securitisation market suggests that additional action might be needed.

The European Commission is finalising the Level 2 measures which, together with the Q&As by the ESAs, should dispel any lingering uncertainty about the application of the new rules. To support issuance, the Commission will explore extending the STS label to synthetic deals and facilitating securitisations of non-performing exposures, based on input from the EBA.

The upcoming comprehensive review of the securitisation framework, mandated to take place by January 2022, will look carefully at all of its aspects, including the Level 2 measures. Moreover, The CMU High Level Forum is preparing recommendations with the objective to relaunch and scale up EU securitisation as it can bring considerable benefits to the European financial system.

> *The new label has helped to reduce the stigma among investors. However, additional action might be needed.*

With regard to the capital treatment of securitisation exposures, there is widespread acknowledgement that it needs to be adapted to the specific features of non-performing exposures. The EBA and BCBS are already actively working on possible adjustments in particular to the formulaic approaches for the calculation of capital charges. Another area requiring potential improvement is that of the recognition of significant risk transfer where stakeholders claim a more uniform interpretation and application of CRR provisions by supervisors.

The EBA is expected to produce a report by the beginning of 2021 that could serve as a basis for a delegated act by the Commission. The Commission is also working on the adoption of the RTS that will allow a more widespread use of the Internal Ratings Based Approach, the most risk-sensitive method for the calculation of capital charges for securitisation exposures.

Supporting the EU securitisation market remains a priority for the Commission. The aim of the securitisation framework is that the market functions on a solid and sustainable footing, subject to clear criteria and appropriate supervision and prudential rules, in order to ensure that the securitisation duly contributes to the CMU objectives. ●

Alexander Batchvarov

Managing Director, Bank of America

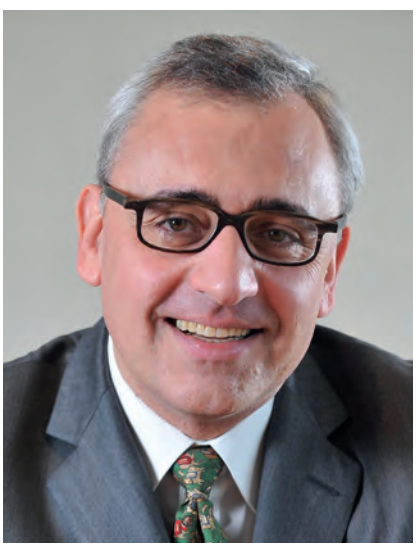
STS: unleasing the potential of EU-27 Securitisation Market

In each of the last two years EU-27 issued €370-€400bn of covered bonds, placed €7-€9bn of RMBS, and €50-€60bn of other securitisation bonds. The STS introduction in 2019 did not boost issuance volumes; it is unlikely to do so in 2020. By way of comparison, securitisation represents 12.5% of GDP in the US (excluding GSE securitisations) and 12% in the UK vs. 3% in the EU-27; covered bonds represent 21% of the EU GDP and 4% of UK GDP.

Securitisation represents 6% of all green bonds in China and about 1% in the EU. Many factors affect securitisation activity: ECB policy, non-bank lending, bank capital needs, but they alone cannot explain the low utilisation of securitisation in EU-27. Securitisation has an important role to play in the EU-27. The introduction of Basel 3 will increase bank capital requirements by an estimated EUR100bn.

> *The securitisation regulatory regime must be realigned with that of other fixed income sectors.*

The focus on sustainable finance and ESG impose new criteria on bank balance sheets. Banks must address the new capital and financing needs through sale of assets, balance sheet optimisation and/or securitisation. Banks offload assets to asset managers and finance companies, which in turn finance their acquisition via securitisation. If half of the bank capital increase is due to residential mortgages and



half of that is addressed via securitisation, then a need for EUR800bn of RMBS issuance in the next 5-10 years will arise.

Funding the EU Green Plan also needs a functioning EU securitisation market. EU-27 needs to scale up its securitisation market, but it remains underutilised. ▶

With the introduction of STS in 2019 the regulatory capital for securitisation increased on average under CRR, remained unjustifiably high under Solvency 2, there was no change in liquidity and repo treatment of securitisation bonds, and detailed disclosure and due diligence requirements (unparalleled in any other fixed income sector and in any other jurisdiction) were imposed. The calibration of regulatory capital for EU securitisation does not reflect its historical performance and is subject to non-neutrality.

The securitisation regulatory regime must be realigned with that of other fixed income sectors, especially loans, corporate and covered bonds. Several changes can be introduced in the near term to allow for the EU securitisation market to scale up and to provide the much needed support for the EU economy and banking sector: A/ Modify securitisation capital and liquidity treatment under CRR (e.g. LCR treatment, p factor, WAM); B/ Recalibrate capital treatment for securitisation for insurers under Solvency 2 in line with covered bonds for STS and corporate bonds for non-STS securitisations; C/ Simplify significant risk transfer requirements for cash and synthetic securitisations, expand the STS for synthetics beyond SMEs to include other granular exposures. D/ Differentiate between disclosure and due diligence requirements for public and private securitisations applying proportionality and allow for longer-term use of ND fields.

EU-27 securitisation market has a crucial role to play in deepening of CMU, in greening the EU economy, in strengthening bank balance sheets while introducing new capital and sustainable finance requirements. Key measures necessary to ensure that it fulfils that role lie in the hands of the EU policymakers. ●

Philippe Bordenave

Chief Operating Officer,
BNP Paribas

Five "game-changers" to scale-up securitisation in Europe

Following the implementation of a burdensome STS regime, European issuance dropped to EUR 131 bn in 2019[1], down by 6% y/y, compared to USD 2.5trn in the US. As long as such a gap exists, every banking regulation will have a disproportionate impact on the EU compared to the US.

While the goal should be to develop pan-european home loan securitization, this can only be a mid-term project. In the short term, the current EU prudential framework should be urgently adjusted, with five regulatory changes needed as "game-changers" to scale-up the EU securitisation market:

1. Unlock the Significant Risk Transfer Assessment process

This process is essential, for issuing banks to benefit from a reduction in capital charges, commensurate with the risk transferred to the market. While the CRR defines specific quantitative and qualitative criteria to meet this Significant Risk Transfer, the additional discretion provided to competent authorities has turned into a major obstacle, with multiple metrics added.

- When the level 1 quantitative and qualitative criteria are met, banks should be considered as achieving significant risk transfer, with no additional supervisory scrutiny.
- Such simplified rule would still result in a very prudent framework, given the conservativeness of the RW of the retained tranches, even after the proposed recalibration as per below.

2. Recalibrate capital charges applied to senior tranches, in line with their risk profile, for originating and sponsor banks

The implementation of the STS framework aimed at defining strict criteria for a safe securitization, but instead of reducing the RWs of the senior tranches, it has actually increased them. Also, it did not address the issue of "non-neutrality", whereby the cumulated RWA of securitized tranches is between 2 and 4 times the RWA of the loan pool prior to securitization, making securitization economically unviable.

- The non-neutrality should be reduced by recalibrating the "p factor" that drives this multiple
- The RW floor applied to senior tranches should be reduced for originators and sponsors, as they have a perfect knowledge of the securitized pool.

3. Enlarge STS benefits to synthetic securitisation beyond SMEs

Synthetic securitizations are easy to execute, standard, and very useful to transfer risks and release capital. Protection sellers are highly specialized, and they perfectly understand the risk.

- The same RW should apply as for cash securitizations.
- STS synthetic securitisations scope (currently limited to SME's) should be extended to all corporates and retail exposures.

4. Upgrade eligibility of senior STS tranches in the LCR ratio

The revision of the LCR Delegated Act has not improved the treatment of senior STS tranches.

- Senior STS tranches should be promoted to Level 1 (for residential and auto loans, the most liquid types of securitization) and Level 2a (SME loans and other ▶

consumer loans), with same haircuts as for covered bonds.

5. Review the Solvency II calibration of senior tranches

Insurance companies should be able to invest in senior tranches instead of investing directly in the underlying assets with no credit enhancement.

- The credit spread shocks applied to senior STS securitization positions could be aligned with those applied to the bonds and loans.
- Finally, removing ESMA disclosure constraints on private transactions also appears as a pressing issue.

Those five measures are needed to rebuild a functioning ecosystem for securitization, allowing for a significant scale up of issuance, far above recent levels, which represent only about 1% of EU banking assets. Given the upcoming Basel III regulatory pressure, the need to finance the energy transition, while reducing the over-reliance on bank funding, the EU should take prompt action to significantly scale-up the securitization market. ●

1. Figures based on SIFMA, BNPP data. European securitisation placed issuance (EUR bn); scope: ABS, CDO/CLO, CMBS, RMBS, SME.

Dimitris Zafeiris

Head of Risks and Financial Stability Department, European Insurance and Occupational Pensions Authority (EIOPA)

EU regulation supports functioning of the securitisation market in a prudent way

A well-functioning securitisation market improves the funding capacity of the real economy and contributes to completing the Capital Markets Union. At the same time, securitised assets may provide an alternative investment opportunity to insurance and reinsurance undertakings, which need to diversify their portfolios in a low yield environment. As institutional investors, insurance and reinsurance undertakings should be fully integrated into the Union's securitisation market.

It is important that Solvency II, as a risk based regulatory framework, provides a sound basis for (re)insurers to invest in securitisations without jeopardising the regime's prudential risk-based nature. In 2013, EIOPA proposed a solution to reduce capital requirements for specific securitisations by a more granular treatment of securitisations. For identifying less risky securitisations, EIOPA developed a set of criteria related to the structure of securitisations, the quality of the underlying assets, the underwriting processes and the transparency for investors.

The proposal was based on analysis which had shown that those types of securitisations meeting a set of quality criteria had a good track record of performance. From a supervisory perspective, EIOPA proposed to apply lower capital requirements to those instruments.

> *EU regulatory frameworks including Solvency II support the functioning of the securitisation market and long-term growth objectives in a prudent way.*

To ensure a sound recovery of the EU securitisation market after the financial crisis, in 2017 a new overarching securitisation framework was introduced. The new framework includes criteria to identify simple, transparent and standardised ('STS') securitisations and a system of supervision to monitor the correct application of those criteria by originators, sponsors, issuers and institutional investors.

The Regulation also provides for a set of common requirements in relation to risk retention, due diligence and disclosure for all financial services sectors[1]. To avoid double regulation and for reasons of clarity and consistency, the Solvency II framework was adjusted accordingly in 2018. The amendments to the Solvency II Delegated Regulation[2] introduced a more risk-sensitive calibration of the solvency capital requirements for STS securitisations held by undertakings.

The level of the calibration and the risk sensitivity across tranches was aligned with the features of STS securitisation, and is now consistent with the prudential requirements developed for credit institutions and investment firms. The objective is to provide the right incentives across different forms of securitisation investments and allow for better alignment between risk and capital management. A more detailed review of the Solvency II reporting and disclosure requirements will be part of the 2020 review. ●

1. Regulation (EU) 2017/2402 of the European Parliament and of the Council of 12 December 2017 laying down a general framework for securitisation and creating a specific framework for simple, transparent and standardised securitisation.
2. COMMISSION DELEGATED REGULATION (EU) 2018/1221 of 1 June 2018 amending Delegated Regulation (EU) 2015/35 as regards the calculation of regulatory capital requirements for securitisations and simple, transparent and standardised securitisations held by insurance and reinsurance undertaking.

Jan-Peter Hülbert

Managing Director,
True Sale International GmbH

Securitisation and STS: contribution to financial markets stability in the EU

In order to asses this question, the review of the last financial crisis provides two important insights: First, default rates of European securitisations were consistently low and did not cause losses and bank bailouts.

Rather, securitisation as a highly collateralised financing tool has contributed to financing the real economy in times of crisis. Secondly, the European legislator and the ECB have rightly adopted a number of important regulations in the period 2009 to 2011 that will prevent securitisation types that were responsible for the financial crisis 2008, especially: 5% risk retention, loan-level data, no originate-to-distribute models and ban on re-securitisation.

Now how is securitisation used in practice and what impact does the new EU Securitisation Regulation (applicable since 2019) make? Firstly, banks can provide its customers with solutions for funding and capital relief, products employed are public term ABS with placement to investors, and private securitisation financed via bank balance sheets and including ABCP programs (Asset Backed Commercial Papers). Secondly, banks securitize own assets from their ordinary course of business to achieve funding and capital relief. This again involves term ABS as well as private, bilateral securitizations for risk transfer. This differentiation is necessary in order to understand what contribution the EU Securitisation Regulation has made and what problems still need to be solved.

The EU Securitisation Regulation overall and also the STS criteria for simple, transparent and standardised securitisations as a quality segment distinguish between ABCP and non-ABCP (i.e. term ABS). Term ABS issuance of €220bn in 2019 has declined by ca. 15% compared to 2018, and no new issuers or investors could be attracted. On a positive note, STS has gained broad acceptance as new market standard in the asset classes residential mortgages (RMBS), auto, consumer and equipment leasing ABS.

This has been supported by the independent third-party verifications of the STS criteria. The strong regulation, acceptance of STS and increased transparency have strengthened confidence of politicians, central banks and supervisory authorities. However, this positive aspect only applies to the Term ABS market.

The picture is different for private securitisations and ABCP, as well as the market for capital relief trades, together making up a volume of ca. €200-250bn p.a. in Europe. The new Securitisation Regulation does not reflect the particularities of these market segments, with sometimes inconsistent, inappropriate and prohibitive rules and reporting obligations. ABCP securitisations should be treated as what they are: Highly secured funding instruments, allowing banks to finance the real economy and receive secured refinancing with short maturities, similar to covered bonds at the longer end of the maturity spectrum.

> *Securitisation will contribute to stability and be part of the solution this time.*

Still a series of changes and improvements need to be made to the level 1 regulation and certain level 2 RTS issued by the respective ESAs. The level playing field of securitisation with other products like covered bonds as part of the Capital Markets Union still needs to be achieved. A clear and consistent ruleset for banks applying significant risk transfer (SRT) for capital relief needs to be established by the legislator and applied uniformly from supervisors across Europe.

Especially in the context of the current situation with severe consequences due to Covid-19 for the real economy and the stability of the financial system, this once again shows the necessity for clear and consistent rules, limited complexity and no procyclical consequences. Under these premises and based on trust, securitisation will contribute to stability and be part of the solution this time. ●

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CCPs outstanding issues

John Berrigan

Director-General, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Making clearing safer: two new frameworks for CCPs

In mid-October 2019, the European co-legislators adopted a set of targeted amendments to EMIR – the European framework for CCPs – to strengthen the supervision of CCPs in light of their growing systemic importance ('EMIR 2.2'). The objective is twofold: first, fostering convergence in the supervision of CCPs established in the EU, and, second, improving the supervision of third-country CCPs that provide services to EU firms according to the risk they present for the stability of the EU financial system. While not being the only driver, these amendments are of course especially important for the EU in the Brexit context.

The new rules enhance the supervisory role of ESMA and EU Central Banks over third-country CCPs. The amendments introduce a new category of third-country CCPs that are systemic for the financial stability of the EU, and that could therefore become subject to specific requirements and direct supervision from ESMA. As a last resort, the Commission can also require a third-country CCP to provide certain services to EU firms from within the Union. The Commission will soon come up with a set of delegated regulations that will specify how EMIR 2.2 shall be implemented. The Commission is working to make the new approach proportionate, predictable and efficient, while safeguarding financial stability.

The implementation of EMIR 2.2 will require close cooperation with our international counterparts with which we intend to keep an open and balanced dialogue in order to reach a proportionate and common approach to deference in the field of CCP supervision.

Already in 2016, the European Commission adopted a legislative proposal for a framework for the recovery and resolution of CCPs. While a CCP failure is an unlikely event, it is essential to have in place rules that will enable us to deal with such a situation should it occur. The Commission proposal implements the internationally agreed FSB framework, ensuring that the critical functions of CCPs are preserved while maintaining financial stability and protecting the taxpayers.

The European Parliament adopted its report in March 2018 while the Council adopted its general approach in December 2019. The positions are close, hence a political agreement could be reached soon – potentially during the Croatian presidency.

The current points of divergence are twofold. First, both the Council and the Parliament have proposed to increase the involvement of the CCP's own resources in the recovery phase. The Council does not require this additional involvement to be prefunded, to the contrary, the Parliament proposes to significantly increase this involvement and make it prefunded. Second, on decision-making in resolution, while insisting on a fair representation of all relevant authorities of potentially affected Member States, the co-legislators recognise the primary role of the CCP's resolution authority but have different views on the design of the resolution college and on when and how to inform the resolution college about resolution actions.

The CCP Recovery and Resolution Regulation will complete the legal framework applicable to CCPs in order to ensure safe clearing in the EU. ●

Robert Ophèle

Chairman, Autorité des Marchés Financiers (AMF)

EMIR 2.2, a new allocation of supervisory responsibilities for CCPs

On 2 January 2020 EMIR 2.2 entered into force, revisiting supervisory arrangements for EU and third-country CCPs in light of the growing size and cross-border dimension of clearing in the Union.

EMIR 2.2 clearly allocates the supervisory responsibilities and enhances ESMA's role for both authorised EU CCPs and recognised third-country CCPs, especially through the creation of the "CCP Supervisory Committee", an internal committee of ESMA composed of a Chair, two independent members and the competent authorities of Member States with an authorised CCP.

Regarding EU CCPs, diverging supervisory practices across the EU have brought out the need for supervisory convergence: in particular, there have been discrepancies in national practices with respect to the consultation of supervisory colleges ▶

▶ for the purpose of issuing an opinion on CCP extensions of activities and services (Article 15 of EMIR) or risk model changes (Article 49).

Under EMIR 2.2, the home-country supervisor remains ultimately the responsible competent authority of the CCP but ESMA's role has been reinforced in order to promote a convergent approach towards European CCPs and to homogenise the application of EMIR across the EU.

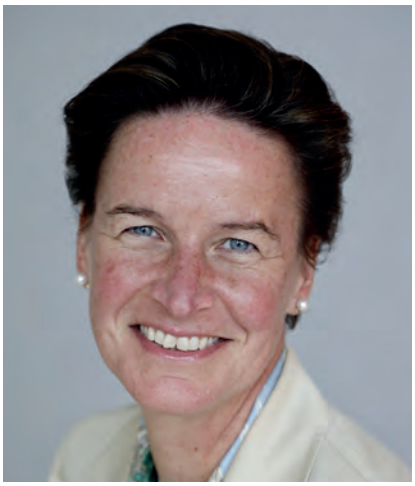
The new CCP Supervisory Committee is responsible for conducting analyses, such as peer reviews of the supervisory activities towards CCPs or Union-wide stress tests of the resilience of CCPs, and promoting convergence between competent authorities and across Colleges through decisions and opinions, especially with regard to supervisory areas which have a cross-border dimension or impact, such as access of trading venues to CCPs (and vice versa), interoperability arrangements, authorisation and extension of services and activities. [The recruitment process of the Chair and the independent members of the CCP Supervisory Committee is in progress and ESMA's Board of Supervisors should appoint them in the coming months].

> *ESMA's role has been reinforced in order to promote a convergent approach towards European CCPs.*

In addition, the composition of EMIR Colleges has been enlarged to central banks of issue and additional competent authorities, where the jurisdiction's financial stability could be impacted by a CCP's financial distress, and their role has been strengthened. EMIR Colleges can provide opinions on additional supervisory areas and a comply or explain process has been introduced for the competent authorities when they significantly deviate from an opinion issued by the College.

Regarding third-country CCPs, ESMA is responsible, mainly through the CCP Supervisory Committee, for classifying third-country CCPs depending on the level of systemic risk they pose for the Union and effectively and directly supervising recognised CCPs that are determined to be systemically important Tier 2 CCPs. ESMA powers include the ability to conduct investigations and on-site inspections and to impose fines. Besides ESMA, relevant Union central banks of issue are also involved in the recognition, supervision, review of recognition and withdrawal of recognition of third-country CCPs.

The implementation of this new regime is pending, subject to the finalisation of the Delegated Acts that will define the tiering criteria and the conditions for comparable compliance. This is particularly sensitive taking into account the perspective of the end of the Brexit transition period. ●



Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

Putting in place ESMA's new supervisory powers

EMIR 2.2 came into force on 1 January 2020. One of the first measures adopted by ESMA has been to establish the CCP Supervisory Committee as an internal committee of ESMA, creating the new governance and decision-making process. While the recruitment of the Committee's Chair and the two Independent Members is ongoing, the committee has met already a number of times in its interim composition and is organising its new tasks with respect to EU-CCPs.

The provisions in EMIR 2.2 introducing new tasks and processes promoting supervisory convergence in the supervision of EU-CCPs are already applied by ESMA, the relevant competent authorities and CCP colleges. For example, in the case of significant changes to risk models and parameters, CCPs are already applying the revised process.

ESMA has also established a CCP Policy Committee to deal with the new regulatory mandates in EMIR for developing draft regulatory technical standards (RTS) and guidelines. ESMA is now finalising its draft proposals to adjust existing RTS and guidelines on CCP colleges to the new tasks and processes envisaged in EMIR 2.2, and will next work on the remaining mandates for RTS specifying when an extension of authorisation is required and a change to a CCP's risk model or parameters is significant and subject to validation.

However, the provisions in EMIR 2.2 introducing a new regime for the recognition and supervision of Third Country CCPs (TC-CCPs) are not yet applicable, pending the adoption of the relevant Delegated Acts by the European Commission.

In November 2019, ESMA provided the European Commission with technical advice concerning these Delegated Acts in relation to (i) the tiering criteria to be taken into account by ESMA when determining the systemic importance of TC-CCPs (ii) the minimum elements and the modalities and conditions when assessing comparable compliance for systemically important TC-CCPs, and (iii) the supervisory fees for TC-CCPs.

ESMA's role and ability to perform effective supervision of TC-CCPs will be largely determined by these Delegated Acts. They will determine the TC-CCPs that will be in scope of ESMA's more robust supervision, due to the fact that these CCPs are systematically important for the European Union or one or more of its Member State(s). They will also determine the nature and extent of ESMA's assessment of compliance of those so-called "Tier 2 CCPs" with the EMIR requirements under the new comparable compliance regime and they will determine the fees charged to finance ESMA's supervisory activity. Fees are key to ensure that ESMA's required supervisory costs related to TC-CCPs are covered by the entities and not by EU taxpayers. ●

Toks Oyebode

Executive Director, Regulatory Affairs, J.P. Morgan

Better aligning incentives between CCPs and market participants

It is generally understood that CCPs have grown in systemic importance since the 2008 financial crisis. Together, regulators, CCPs, and market participants have made strides towards improving CCP resilience, recovery and resolution planning. However, a number of critical issues remain outstanding. Moreover, the current period of market volatility associated with COVID-19 is likely to highlight strengths and vulnerabilities in the system.

J.P. Morgan recently published a paper alongside eighteen other global buy- and sell-side institutions – "A Path Forward for CCP Resilience, Recovery, and Resolution" – which identifies outstanding issues that regulators and CCPs should consider and makes twenty recommendations to address them.

In the spirit of ensuring on-going financial stability in times of market disruption or crisis, the paper seeks to better align incentives between CCPs and market participants and ensure that clearing member and end-user liabilities are appropriately limited and manageable. In doing so, the paper seeks to protect financial stability and ultimately taxpayers, by ensuring that CCPs are resilient and that recovery and resolution processes are reliable and are not procyclical. The paper is intended for a global audience, but many of the recommendations are directly applicable to matters under consideration in the draft EU Regulation on CCP recovery and resolution.

- On resilience, the paper recommends that CCPs should make material contributions of their own capital to the default waterfall in two separate tranches, as a mechanism to align a CCP's incentives and ensure effective risk management related to the CCP's clearing activities. In addition, it recommends that CCPs should be responsible for non-default losses, supported by appropriately sized regulatory capital requirements.
- On recovery, the paper emphasizes the importance of compensating market participants for losses incurred through the use of recovery or resolution tools and capping pre-defined assessment rights at an amount equal to each clearing member's default fund contribution. In addition, the paper emphasizes the need for appropriate governance and regulatory oversight of the use of procyclical recovery tools.
- On resolution, the paper recommends that CCPs set aside ex-ante resources (e.g., issuance of long-term debt that could be bailed-in) for recapitalization, and that regulators conduct regular reviews of CCP rulebooks to ensure a common understanding of CCP risk.

These and other recommendations are covered in more detail in the full paper.
The EU should be commended for introducing important measures to improve the safety and soundness of derivatives markets and related financial market infrastructure through the European Market Infrastructure Regulation (EMIR) in 2013. The draft EU Regulation on CCP recovery and resolution presents an opportunity for further progress through the establishment of a comprehensive framework to address the recovery and resolution of CCPs.

While the existing draft Regulation is an important step forward, we strongly believe more can and should be done. Incorporating the recommendations of this industry white paper into the Regulation would further the goal of enhancing financial stability through even more resilient and robust CCPs within the EU. ●

Daniel Maguire

Group Director, Post Trade Division, LSEG & Chief Executive Officer, LCH Group

CCP R&R – Why access to highly liquid markets and resilience matters

The EU CCP Recovery and Resolution (R&R) framework seeks to ensure that, if the conditions for a CCP R&R are met, swift action can be taken to: (i) safeguard financial stability; (ii) secure the continuity of the CCP critical functions; and (iii) protect taxpayers. We are fully supportive of these objectives and believe that resolution (and to a further extent, recovery) should be managed by the clearing community (including CCPs, clearing members, clients, competent authorities) without recourse to taxpayers.

CCPs manage the risks of the wider market and act as circuit breakers in case of crisis. The use of R&R tools would therefore be the result of a much wider stressed market scenario whereby, for example, several major banks would have defaulted on their obligations towards the CCP, and their corresponding capital requirements and resolution regimes have proven to be insufficient. Even under these conditions, margin requirements and mutualised ▶

resources should still allow CCPs to manage extreme but plausible scenarios. It is therefore imperative to focus on the prevention of a crisis, by ensuring that CCPs operate to the highest standards. It is also vital that everyone is incentivised to support these strong resilience standards.

However, CCP R&R discussions have not typically focussed on prevention, and instead focused on increasing CCP resources to cover for losses from a default. It is important to recognise that increasing CCP resources to cover default losses in recovery or resolution does not strengthen financial stability or CCP resilience. In fact, this would have the opposite effect and increase CCP 'dead capital', which would limit the resources available to strengthen their resilience and increase clearing costs. This could also run counter to and hence change clearing members' incentives to support the liquidation of a defaulter's portfolio, potentially weakening the resilience of the whole system.

We believe that, in order to ensure a safer and more robust clearing community, in line with CCP R&R objectives, the discussion should be focussed instead on the following two aspects:

- **How to ensure a resilient and diversified CCP membership,** in particular by ensuring that only strong profiles have access to the CCP. CCP membership should also be sufficiently diversified (to limit wrong-way-risk) and actively engage in CCPs' fire-drills, to ensure it is well prepared to respond to a market event.
- **How to ensure the corresponding diversified supervisory input:** CCP R&R is unlikely to happen in isolation: there is a need to ensure a wide and diversified regulatory overview and input into CCP supervision, and also to 'stress-test' supervisory cooperation to ensure that the entire clearing community (including authorities) is well prepared.

CCP R&R frameworks should be implemented in such a way that there is sufficient preparedness primarily within the clearing community to manage shocks in the most effective way. Supervisors must also be able to use the relevant tools to ensure close ex-ante coordination. In addition to the increased scrutiny on CCP resilience, bringing the clearing community closer is the 'extra-layer' that will be most beneficial to financial stability, and ultimately, taxpayers. ●

Jochen Metzger

Director General,
Payments and Settlement Systems,
Deutsche Bundesbank

It's all about incentives!

The EU CCP R&R proposal is the latest addition to regulation following the financial crisis. It provides a framework for dealing with events even beyond extreme but plausible scenarios. Since the introduction of the clearing obligation for OTC derivatives, CCPs have become even more crucial providers of post-trade services. Hence, rules on how to deal with default and non-default related losses are imperative. One particular challenge is how to deal with losses which exceed the resources provided for by the rulebook. In the CCP R&R this challenge is addressed by a multitude of instruments, one of which is a cash call reserved for the use of the resolution authority to cover losses from default as well as non-default related events.

In general, resolution is a very severe and disruptive situation that should be avoided. The best resolution is the one that does not take place. We need to test and increase the resilience of CCPs, applying scenarios in which established correlations cease to exist.

The default management process of a CCP determines the size of the losses. This means that management, shareholders and participants need compelling incentives for contributing to its success. Auctions play a pivotal role here. The more successful the auctions, the more likely it is that the CCP will recover without recourse to recovery measures or resolution.

A strong incentive for the CCP to ensure effective risk management and soundly designed auction processes is its own contribution to the default waterfall, which in the EU currently stands at an additional 25% of a CCP's capital. The draft R&R regulation seeks to add another 25% when in recovery. For clearing members, unsuccessful auctions can mean that losses are mutualised as agreed in the rulebook, pre-funded resources may be used up and need to be replenished through the assessment regime. Or worse, if losses persist, positions may be returned to the clearing member via partial tear-up. Such consequences represent a clear and strong incentive for clearing members to make meaningful contributions in auctions and should not be weakened by additional contributions of the CCP.

Non-default losses can originate from investment risks, custodian and settlement risks, operational risk, and legal risk and are supposed to be covered by the capital of a CCP. One exception are investment losses where loss-sharing arrangements with clearing members often exist. The draft EU regulation also provides for a cash call in case of resolution caused by a non-default related event. The welcome advantage of this is that it gives the resolution authority additional resources to cover losses. However, it may have repercussions on the incentive structure as clearing members will have to cover losses for which the CCP's shareholders and management bear the ultimate responsibility.

EMIR requires that capital be calibrated by the CCP with the approval of its regulator such as to also cover risks from non-default losses, and the FSB is working on guidance to help resolution authorities calculate potential gaps in resources for loss coverage with the aim of closing them. In the case of non-default related losses, more CCP-side contributions could help avoid increasing the burden on clearing members. ●

Capital market development in CEE

Pierre Heilbronn

Vice President, Policy and Partnerships, European Bank for Reconstruction and Development (EBRD)

CEE capital markets in the post-crisis environment

The earlier global financial crisis of 2007 hit the economies of Central and Eastern Europe (CEE) hard, exacerbated by over-reliance on foreign currency lending, a highly Eurorised economy and low levels of domestic savings. The actions agreed at the Vienna Initiative stemmed the immediate financial stability risks and established that a move away from an over-reliance on traditional banking services was an absolute priority.

A lot of constructive policy reform has occurred since then- including the launch of the EBRD's "Local Currency and Capital Markets Development Initiative" in Zagreb in May 2010- but the latest crisis, precipitated by the COVID-19 pandemic, and the capital outflows from the region, show that there is some way to go.

We recognise the CEE as a dynamic region, which has the potential to grow at a faster rate than the EU as a whole. Integrated capital markets must remain an essential part of this formula, and a constructive and innovative approach is required to shift these economies in the right direction.

The CEE countries face specific challenges in developing their financial sectors due to the limited size of their individual markets. Any policy interventions, including post-crisis response, should consider these when arriving at solutions:

- Recent events suggest that an on-going priority is to develop secondary market liquidity in order to build investor confidence – volatility in markets was exacerbated by the inability to execute trades and hedge currency and interest rate risks. Facilitating access to local markets for all investors is key, as well as developing connectivity, and reducing transaction costs.
- Linked to this, single country solutions for developing capital market infrastructure tend to be uneconomic and do not pique investor interest. Regional solutions that highlight the CEE as a "region within a region" are preferred.
- Local capital markets in CEE countries do not attract investors nor support larger issuers because of their limited scale. Under-developed money markets, domestic government and corporate bond markets undermine strong, market-oriented economic development.
- Banks still finance 90% of the economy in CEE (the EU average is 75%) and focus on traditional business, resulting in a relatively limited range of financial products available. The rise of innovative products, such as covered bonds, is recent and limited.
- EU funds have been valuable in targeting public sector and infrastructure development, but there are huge gaps in access to finance for the private sector, particularly SMEs. SMEs will also be hardest hit by the adverse effects of the current crisis.

The EU Capital Markets Union is a hugely beneficial initiative, which will remain integral in post-crisis actions to reopen financing channels. It needs to remain an agile framework that takes into account the distinctive challenges of the CEE countries.

So, where do we go from here? Regardless of whether we are undertaking crisis response or post-crisis rebuilding, 'regional initiatives', something that the EBRD has championed for many years, must remain a priority. Short-term Central Bank securities purchase programs and IFI support facilities to boost liquidity are valuable but we also need to address the core issues of instrument supply, secondary market liquidity and regulation on an on-going and multi-asset basis.

> *Going alone is not an option: through collaboration, CEE countries can tackle the unique challenges they face.*

In the Baltic States, expansion of products through uniform Covered Bond and Real Estate Investment Trust (REIT) regimes, championing a regional index, and promoting their green credentials, are tangible steps in supporting our broader effort to obtain a single Frontier market classification for these combined markets.

Equally, the SEE link project currently connecting the stock exchanges of seven countries in a virtual trading hub – should boost secondary market liquidity when the clearing and settlement infrastructure is connected in Stage II. Harmonisation of regulation both facilitates investments and enhances private sector competitiveness.

Capital markets in the CEE region will only flourish if we continue promoting collaborative innovative solutions and strategic priorities.

Going alone is not an option: through collaboration, CEE countries can tackle the unique challenges they face. Should they grab it, they will show that unity makes strength. ●

Tomislav Ridzak

Member of the Board,
Croatian Financial Services Supervisory Agency (HANFA-CFSSA)

Capital markets promote best practices for corporate governance in the CEE

Capital market development is important for any country and its effects go beyond financing. Specifically, in the CEE region capital markets are important promotor of best practices for corporate governance. Companies that are listed on the market adhere to higher standards of corporate governance and serve as a role model for other companies. If the listing is successful and other companies follow suit, positive economic and social effects of good governance spread throughout the economy.

However, the importance of promoting and adhering to higher standards of corporate governance does not mean that financing part of the equation is not important. Especially in times of crisis, one can clearly see that the companies with strong balance sheet, that are adequately capitalized, fare better. Such companies have less need to shrink their business, and weather the storm much better than companies that use a high leverage based on debt. As a result, social costs of adjustment for those companies are much smaller. Croatian experience from previous financial crisis that started in 2008 had shown exactly that. Croatian companies that were highly leveraged experienced significant problems and had to adapt to new reality where financing was scarce with significant costs. This change also affected lenders, with non-performing loan ratio for medium sized enterprises surpassing 30 per cent and for the large corporations 19 per cent. On the other hand, companies that were solidly capitalised fared much better through recession.

Although the CEE region is not big, there are significant differences in terms of capital market development and levels of cross border investments. Several decades after their (re)opening, there is relatively big variation between regional stock markets in terms of trading volume and listed shares. Originally, at the beginning of transition, stock exchanges and public listings were a venue where recently privatized state owned companies listed their shares in order to facilitate trading for new owners. Nowadays, we see relatively livelier trading on some of the exchanges (i.e. Warsaw stock exchange, Bucharest stock exchange). On the other hand, many other CEE exchanges have firms with significant market capitalization listed while trading is less dynamic. Some exchanges seem to settle in an equilibrium with low turnover and only few listed companies. Finally, international integration of the regional stock exchanges also varies, where exchanges with more turnover attract more international investments.

Capital markets union is an important part of the single market that should be further promoted in the future. At the same time, regional markets are still very important in the CEE countries. Plans to further develop capital markets union should take this in to account. Many companies that are listed on regional exchanges will not list on the big EU exchanges due to various reasons (i.e. listing requirements, costs, dual reporting, etc.). On the other hand, some companies that surpass the ability of the local market to service them, will graduate towards dual listings on bigger EU exchanges. However, in order to save the ability of such companies to fund on capital market and preserve ecosystem of financial intermediaries, we must implement sensible policies. Decreasing regulatory requirements for financial intermediaries that operate on a small scale while increasing capital market integration should provide relief and incite the development of regional capital markets not only in CEE but throughout European Union. By doing so, we are increasing options for consumers with supply of more readily available products from intermediaries throughout EU, while at the same time giving chance to regional markets and intermediaries to operate with the regulation level that is suitable to their size and risk profile. ●

Leonardo Badea

Deputy Governor, National Bank of Romania

Continuing the development of capital markets in Romania

Unquestionably, modern capital markets have come a long way in Romania since their reopening during 1990s, their evolution being in close sync with the development of the market economy and the consolidation of the democratic society after the communist era. However, as it is often the case almost in all areas, this progress has not been linear and has not always been consistent. In financial markets, our most valuable asset is trust, that's why all the past major crises took their toll and caused important setbacks, as will certainly be the case with the one that we are fighting now.

Today, Romanian capital markets are mostly aligned with developed western European capital markets in terms of institutions, systems, technical capabilities and interconnections, regulation and best practices, thus are better ▶

equipped to go through bad times and to recover afterwards, although it will most probably not be an easy or fast recovery given the complexity of the crisis.

> *Romanian capital markets are now better equipped to withstand bad times and to recover afterwards.*

Of the two main sectors of the capital markets, the collective investment undertakings enjoyed a significant increase in assets during the last years, especially for the open-end fixed income funds, while the alternative investment funds remains an important segment (mainly former privatization funds - a particularity of the Romanian market). The structure of funds by risk categories is well diversified and the situation should further improve once the new law regarding the alternative investment funds is implemented.

The other main sector, the stock market, experienced a significant decline during the global financial crisis (both as a traded value and as a level of the stock indices) and was not able to recover in a consistent manner since than. Moreover, the term market for derivative financial contracts has gradually decreased until total termination of transactions in 2017. Although there are projects to restart it, they are largely dependent on the success of the current actions for the establishment of a local central counterparty. As a result, the market is currently mostly focused on stock transactions, and traded values are only slowly improving, being still below 2007-2008 levels, despite listings of major companies over the past two years.

Also, the market capitalization related to GDP is rather low when comparing at regional level. In order to recover the gap compared to the European average, we need to continue the efforts for listing new companies, to stimulate the local corporate bond issuances and to restart the financial derivatives market.

Perhaps the most important recent progress was registered in September last year when the FTSE - Russell rating agency published the decision to promote the Bucharest Stock Exchange to the emerging secondary market status. Also, significant steps were made towards the setting up the local central counterparty and for resolving the situation of latent accounts of financial instruments (with the Central Depository), with the support of the EBRD. An optimal and rapid conclusion of these projects will certainly have benefits for the entire local financial markets. We are also currently working at a national strategy for developing the capital markets, with the help of World Bank, following similar examples in our region. ●

Lukasz Januszewski

Member of the Board,
Raiffeisen Bank International AG

Capital markets development requires long-term players

What are the main areas of improvement and future development objectives of capital markets in the CEE region?

When it comes to local bond markets, we have seen a shift to local currency issuance by the major sovereigns in the CEE region in recent years. Such a move boosts the depth of local capital markets and strengthens sovereign credit profiles. Moreover, we have seen increasingly long maturity local currency debt issuance, lengthening the duration of government's liabilities.

All in all, the above-mentioned trends contribute to the development of a dedicated local and international investor base, a key aspect for developing capital markets and an important business area for leading banks in the region such as RBI.

How are banks such as Raiffeisen contributing to the development of capital markets in the CEE region and are there significant challenges or obstacles?

Capital markets development requires long-term players, such as RBI, who understand the region's economies and spreads best-in-class know-how across markets.

> *Capital markets development requires long-term players, such as RBI, who understand the region's economies and spreads best-in-class know-how across markets.*

RBI continues to grow as a primary market dealer and now provides direct LCY government bond auction access in 11 government bond markets in the region. Alongside this RBI continues to invest heavily in trading technology to facilitate secondary market making in interest rates, equities and FX.

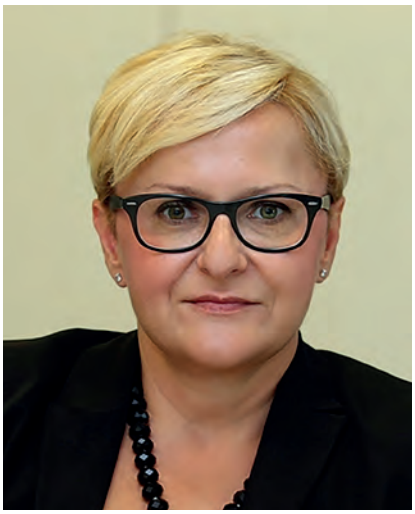
The group also supports corporates and governments in the region hedge risk through a broad cross currency and interest rate derivatives offering. RBI also continues to leverage its capital markets franchise to arrange bond financing for the region's sovereigns and corporates and within this is increasingly active in green bonds too. It goes without saying that RBI is actively working on bringing Western investors in the CEE region.

Do current EU and regional policies support appropriately the development of capital markets in the region?

The EU's Capital Markets Union project is also positive for CEE capital markets development, especially given the CMU also covers ECM, corporate bond issuance and venture capital. For CEE, this means that larger corporates may get easier access to international/offshore financing. In terms of green financing and the European Green Deal (EGD) we also see a lot of potential. However, estimated investment sums for "greening" in CEE far exceed public funds announced to date. In this respect, considerable private sector co-financing will be necessary. Therefore, the EGD could contribute to the development of local capital markets in the area of long-term and structured financing in CEE. Participation in such a process would certainly be of interest to players like RBI.

What new or additional actions may be needed?

Three areas are important: (a) a clear classification system for sustainable economic activities for green finance. (b) faster progress in CMU. (c) an inclusive framework for non-euro area EU capital markets. The fact that the euro area is largely limited to Western EU members suggests that the ECB monetary policymaking shall not be instrumentalised for the EGD implementation. Such a move would possibly fuel further scepticism among EU members in CEE towards the EGD. It goes without saying that having strong private pensions systems would support local Capital Markets development and ensure a steady stream of new equity and debt finance for domestic economies. ●



Ivana Gažić

President of the Management Board, Zagreb Stock Exchange

Croatia: leading the capital markets development in the region for 30 years

Croatian capital market has been leading the development of the capital markets in the region for almost 30 years and represents a bridge between the European Union and the rest of the region.

Croatia joined the EU in 2013, and it can be said that long before that, the financial sector was completely ready for this step and harmonized with the EU regulation. And for a long time before that, we followed all EU and global trends and working on developing the capital market in line with the best European and global practices. From this standpoint, it proved to be quite beneficial for Croatian capital market, and many Zagreb Stock Exchange's (ZSE) project were supported by the EBRD.

ZSE's strategy is to ensure the highest level of transparency and open up some new investment opportunities as well as create the conditions to provide growth capital to companies in all stages of their development, fostering a positive environment for entrepreneurs that also will be conducive to economic growth and employment.

In order to achieve these goals, ZSE has developed several solutions as a part of its integrative strategy. Young innovative companies will be the main driver in the years to come, and therefore it is extremely important to keep them operating in an environment in which they were established and enable them to access the capital for growth and development. ZSE has a 20% interest in the Funderbeam South-East Europe Company, a part of the Estonian Funderbeam Group, which operates a start-up financing facility and runs an innovative trading platform for start-ups based on blockchain technology. To date, Funderbeam SEE has enabled Croatian start-ups and SMEs to raise more than EUR 5 million in capital via 10 campaigns.

Progress Market was registered as one of the first and very few SME growth markets in Europe. It is a multilateral trading facility which may be used by small and medium-sized enterprises as a vehicle for the implementation of their investment plans.

Cooperation between markets is a necessity. As owners of the Ljubljana Stock Exchange, ZSE sees many positive effects for both exchanges and both capital markets. At the very close of the year 2019, the ZSE acquired a 5.3% share in the Macedonian Stock Exchange (MSE) as a step towards active participation in its development.

Together with Bulgarian and Macedonian stock exchanges, the SEE LINK Company was established in 2104 with the objective of creating a regional infrastructure for trading securities listed on those three markets. SEE Link order-routing system now supports trading for a total of seven markets, with over 1500 securities eligible for trading. A total of 26 investment companies are licensed to trade via SEE Link. There are still many challenges ahead of obtaining full potentials of this project, primarily regarding the solution for settling cross-border trades.

> *Leading the development of the capital markets in the region for almost 30 years.*

ZSE's goal is to continue to lead the development of the capital market in the region while providing transparent, secure, cost-effective and efficient marketplace as well as obtaining the highest quality of capital market services in order to meet the needs of investors, issuers and all stakeholders. ●


Photo by Karel Šanda

Miroslav Singer

CEE Institutional Affairs & Chief Economist, EXCO Member, Generali CEE Holding B.V.

Insurance as the driver of the development of Balkan Capital Markets

The potential contribution of the Insurance industry to the development of Balkan and the „new Europe" states capital markets cannot be overstated. This is clear from comparisons with the developed European economies. The investment portfolios exceed 60% of GDP of an average European economy, such as Belgium or Germany. In some cases, Spain, Sweden, UK not to focus on somehow specific Luxembourg case, they are comparable with the GDP. Thus, investment portfolios of insurance companies -in line with one of the major social benefit of insurance companies, i.e. investments into the valuable but lower liquidity long-term projects-, support the development of capital markets and the economy as a whole. The situation contrasts sharply with the Balkans and „new Europe." Here investment portfolios of insurance companies are much smaller. They range between few percent of GDP – Bulgaria, Romania – and a quite meagre 15% (circa) of GDP in the case of Slovenia. The unfulfilled potential is clearly enormous.

As for the state of financial markets in the region let me stress that since the Generali group insurance companies are present in most CEE and Balkan countries, we can dare to assess the situation with a local perspective. Currently, only the „big new 4" countries – Czech Republic, Hungary, Poland and Romania –possess reasonable liquid forex and governmental bond markets. Once we begin to asses less elementary instruments, we find only three CEE economies that can enjoy sufficiently liquid IRS markets. And moving further up the ladder of sophistication of products, the situation gets worse. Smaller Balkan economies do not have a depth of markets thanks to both lack of issuers and investors for domestic currency debt, in terms of euros the situation is a bit better but keep in mind international buyers are open to consider issues over 300 million euros from rated issuers... As to equity markets, their development is related to pension or health reforms. The largest equity market in Poland reflects the size of the Polish pension industry and also the regulation limiting hedging of the portfolios. The relatively larger assets of the insurance industry in Slovenia is a consequence of a health system mainly based on private insurance.

As to the role of global players like Generali, I believe that apart from an obvious role of investor, we are contributing to the development of the market by setting the example to other market players as well as setting standards that in some markets are stricter than those set and enforced by local authorities. We are observing in compliance with group ESG standards preventing us from investments of some issuers, we are flag bearers of implementation of new pan-EU regulation in countries and being an anchor investor, we are simply with our presence making some issues reality.

Of course, EU regulation plays a positive role as local authorities strive for convergence. At the same time its implementation is rather expensive, and the costs associated might hinder the arrival of new investors in many smaller Balkan markets. Consequently, a simplification corresponding with the market size might become a significant impulse for the development of those. ●

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IV. ENHANCING SUSTAINABILITY AND LONG-TERM INVESTMENT

Issues at stake

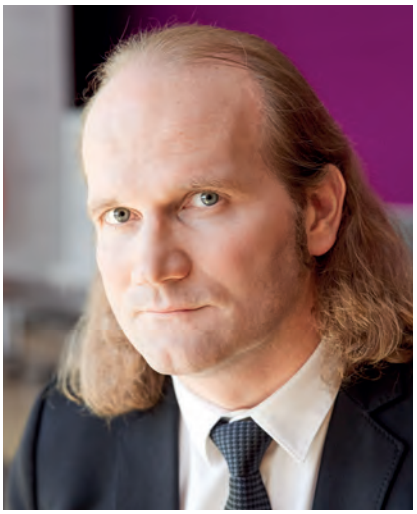
The current Covid-19 crisis shows that certain risks that may appear negligible can provoke huge socio-economic damages. Although the Green Deal can contribute to long term growth, it cannot be considered the top priority for relaunching the EU economy. However, it defines an indispensable set of (ESG) targets that must be pursued to reduce climate and biodiversity-related risks that are becoming increasingly material.

Such a vital and ambitious repositioning of the economy will require a significant and sustained deployment of capital. This makes the definition of an ESG language, common to financiers and entrepreneurs, necessary. One essential contribution in this perspective is the taxonomy of activities currently being defined by the Commission. However, monitoring whether each category of economic player is both transitioning and leveraging these fundamental changes in a timely manner, is also essential in order to gain strategic advantages in addition to a general mitigation of these threats.

Consequently, integrating the whole ESG considerations into the strategy planning processes and governance of financial and non-financial companies is indispensable, in addition to the necessary consideration of climate related financial risks, which is required to ensure the resilience of the economy. However, an appropriate framework that EU Small- and Mid-Caps and more generally SMEs can use to define and report on their ESG strategy is still lacking. It would be preferable that such efforts are undertaken at the EU and global levels to ensure that they are sufficiently cost efficient and proportionate

Content

Green Deal: implications for the financial sector



Harald Waiglein

Director General for Economic Policy,
Financial Markets and Customs, Federal Ministry of Finance, Austria

Sustainable Finance – a broader approach seems necessary

Considering the major challenge to combat climate change it is comprehensible and very positive that numerous initiatives regarding Sustainable Finance are taken, at global as well as at European level. As a matter of fact, this is also exactly why it is essential to coordinate all those initiatives in the best possible way to further strengthen cooperation and to avoid any overlap or duplication tying considerable resources.

While Europe is about to take a leading role in the international community when it comes to setting and achieving climate change goals, proportionality with respect to the European share of the global greenhouse gas emissions should not be forgotten.

I certainly share the view that the European Union should show leadership in the global fight against climate change, but this must not lead to pioneering activities inviting others to lean back without any ambition. In this respect the coordination of joint efforts of the International Platform on Sustainable Finance, the Coalition of Finance Ministers for Climate Action or the Network for Greening the Financial System to name the most important ones, should be the prior interest of the European Union and European institutions.

However, to give those initiatives the necessary purview it remains to be wished that these important international cooperation activities are joined by more and more countries in the near future. What is also deemed decisive for the success of the joint objectives is that measures are not over-bureaucratic and too cumbersome and allow for the necessary flexibility and proportionality supporting the market to adapt.

Another example for European leadership is the recently adopted business model of the European Investment Bank, pushing the climate and sustainability agenda within the International Finance Institution peers. International Financial Institutions, such as the World Bank Group, together with regional Financial Institutions in Africa, Asia and Latin America are key when it comes to leveraging climate financing on a global scale. They ensure that "green washing" is held at bay and common quality standards are adhered to. These institutions committed over 43 billion USD in climate finance alone in 2018 for developing and emerging economies.

> *It is essential to coordinate all initiatives in the best possible way to further strengthen cooperation.*

A further key task when it comes to Sustainable Finance is the proper integration of climate and sustainability risks posed by climate change in the overall risk management of financial institutions. Concerns still exist that this relatively new task, at least to this extend, could be misinterpreted by financial market participants prioritising climate and sustainability risks and underestimating or neglecting general banking or financial risks still continuing to exist at an unchanged level.

It is fundamental to address and mitigate the entire risk of a financial instrument, otherwise unanticipated losses would impose negative economic impacts and threaten financial stability.

With a view to the market, the recent past has shown that the interest in sustainable finance in general is high and the demand for green or sustainable financial products is strongly increasing. Against this background, the availability of sufficient sustainable projects and investment possibilities is fundamental for the proper and swift functioning of the market. Therefore, ▶

policy priorities should not only focus on avoiding "green washing", but also on fostering private sustainable projects and initiatives. In this context it is also an undisputed fact that a swift and smooth transition to mainstreaming sustainable finance is required. However, to avoid incalculable risks and consequences as well as stranded costs it seems to be important to not immediately and abruptly drive certain branches out of the market, but rather to support their timely transition.

Mario Nava

Director Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Commission's rising ambition on sustainable finance

The current pandemic crisis of COVID shows that risks that were ignored may materialise and provoke huge damages to the socio-economic fabric of the world. The Action Plan on sustainable finance aims at preparing an orderly response to the sustainability risks that have kept accumulating in the last decades.

The start of the adventure on sustainable finance can be traced back to 2017 when the Commission set up a High Level Expert group and asked the members and experts of that group to make strategic recommendations for a financial system that supports sustainable investments. Those recommendations informed the European Commission's initial 2018 Action Plan on financing sustainable growth, which laid down the foundations for channeling private capital towards sustainable investments.

Among the 10 priority actions it's worth recalling the Commission's proposal of a "green" taxonomy (i.e. classification system of environmentally friendly economy activities) for which a political agreement was found in December 2019 establishing the overall framework and principles. This piece of law, also through the adoption of subsequent delegated acts, provides clarity to and a common language for the financial market hence on one side fighting green-washing and on the other side facilitating sustainable investments.

Now fast-forwarding to 2020, the political context has changed compared to when the Commission put forward the initial Plan. The EU Green Deal is the political priority of this new Commission and the vision is clear: we need to act now and decisively to transition the EU economy to carbon net zero by 2050. To this end, the Green Deal proposes the design of deeply transformative Europe-wide policies that will aim to revolutionise the continent's clean energy supply, industry, production and consumption, large-scale infrastructure, transport, food and agriculture, construction, taxation and social benefits. This increased ambition of the goals and targets under the EU Green Deal requires a much more fundamental transformation of how the financial and corporate sectors operate.

> *The EU Green Deal is a priority: we need to act to transition the economy to carbon net zero by 2050.*

The financial sector is making progress, but its efforts should be assessed against this new policy framework and the pressing necessity to avoid climate and biodiversity crisis tipping points. It is now time to intensify efforts to reach the higher level of ambition set out in the European Green Deal. After an Action Plan that started to address the most urgent issues, the current context requires a more comprehensive and fundamentally more progressive strategy. The renewed strategy on financing sustainable and inclusive growth is foreseen over Fall 2020 and is expected to predominantly focus on three areas:

1. Strengthening the foundations for sustainable investment by creating an enabling framework, with appropriate tools and structures. Too many financial and non-financial companies still disproportionately focus on short-term financial performance compared to their long-term development and sustainability-related challenges and opportunities.
2. Increased opportunities to have a positive impact on sustainability for citizens, financial institutions and companies. This second pillar aims at maximising the impact of the frameworks and tools in our arsenal in order to "finance green".

3. Climate and environmental risks will need to be fully managed and integrated into financial institutions and the financial system as a whole in order to move from brown to green, while ensuring social risks are duly taken into account when relevant.
4. As it's the case for all major initiatives, the Commission will consult over spring 2020 on some preliminary ideas and strongly invites citizens, the business world, the national administrations, NGOs and society at large to engage in this process. Only through a collective effort and broad feedback and support can the Commission put forward an ambitious strategy that will provide the right framework for-and recognize the important role of-the financial sector in accelerating the sustainability transition and mitigating potential sustainability related risks.

This will be all the more true in the months and years to come given that adherence to sustainability criteria like the Sustainable Development Goals will be key to channel the right type of support to economies around the globe currently struggling due to the pandemic COVID-19 crisis. ●

Gilles Boyer

MEP, Economic and Monetary Affairs Committee, European Parliament

EU taxonomy: crucial first step to fulfil citizens' sustainability expectations

The world is changing rapidly and what just a short time ago may have seemed unrealistic, unfeasible and a pipedream is quickly becoming a reality in the field of the greening of the financial sector, amongst others. The sustainable finance (taxonomy) file recently agreed between the European Parliament and the Council is a concrete example. In reaching an agreement on the taxonomy file, the EU institutions have created a clear framework for the financial sector regarding sustainable finance and investments for the future.

The European Union is leading the world in this field having created this unique taxonomy. This is an incredibly dynamic and rapidly growing sector and lawmakers are aware of the stakes involved. Citizens are calling out for clear and transparent rules for this sector, to provide clarity and uniform standards to enable them to invest with confidence in certified sustainable projects.

The financial sector is also, in my experience as a lawmaker in this field, in general highly supportive of clear legislation in this field. By providing a legislative framework this allows them to propose sustainable products to the market and create their internal modelling to ensure they are able to provide the required reporting information and respond to the increasing market demand in this sector.

There are of course legitimate concerns about how the adoption of ESG targets more generally and the taxonomy framework more specifically will be implemented, both in terms of which investments will be taxonomy compliant and the timeframe available to ensure that the required reporting data is available and able to be submitted in the appropriate format and at an appropriate cost.

In discussions with the financial sector there is a clear consciousness that this sustainable finance evolution is not a flash in the pan but a sector which will increase in importance rapidly over the coming years. Those actors who understood this early have already made significant progress in incorporating changes into their products, modelling, reporting and decision-making process and are supportive of the legislative evolutions.

> *What may have seemed a pipedream is becoming a reality in the field of the greening of the financial sector.*

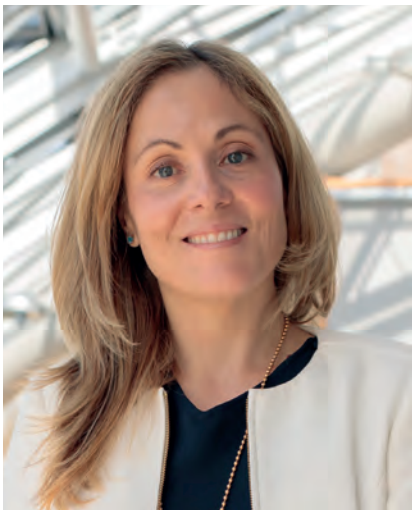
The journey is only just beginning. The EU has currently agreed on a sustainable finance framework but the concrete details of which investments will qualify remain to be finalised. This will happen in a staggered approach over the next two years. As legislators we have foreseen a difference of 12 months between the adoption of the specific standards concerning what can ▶

be considered a sustainable investment and the entry into force of this legislation, and thus the reporting requirements, in order to try to ensure that the market has sufficient time to adapt, as these are significant and important evolutions.

It was a strategic choice for the EU taxonomy framework to focus on environmental activities. This is already an important step forward, which will have significant implications for the financial sector. This is just the beginning. Before making the taxonomy proposal the Commission established the High Level Expert Group on sustainable finance to work on the issue (HLEG). The HLEG undertook a thorough and important job of deep analysis and reflection. This serious and essential work provided crucial input to the legislative process, which is advancing rapidly.

To complement the environmental strand, social and governance issues are also of crucial importance but the HLEG focused their initial work on the environmental aspects, which already took years of analysis and reflection. The European Parliament and the Council decided to start with an environmental taxonomy and called for further analysis to enlarge this taxonomy to also include social and governance issues in time.

The story does not end here. It is essential to see the taxonomy legislation within the broader EU legislative framework, for example the ambitious European Green Deal, and within that notably the Sustainable Europe investment plan.



Emma Navarro

Vice-President, European Investment Bank (EIB)

Getting sustainable finance right

The coronavirus has disrupted our daily lives and global efforts are rightly focused on combating the pandemic and its economic impact. The EIB is also committed to supporting the EU and partner countries in these times of hardship. Yet, while we are all doing our utmost in response to the pandemic, we should not forget about the medium and long-term perspective and the other global defining challenge. Climate change poses major threats to our societies and economies, with irreversible consequences if we do not act now. Once we get out of the current emergency, we will need to spur recovery by supporting investments consistent with our climate action efforts.

The transition to a more sustainable, carbon-neutral society is critically needed to face the pressing climate and environmental challenges and ensure our future prosperity. This transition implies a profound transformation of our economies and lifestyles that will require massive investments. The European Commission has estimated that achieving Europe's 2030 energy and climate targets will require EUR 260bn of additional investment every year. And this estimate does not factor the revision of these targets announced as part of the European Green Deal or broader environmental objectives. It is clear that the private sector will have to play a key role to close this investment gap. For that, we need a financial system that takes into account climate considerations and guides investors and savers towards sustainable investments. The EU has moved quickly in this direction.

Building on the recommendations of a High-Level Expert Group, the Commission launched an ambitious Action Plan on Sustainable Finance to anchor sustainability in the EU's financial regulatory framework and help redirect private capital flows towards more sustainable investments. One of its key measures is the EU sustainability taxonomy that seeks to establish a common language for green investments, giving investors the much needed clarity.

> *Today, green finance has become one of the most important topics for the financial sector.*

Since the launch of the EU's Action Plan, the topic of sustainable finance has gained strong momentum. When the Paris Agreement entered into force in 2016, sustainable finance was only a small part of the financial market. Today, green finance has

become one of the most important topics for the financial sector. This is notably the case in Europe, where the sustainable finance agenda is moving ahead at significant pace. Last December, the co-legislators reached a political agreement on the taxonomy regulation. Other important legislative initiatives have also been adopted to create new low-carbon benchmarks and strengthen disclosure obligations for sustainable investments. The European Green Deal will continue on this path with new initiatives to scale up sustainable finance even further. For the EIB, the commitment to sustainable finance is clear. As a public, policy-driven bank, sustainable investments lie at the heart of our mission. Yet, in view of the scale of the climate and environment challenges, we have significantly stepped up our climate ambition to support a just transition to a more sustainable future.

Progress is also visible at a global scale. Around 250 banks from all over the world have signed the UN's Principles for Responsible Banking, committing to embrace sustainability and support the Paris Agreement Sustainable Development Goals. Climate disclosures are also widely spreading with more than one thousand private organizations today supporting the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

Climate risks are also attracting increasing attention. More than 50 central banks and supervisors are now cooperating under the Network for Greening the Financial System (NGFS) to develop a better understanding and management of climate change financial risks. The challenges of climate change and environmental sustainability are important to the whole world and require collective action.

In today's global financial markets, international consistency and global standards are critical. In this sense, the EU's initiative to launch the International Platform on Sustainable Finance, of which the EIB is a partner, is a major step forward in promoting coherent approaches and accelerating sustainable finance globally. It seems clear that sustainable finance is here to stay.

Laurent Zylberberg

President, European Association of Long-Term Investors (ELTI)

Investing today for the long-term

In the context of the future recovery, National Promotional Banks and Institutions (NPBIs) are firmly committed to promoting sustainable development by increasingly integrating these concepts into their operations. Ensuring a robust economic recovery compatible with sustainable development is at the very heart of NPBIs' mission, namely to provide the right balance between today's constraints and tomorrow's challenges, with activities being aimed at improving economic, environmental and social living conditions — on a local, national, European and global level and from a long-term perspective. ELTI members committed more than 50 bn EUR of financing for sustainable projects in 2018.

Such a fundamental task involves the development of sustainable, self-supporting economic structures. Therefore, NPBIs strive to deliver financial solutions which enable our industries and economies to cope with today's and tomorrow's huge challenges. Close to the European citizens, NPBIs remain beacons for trust and confidence. In this perspective, the long-standing co-operation of NPBIs with the EIB Group, the Council of Europe Development Bank or the EBRD allows for a more effective impact of European initiatives as well as of the financing provided by NPBIs. Working together is not an option, it's a must. NPBIs are part of the missing link between citizens and our European common future.

> *European NPBIs will be at the heart of the future economic recovery. Before the crisis, ELTI members committed more than 50 bn EUR of financing for sustainable projects in 2018.*

Following the commitment to achieve climate neutrality by 2050, carbon-neutral projects need to be implemented and financed today. With this in mind, NPBIs are committed in achieving the success of this endeavour. The role of Long-Term Investors has become more important today than ever since infrastructure investment projects have an average lifetime of around 30

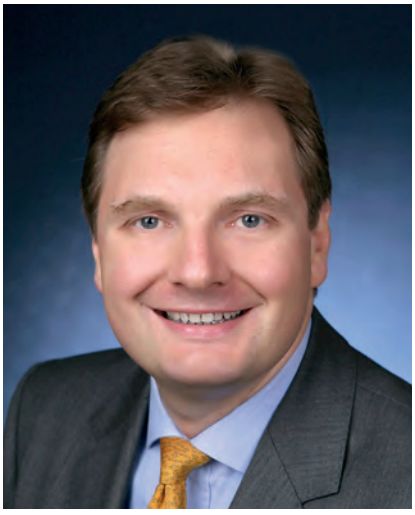
years whilst projects which require long planning phases – and financed today, might run longer than 2050.

NPBIs commitment towards Sustainable Finance has several dimensions:

- Environment, Energy, Climate, Social, Health and more: Beyond the fields of environmental improvements (energy efficiency, transport, infrastructure), NPBIs partners benefit from financing innovation as well as social projects (student loans, municipal financing, affordable housing, health projects).
- Green, Environmental and Social Bonds: Bonds with an amount of more than 3.5 bn EUR were issued from ELTI members in 2018.
- Market experience at local, regional and national level: The European Green Deal relies on ESIF as a source of funding in order to cover "every corner of the EU". NPBIs will be essential players in making this happen, by contributing to financial leverage, combining national funds with EU promotional instruments and by providing their market experience at local, regional and national level.
- Cooperation between members and with International Financial Institutions: Cooperation is a key strategy in addressing the challenges of our sustainable future. ELTI members are already engaged in projects such as the "Joint Initiative on Circular Economy", the "Clean Ocean Initiative" or the "Marguerite Fund", all of which have a strong cross-border dimension.
- Know-how transfer between members: The financing of Sustainable projects requires specific know-how to adapt financing programmes to the state-of-the-art technology in order to reach projects on the ground.
- Providing support to public authorities: ELTI welcomes the initiative of the European Commission to reach a common understanding about Sustainable Finance, ultimately streamlining the flows of private investors' capital towards sustainable projects.

ELTI members are actively engaged in discussions on the Sustainable Finance Action Plan of the European Commission by participating in the High-Level Expert Group and in the Technical Expert Group and they will be deeply involved into the revision of the Action Plan in fall 2020.

All ELTI members have provided emergency measures to tackle the economic crisis, we proved our agility and capability to answer quickly to major challenges. Let's do it together for the long-term!



Tobias Bücheler

Head of Regulatory Affairs, Allianz SE

Sustainable finance regulation needs to facilitate a broad economic transition

Climate change poses a major challenge to the world and to society as a whole and requires comprehensive structural change. If the objectives of the Paris Climate Agreement and the UN Goals for Sustainable Development are to be achieved, not only the way how we generate energy must change fundamentally, but also the way we use energy, how we feed ourselves, how we travel, and much more. The transition to a low-carbon economy will be a long and complex process. A sustainable path must be established that is ambitious enough but does not set unachievable or unrealistic goals for institutions while also being politically and socially viable.

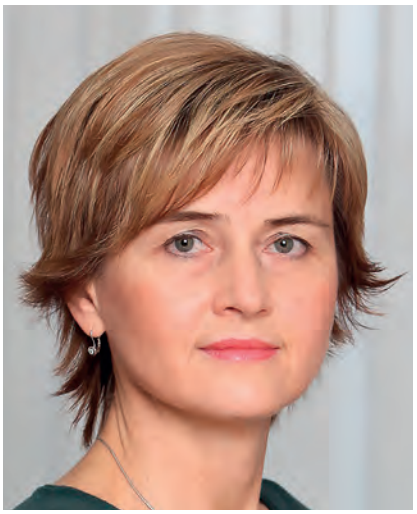
The financial sector has an important role to support the aspiring political and economic sustainability agenda set by the European Union. Banks and insurers can facilitate the transformation towards a more resource-efficient economy in various ways: By mobilizing capital through investments and loans, providing sustainable insurance solutions, integrating social and environmental considerations in business and risk management and - last but not least - by ensuring a progressive decarbonization of portfolios including engagement processes with investee companies. Already today, the financial industry mobilizes private investment for sustainable purposes such as climate and environmental protection, provides financing for infrastructure projects – and over the past years, more and more financial companies started integrating sustainability factors into key business areas.

However, the financial industry should not be regarded and treated as the sole change agent to achieve global sustainability

targets, especially when it depends on third-party efforts. In order to channel investments towards sustainable assets and assess sustainability risks correctly, the financial sector needs reliable information by investee companies. Improvements to the availability, quality and comparability of sustainability data are therefore of utmost importance in order to be able to provide sustainable financial products. Ultimately, sustainability will become a key factor in assessing companies' risk return profiles, both in the financial sector and in the real economy.

In order to promote sustainability and sustainable finance more widely, there is a need for a certain level of regulation. In this context, greater transparency (e.g. global corporate disclosure requirements based on the recommendations of the task-force on climate-related financial disclosures) is an imperative, but even more important is to establish regulation that facilitates and incentivizes structural change on a broad basis. Financing only a narrow "green" niche will not be sufficient to transform the economy. Moreover, to mainstream sustainability, relevant regulation needs to be straight-forward to apply.

The current state of knowledge in climate science calls for decarbonization as quickly as possible. At the same time, an orderly and just transformation process comprising adequate regulation must be ensured. We can only achieve this balancing act if politics, real economy and financial services industry work together.



Sandra Švaljek

Deputy Governor, Croatian National Bank

Crisis urges financial systems to adapt to foreseeable global shocks

The establishment of the High-level Expert Group on Sustainable Finance (HLEG) late in 2016 and the publication of its final report at the beginning of 2018 put in motion a series of actions at the EU level. They were aimed at creating a framework for economic growth based on sustainable public and private projects and underpinned by financial products that take into account the environment-related risks. The European Commission incorporated HLEG's recommendations into its Action Plan on Sustainable Finance and, following to that plan, set up a Technical Expert Group on Sustainable Finance.

The European Union's political orientation to taking decisive steps towards sustainable finance supported by expert advice has so far resulted in an elaborated and complex sustainable finance regulatory framework. The framework covers various issues, among which the issue of the unified classification system for sustainable economic activities ("taxonomy"), the EU green bond standard, methodologies for low-carbon indices (Benchmark Regulation), the regulation on disclosures relating to sustainable investment and sustainability risks etc. Finally, at the end of 2019 European Commission published the European Green Deal, a comprehensive EU growth strategy with the aim to achieve climate neutrality by 2050.

The developments setting a stage for sustainable finance are without any doubt based on the increasingly pronounced environmental and societal concerns (WEF, 2020), urging the need that the world of finance itself aligns with those concerns and incorporates the ESG principles into its daily business. However, those developments are equally driven by the awareness that there is a strong preference for sustainable financing among the interested public – retail investors, pension fund policy holders and savers in general (University of Cambridge Institute for Sustainability Leadership, 2019).

It should therefore not come as a surprise that there is a growing population of financial institutions that are individually, or jointly within initiatives such as the Task Force on Climate-Related Financial Disclosures, putting their efforts to provide green financial products as well as to disclose to the investors the financial risks related to the climate change and other environmental risks. For the last few years, the issue of sustainable finance has also attracted the attention of both central banks and supervisors.

At the end of 2017, eight central banks and supervisors established the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), which, only two years later, consisted of 54 members and 12 observers representing countries from five continents, and contributing to the global output with 57 percent. The NGFS is a consensus-based forum aimed at sharing best practices, contributing to the development of the climate and environment related risk management in the financial

sector and mobilising mainstream finance to support the transition toward a sustainable economy.

Vigorous developments in the area of sustainable finance were going to continue in 2020 and the years to come. However, the global economic crisis caused by the outbreak of the COVID-19 pandemic might disrupt this, otherwise certain trend. Due to the pandemic crisis, the focus of both businesses and policy makers is turning to preserving economic activity and maintaining financial stability, so that environmental considerations might disappear from the priority list. There are two ways forward. The current economic crisis can be an opportunity to strengthen the efforts on climate change. However, it can also cause the loss of the momentum on the pathway towards the low-carbon transition. It is up to the central banks and regulators to use this crisis to make the financial system more resilient to future global shocks, with shocks related to climate change and biodiversity loss being the foreseeable planetary emergencies. ●

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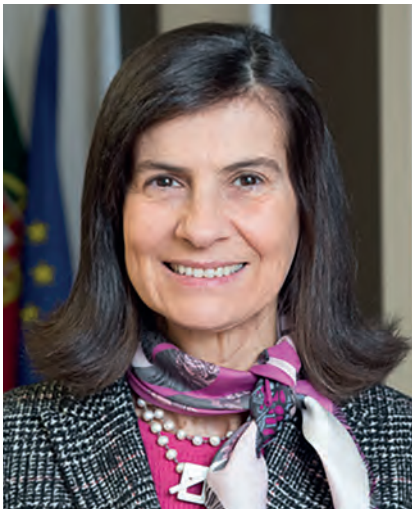


Margarida Corrêa de Aguiar

President, Portuguese Insurance and Pensions Funds Supervisory Authority (ASF)

Sustainable finance challenges – the role of the insurance sector

The issue of sustainability in general – and of climate change in particular – has risen to the top of the political agenda in recent years.

It is widely acknowledged that transitioning to a more sustainable economic model and achieving the objectives of carbon neutrality will require full commitment from all economic agents. The financial sector will, in particular, have a pivotal role in a successful transition considering the financing needs required largely surpass the capability of public spending. Within the Union, the announcement of the European Commission's Action Plan for Financing Sustainable Growth, in March 2018, was a determinant stepping stone for mainstreaming 'sustainable finance'.

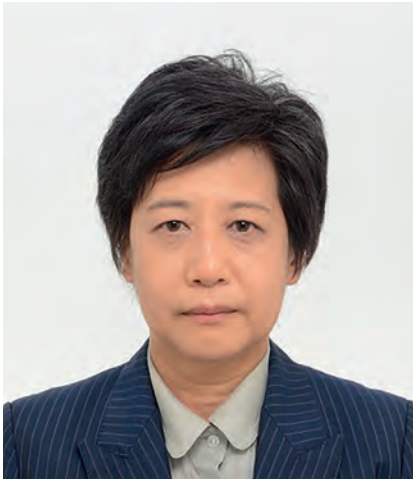
As the discussions deepened on how to materialize the actions foreseen in the Action Plan, the introduction of 'green supporting' and/or 'brown penalizing' factors in prudential regimes of the financial sector has rapidly gained momentum as a catalyst to reorient capital flows towards sustainable investments, activities and projects. The insurance and pension funds sectors, in particular, due to their notorious role as a major institutional investors with a long-term profile, are considered as natural candidates for this task, and, for the former, the upcoming review of the Solvency II Directive – which establishes the Union's harmonized insurance prudential regime – provides an appealing opportunity to do so.

ASF – the Portuguese Insurance and Pensions Funds Supervisory Authority – has always advocated that the prudential regime, and particularly the capital requirement' calibration, should be corroborated by empiric evidence as a precondition to maintain the regime risk-based and ensure adequate levels of consumer protection, while safeguarding financial stability. Such evidence should, however, not be available in the short-term due to the scarcity of available and reliable data with the relevant level of granularity to perform adequate calibrations. In this regard, other initiatives under the Commission's Action Plan will be crucial to close that gap, such as the development of a unified EU classification system (taxonomy) and of sustainability benchmarks, as well as the enhancement of non-financial disclosure requirements.

Moreover, it should be highlighted that an eventual introduction of green supporting' and/or 'brown penalizing' factors in prudential regimes, should not be seen as a sufficient condition for mobilizing substantial funds to sustainable activities, as a multitude of other criteria are factored in when making investment decisions.

In that sense, other actions could prove a more efficient vehicle towards that end. For example, mandating supranational bodies to set up 'green banks', back-up the issuance of 'green bonds', and to attribute 'green labels' to financial products could act in a more effective and also more swift manner to build relevant capacity considering the long period of time it will be necessary to mobilize and consolidate 'green' activities and projects, while preventing abrupt disruption to businesses or assets. ●

ESG trends in business and finance



Tomoko Amaya

Vice Commissioner for International Affairs, Financial Services Agency, Japan (J-FSA)

The business community and financial community working together

The attention on sustainable finance has been significantly increasing globally, including in Japan. I see this topic appearing more often on the agendas of international and national conferences in the financial sector. The ESG investment has been rapidly growing. For example, some reports state that in Japan, the issuance of ESG bonds doubled between 2017 and 2018.The JFSA is proactively working to support the SDGs initiative given that SDGs' vision is consistent with the JFSA's mission, i.e., to contribute to the national welfare by promoting the sustainable growth of the economy and stable asset building.

At the same time, it is also important that the private sector (e.g., companies, investors and financial institutions) takes action to achieve SDGs on their own initiatives in such a manner as to enhance corporate value and investment returns in the medium to long term.

From this perspective, we see great value in the FSB Task Force on Climate related Financial Disclosures (TCFD) initiative. With more than 200 companies and organizations supporting it, Japan now has the highest number of TCFD supporters in the world. Among the TCFD supporters, the number of business corporations is larger than that of financial institutions. Moreover, carbon intensive industries such as energy, electricity, steel, chemical and cement have also expressed their support and willingness for engagement with the TCFD recommendations.

As a background to this increase, the TCFD Consortium was established as a private sector initiative in May 2019. The Consortium brings together companies and investors to discuss challenges and share leading practices to move ahead with corporate disclosure aligned with the TCFD recommendations. As a product of such discussions, the Consortium released Green Investment Guidance last year to demonstrate viewpoints and good practices for investors making use of information disclosed in line with the TCFD recommendations. This Green Investment Guidance would also help companies better understand investors' expectations, and thereby improve their own disclosures. In furtherance of the work, the Consortium is planning to revise the Guidance for Climate related Financial Disclosure (TCFD Guidance), which was initially published in December 2018. Both the Green Investment Guidance and the revised TCFD Guidance will facilitate collaboration with the business and finance sectors.

The inclusive, dialogue-based framework of the Consortium is the key to success of increased support of the TCFD in Japan. Through its activities, participants are able to deepen their thoughts on the effect of climate change on their business environments. We expect both business corporations and financial institutions to review their strategies, business models and risk management, which may contribute to turning the risk into an opportunity for innovation in the low- and zero-carbon economy. ●

Liange Liu

Chairman of the Board of Directors, Bank of China

Sustainable finance: China's practices, challenges and future actions

In recent years, sustainable finance with green finance at its core witnessed robust development in China. It has become common practice among major Chinese financial institutions to support sustainable development as a key aspect of embracing corporate social responsibility. As of the end of 2019, China had a green credit balance of approximately USD 1.5 trillion, and witnessed a total of more than USD 150 billions of green bond issuance.

Mutual funds that have incorporated ESG related strategies reached a volume of USD 7 billion, while other innovative green financial products, such as Green Insurance, Green Trust and Carbon Finance, are thriving. ▶

Despite the rapid growth, sustainable finance development in China is still facing challenges.

The total volume is still insufficient to meet needs. According to the China Green Financial Development Research Report 2019, the total demand for green finance in 2018 stood at about USD 300 billion, while the supply was less than USD 200 billion, making a shortfall of over USD100 billion. The financial industry needs to attach more importance to and effectively stimulate internal driving forces to fill the gap.

The structure of sustainable finance imbalanced. In China, the funding for urban rail transit and renewable energy is ample, but that for environmental restoration relatively falls short. Although green bonds are growing rapidly, green credit still accounts for over 90% of the green finance. Financial institutions need to foster product innovation and provide better-targeted services.

External incentives and policy support are insufficient. As public product, the pricing of sustainable finance is difficult. Compared with regular financial projects, sustainable financial projects often involve longer duration, higher-standard disclosure requirements, and more cost of management and risk control. China has introduced a comprehensive policy framework to support green finance development, while the specific measures are still in the process.

> *More efforts should be made to further promote the sustainable finance in China.*

Financial institutions should actively tackle the challenges and provide strong support for environmental and social sustainability.

Boosting internal driving forces. To enhance the development on sustainable finance, financial institutions should develop a unified strategy of sustainable development and incorporate it into the management framework, strengthen the strategy implementation and post-assessment, and reasonably increase the weight of sustainable finance indicators in the KPI assessment system.

Enhancing the service capabilities. Adhering to market principles, financial institutions should implement differentiated pricing on the sustainable development risk of customers, strengthen development of green bond/credit and product innovation of green insurance, green trusts, green industrial funds, etc., and build powerful brands, to support the development of an eco-value compensation mechanism, hence the appropriate pricing on externalities of green projects.

Improving the quality of development. By establishing an international platform to share best practices in sustainable finance, financial institutions can share relevant policies, data information and business experiences on sustainable finance, and co-establish a supportive and coordinative mechanism to improve the global participation and development quality. ●

Sylvie Goulard

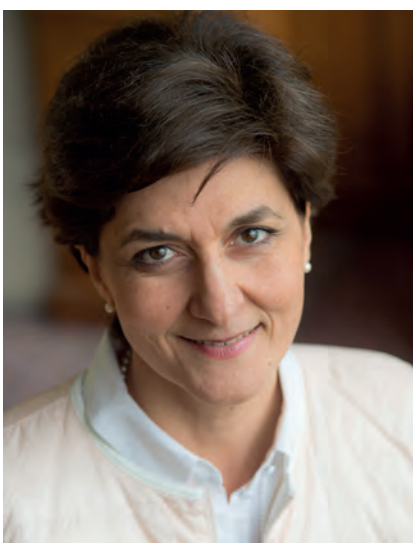
Second Deputy Governor, Banque de France

Greening the financial sector remains an urgent need to face the persistent challenge of climate change

Amidst the current Covid-19 crisis, we all need to keep fighting another crisis, climate change, and keep thinking about the best measures to undertake to finance the transition to a low carbon economy. In that perspective, one priority stays to ensure that "green" projects can be appropriately funded. Financial institutions must be able to assess the risks and returns of such projects on the accurate (longer) time horizon. Considering climate change seriously also means, for the financial sector, taking into account the financial risks relating to transition- notably the risks of stranded assets- and physical risks in their own balance sheets. In a nutshell, climate-related risks must become a widespread axis of risk analysis by financial institutions.

> *The political will to produce standards should not weaken in the context of the current Covid-19 crisis.*

Over the past years, the financial sector has been moving in a greener direction, no doubt. Part of this trend has indeed resulted from both market pressure and clients' appetite for greener products. However, regulation has also played a key role, both at national and European levels, by setting disclosure standards for instance. In France, since 2016[1], financial institutions must disclose their exposure to climate-related risks and assess the related financial risks.



The French supervisory Authority for Banks and Insurance (ACPR) recent studies[2] find that there was a significant progress in the governance of climate change risks and in the analysis of transition risks. The need to closely monitor climate-related financial risks is also observed globally: the Central Banks and Supervisors' Network ▶

for Greening the Financial System (NGFS) is planning to release a Status Report on this topic in the coming weeks.

This is something we follow upon carefully as we, Central Banks and Supervisors, definitely believe that we can support this evolution and foster its harmonization, along with standard setters. The Banque de France is particularly active within the NGFS, launched at the One Planet Summit in 2017.

This network is a coalition of Central Bankers and Supervisors willing to share best practices and leverage each other's knowledge. At the national level, the ACPR established last year a Commission on Climate and Sustainable Finance aiming at keeping track of the commitments taken by banks and insurers relating to climate risks. Our next step will be to simulate the resilience of these institutions: a pilot exercise, based on climate scenario analysis, will be conducted by the Banque de France and the ACPR in 2020.

Nevertheless, the NGFS is not a standard setting body, and we rely on standard setters and policy makers to allow for homogenous data, without which no consistent monitoring and pricing of climate- related risks can exist. The political will to produce standards should not weaken in the context of the current Covid-19 crisis. We should keep in mind that the fight against climate change is vital. Some experts even suggest that both crisis are related at some point. Hence, the biodiversity loss and its impacts on the financial sector may be one topic to further explore in the future.

1. Act of 17 August 2015 on energy transition for green growth
2 Analyses et Synthèses n°101 et 102, avril 2019

Ricardo Laiseca

Head of Global Sustainability Office, Banco Bilbao Vizcaya Argentaria (BBVA)

Sustainable finance: bringing the age of opportunity to everyone

"Good comes out of evil", a Japanese proverb states.

We are living an unprecedented paradigm driven by an unknown evil, the Coronavirus. It is going to have a negative impact on the financial system, the real economy and, also, the aggregated social welfare function.

Good swiftly came out: the whole society, public bodies and private agents quickly reacted to do whatever it takes to jointly battle the COVID-19. We will overcome this tempest. The decisions we are taking now could transform our lives.

Our coordinated response against evil is going to evidence that society, altogether, can overcome huge challenges. Cooperation and working together are the only way. It is time to think about the reconstruction, and to apply what we have learnt from this experience to deal with some other challenges, such as climate change.

> *Breaking the "tragedy of the horizon" and working as one engaged team towards a "new horizon" is the only way forward.*

Public bodies and private agents must keep working as one engaged team that thinks big towards a common goal: to provide value added financial solutions that help society to beat the consequences of negative shocks, like the two previous ones.

In that vein, sustainable finance is also needed to come out as a good and being part of the solution. The Coronavirus is testing companies' environmental, social and governance (ESG) commitment and strategies in a hard uncertain environment. ESG investing and funding has proven some resiliency and a good track so far: there is some empirical evidence that points a better ESG performance than the market in aggregated terms during the last year.

Sustainability is going to gain traction because social dynamics are leading the response, and companies are going to be penalized by investors if they do not take care of their employees and the rest of their stakeholders.

I firmly believe that providing value added environmental and social solutions according to the society and our clients' needs is a win-win that can generate a virtuous cycle:

On the supply side, banks can jointly positively impact the economy and the financial system and contribute to the achievement of the Paris Agreement. We must proactively interact with our clients to provide some high-quality advice and deliver new business opportunities.

On the demand side, the aggregated social welfare function will be enhanced because their needs will be better and more efficiently met. Indeed, society is the key driver of this transformation which is happening faster and deeply than expected.

The enrichment of both, supply and demand, will allow for an improvement of the production possibilities

frontier, and will be a catalyzer for sustainability to continue accelerating.

To achieve that upgraded frontier, sustainable finance markets need to continue their development which is still small and still lacks depth and breath. Banks can contribute by expanding our product offering, strengthening our advisory capabilities and updating our internal processes levering on digital tools and technology.

Last but not least, public authorities, financial regulators & supervisors and international bodies play a vital role, obviously. Their bold and effective response when the COVID-19 impacted the whole system last March, empirically proves that they are also a good needed by the society and by the financial agents.

"Breaking the tragedy of the horizon" and working together for a "new horizon" is the only way forward. There is some work to be done and no time for procrastination: we have the chance of bringing the age of opportunity to everyone when most needed. ●

Ann Prendergast

Managing Director
and Head, State Street Global
Advisors Ireland

Hope on the horizon: addressing the ESG challenge

A growing number of financial institutions, investors and policymakers have shifted focus toward sustainability investing, or incorporating environmental, social and governance (ESG) matters into the investment process.

Although the topic of ESG may seem like a novel phenomenon, the financial services industry has weighed in on certain financially-material ESG factors for some time. What is different now is a heightened sense of urgency given the physical devastation of climate change has become measurably real.

There are two key drivers in this focus shift. The first is increased client demand for sustainable investment and their general changing mindset requiring more stable returns over the longer-term that poses no harm the wider environment.

Even amid the current market turmoil due to the Coronavirus pandemic, investors appear keen to maintain ESG values, for instance by monitoring companies' treatment of employees. The second – perhaps, in part, driving client demand – is regulation which has prioritised policies broadly relating to ESG in recent times, albeit globally divergent approaches have emerged. Clearly, the paradigm has changed and progress has been made.

Nevertheless, persistent key challenges must be addressed. The first step, especially from an investor perspective, is to achieve a common language – or taxonomy – on what constitutes a sustainable investment. The European Union has made headway in classifying economic activities that contribute to its environmental objectives.

> *Clearly, the paradigm has changed and progress has been made.*

To articulate a common understanding of sustainability in practice, however, binary definitions that could limit choice of sustainability products and services should be avoided. Moreover, for financial market participants to apply any taxonomy, there needs to be significant improvements in the quality of sustainability data. Specifically, greater clarity and simplicity is needed for corporate ESG disclosures.

This means harmonisation of reporting standards as well as convergence of data sets and scoring methodologies, at the international level, to allow for better comparability of the sustainability of investments.

Financial institutions, investors and policymakers continue to develop toolkits needed to incorporate sustainability into the investment process. Efforts by the Sustainability Accounting Standards Board (SASB) and the Taskforce on Climate-Related Financial Disclosure (TCFD) have already been important contributions to help industry coalesce around common metrics and reporting standards, akin to what the major credit rating agencies use today to measure credit risk. Importantly, these international frameworks ensure the concept of materiality is upheld when considering ESG integration.

Ultimately, we need to be mindful that the policy goal is not to elevate sustainability risks above other critical components of the investment process, rather it is to ensure ESG is on an equal footing so as to enable private capital flows to be reoriented towards a more sustainable future. ●

Dr. Kay Swinburne

Vice Chair, Financial Services,
KPMG UK

Diversity: time to act upon the evidence

The financial services sector will become more effective if it meets societal demands, such as diversity.

ESG (environmental, social and governance) is the investment phenomenon of our time. The independent research firm ETFGI suggest assets in exchange-traded funds that consider ESG criteria increased from $6bn to more than $250bn between 2015 and 2019.

Much of the ESG debate tends to focus on climate change – the E. This is understandable, but the S and G factors should be of equal prominence. One aspect of S is diversity, on which the sector's record falls short.

Europe's financial services businesses remain remarkably "pale and male". Women, people of black, Asian and minority ethnicity (BAME), and staff with disabilities are all notable by their low numbers. LGBT staff, the industry itself acknowledges, need much greater support[1].

Unfortunately, the COVID-19 crisis may magnify some of these imbalances. In these times of economic stress with no childcare or schooling, it makes sense for the partner earning less to do the childcare. In a greater proportion of households this is likely to be the woman.

Some progress is being made, particularly on gender. The consultant Oliver Wyman says the proportion of senior women in finance now stands at around 20%, doubling over the past 16 years[2]. But women account for only 17% of "approved individuals" according to the UK Financial Conduct Authority[3]. And the European Banking Authority says 42% of credit institutions and investment firms do not yet have a diversity policy[4].

Why should we take this seriously? Well, leaving aside the moral imperative to embrace equality of opportunity, the research overwhelmingly shows a clear link between diversity and corporate performance. Morgan Stanley's "Holistic Equal Representation" research, for example, rates businesses on the diversity of their senior leadership[5]. The stocks of European companies with higher ratings have outperformed by an average of 1.6% a year over the past eight years, it says.

McKinsey research found companies in the top-quartile for gender diversity on executive teams were 21% more likely to outperform on profitability and 27% more likely to have superior value creation[6].

> *Europe's financial services businesses remain remarkably "pale and male".*

Lack of diversity creates "group think" and stifles imagination and creativity. Businesses that look completely different to the range of customers they serve cannot expect to understand their needs.

Recognising these issues, however, is more straightforward than tackling them. The jury remains out, for example, on mandatory quotas. France and Germany have both set legally binding targets for women on the board, at 40% and 30% respectively. In the UK, a softer Government approach has seen the number of women on FTSE 100 boards grow from 12.5% to 33% since 2011[7]. The Women in Finance charter is an example of how a voluntary approach can work well[8].

Quotas will not fix all ills. There is some evidence that the focus on women in the UK has coincided with a fall in BAME representation at the senior levels of companies[9]. No-one is suggesting mandatory quotas for disabled people or the LGBT constituency.

Increased reporting may be part of the answer. Countries including France, Germany, Iceland and the UK already require many businesses to publish data on their gender pay gaps.

This appears to be having some positive results. Given that pay differentials based on gender, sexual orientation, ethnicity, disability and other factors are illegal across much of Europe, there may be scope to do more. The European Commission is now consulting on mandatory gender pay gap reporting.

At the micro level, good practice at some financial services businesses shows what it is possible to achieve. Initiatives linking pay to good diversity-related performance in recruitment and retention show promise. So do efforts to promote flexible working, particularly where both men and women participate; shared maternity and paternity schemes are a good example. Other firms have trialled 'returnee' intern programmes for women who have taken extended breaks from the workforce.

Such initiatives beg an obvious question – will more financial services businesses do more to practice what they preach? ●

1. https://www.theia.org/sites/default/files/press-releases/document/20180701-bringingourwholeselvestowork.pdf
2. https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2019/November/Women-In-Financial-Services-2020.pdf
3. https://www.fca.org.uk/publication/research/research-note-gender-diversity-in-uk-financial-services.pdf
4. https://eba.europa.eu/eba-calls-measures-ensure-more-balanced-composition-management-bodies-institutions
5. https://www.morganstanley.com/ideas/womens-impact-on-the-economy
6. https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/Organization/Our%20Insights/Delivering%20through%20diversity/Delivering-through-diversity_full-report.ashx
7. https://www.gov.uk/government/news/third-of-ftse-100-board-members-now-women-but-business-secretary-says-more-needs-to-be-done
8. https://www.gov.uk/government/publications/women-in-finance-charter
9. https://www.green-park.co.uk/insights/green-park-leadership-10-000-2019/s94929/

Suzan Revell

Deputy Chair and General Counsel, EMEA, BNY Mellon

Why Purpose Matters

This EuroFi conference was going to focus on key challenges for European financial services and beyond – chief amongst them was to ensure sustainability plays a central role in financial services and to leverage digitalisation and technology to help future proof the European financial services sector, in particular in its delivery to consumers and clients. Whilst the Covid-19 crisis may have diverted our attention temporarily, these concepts remain central to the future of financial services.

In looking to tackle them, we cannot lose sight that financial services – despite the advent of algos and AI, Machine Learning and DLT – remains a people business. The human element is critical in determining how our industry can meet these future challenges. Ensuring that our firms remain sustainable, that they stay ahead of the curve within an environment of ever accelerating pace of technological change, requires dedicated individuals, working collaboratively and being attune to the corporate Zeitgeist. In turn, as leaders we need to ensure our industry continues to attract talent in the face of competition, particular from the tech sector, and enable them to reach their full potential.

It is here that the recent Corona crisis comes into sharp focus. It has and is challenging us to find new ways to interact with each other, to work at physical distance to each other including the closest co-workers, to understand the personal circumstances of colleagues and family members – the human element has taken centre stage. And it is the individuals, up and down the organisation, that we rely on to continue to serve clients and deliver services across the various parts of our organisations.

A lot of research has been conducted in how companies can succeed in such challenging circumstances. Through our work on corporate purpose, including by participation in AFME and UK FCA working groups, we have explored how critical individual employees' perception of their personal connection with the organisational purpose can be in setting a framework for all the other corporate objectives that we collectively work towards. A corporate purpose that is focused on serving all of its stakeholders - in addition to shareholders also customers, employees and the community - can help to transform a short term focus on profitability into a longer term focus on sustainability. It is key in setting corporate culture and in turn shapes governance processes and decisions - both in business-as-usual circumstances, but particularly in challenging situations where formal governance structures may need to adjust to meet the needs of the organisation, such as the current Covid-19 crisis.

> *A corporate purpose that is focused on serving all of its stakeholders can help to transform a short-term focus on profitability into a longer term focus on sustainability.*

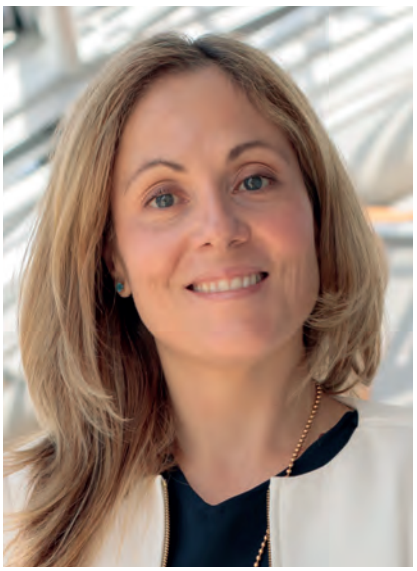
It is therefore critical that companies can embrace a corporate purpose which individuals can align to and rally around. This can take different forms – whether a mission statement, a set of company goals, shared perspective on tackling global challenges. And that corporate purpose can be relevant in multiple different facets – purpose can be a benefitting factor for motivation of the wider workforce but also for wider company alignment. But crucially, being able to internalise a purpose, to harness a purpose which drives performance and profitability, allows companies to compete with a distinct competitive advantage. As the E&Y Beacon Institute has found "companies who clearly articulate their purpose enjoy higher growth rates and higher levels of success in transformation and innovation initiatives".

Whilst purpose is primarily an internal driver, a purpose that permeates into corporate strategy and product development can also be a key success factor with clients. As an example, a company that sets itself a clear purpose to be sustainable may be better able to launch products with a sustainability angle – against the backdrop of growing investor interest in sustainable investment products this can be a crucial success factor.

But there is also a risk in communicating a corporate purpose if such mission statements are not followed up by actions. If they are perceived by the own workforce or externally as mere campaign slogans. In that sense, acting against a stated purpose can bear significant risk for the corporate. A disconnect between the purpose that is being communicated widely and the action undertaken by the firm, can lead to a breakdown in authenticity which, in turn, can lead to a breakdown in trust and ultimately longer-term reputational damage.

These risks aside, I believe the industry and the wider ecosystem, including policy makers, need to embrace corporate purpose as a key factor for our industry in the years to come. To meet the many challenges that lie ahead, only an engaged, talented and inspired workforce can deliver success – and leading by example, embracing a purpose is not only a means to that end but a critical ingredient. ●

Implementing the EU sustainable taxonomy



Emma Navarro

Vice-President,
European Investment Bank (EIB)

Implementing the EU taxonomy

To tackle the climate and environmental crises, the financial system and sustainability will need to be closely connected. Only integrating ESG considerations into investment decision-making, sustainable investments could be unlocked at the scale required to support the transition to a climate neutral society. For this to happen, we must start with a common understanding on what is a sustainable investment.

Having a common language in place is key to give clarity to investors on what is a green investment and avoid "greenwashing" in the market.

This is precisely the goal of the EU Taxonomy on sustainable activities. The taxonomy establishes the conditions and framework to create a unified classification system on what can be considered an environmentally sustainable economic activity. The aim is to develop a list of such activities for the purpose of investment, building around six environmental objectives and based on technical screening criteria. Eligible activities will need to make a significant contribution to one or more of these goals, avoiding significant harm to the others. The list of activities will be developed over time starting with two first environmental objectives, climate change mitigation and adaptation.

The taxonomy will be open to change, to align the classification to market trends and regulatory changes. Transparency and standardization will also be fostered. The regulation on the taxonomy introduces new disclosure obligations for financial market participants that offers financial products. More than 6000 large companies and groups across the EU will be required to comply with its disclosure requirements.

On the other hand, the taxonomy provides green definitions that will be used in the upcoming EU Green Bond Standard and InvestEU regulation. Beyond that, it will also play a major role in promoting consistent and transparent definitions of green loans, green mortgages and other green financial products.

As the EU climate bank, the European Investment Bank has been technically supporting the development of the Taxonomy, through the Technical Expert Group (TEG) set up in 2018. After the final report of the TEG published last March, the EIB will continue to help with expansion of the taxonomy to the other environmental objectives and to provide technical support to Commission towards the publication of the legislation by the end of 2021.

The EU taxonomy will be the most comprehensive guideline of sustainable activities ever developed and is likely to set a global benchmark. One of the key outlets for this taxonomy is the International Platform on Sustainable Finance, of which the EIB is also a supporting partner.

Launched in October 2019 by a group of countries that emit almost half of the world's greenhouse gas, the platform will seek international coordination and information exchange on different sustainable finance initiatives that will help identify barriers and opportunities. It will give an opportunity to promote the EU taxonomy framework.

> *The taxonomy represents a major step for Europe to meet its energy and climate goals.*

A key challenge in the implementation of the taxonomy is data. The development of sound methodologies, metrics, and data collection and reporting systems will be critical for the success of the taxonomy. The TEG has been exploring how to address these challenges, giving guidance on the use of data to different types of users of the classification.

The taxonomy represents a major step for Europe to meet its energy and climate goals. When investors have better information about their climate impact, they can make better decisions. This increases the private sector's investments in low-carbon projects and in climate change adaptation.

That is how we will finance the transition to a green, climate-resilient future. ●

Natalie Westerbarkey

Head of EU Public Policy, Fidelity International

Implementing the EU sustainable taxonomy: a race against time

The EU taxonomy report published on 9 March 2020 is a major milestone providing guidance to investors, companies and issuers on the definition of environmentally green, enabling and transitioning economic activities.

It also introduces specific social and governance criteria, as activities can only be deemed sustainable if they comply with 'minimum safeguards' such as the OECD Guidelines for Multinational Enterprises, the UN Guiding Principles for Business and Human Rights, and the International Labour Organisation's (ILO) declaration on Fundamental Rights and Principles at Work.

Of course, countries can apply more stringent or additional environmental, social and governance (ESG) requirements through local climate, labour or other laws.

There is a systemic nexus between climate change, global disease, social and governance aspects. The pandemic crisis amplifies that ESG criteria are interdependent, exponential and of global systemic relevance. According to the UN, large scale climate migration is expected to increase the frequency and severity of disease outbreaks.

It impacts global medical supply, food security, supply chains, employee rights, economies and financial markets. The WHO suggests that changes in infectious disease transmission patterns are a major consequence of climate change.

The EU taxonomy therefore represents an indispensable policy tool which collectively guides corporates, investors and sovereigns in defining those activities that are environmentally, socially and from a governance perspective sustainable. It has the potential to promote a true shift towards responsible capitalism, if corporates disclose ESG data or roadmap, so to attract more investments. Fidelity has launched a proprietary ESG rating tool to capture that data and engage with corporates and investor clients.

Investor client choices remains the main driver. From a financial perspective ESG assets seemingly show greater resilience during down turns, creating an incentive for investors who look for downside protection. Raising further awareness through investor education will be critical right now.

A timely implementation of the EU sustainable taxonomy is crucial to prevent irreversible environmental damage and future outbreaks to protect the people and planet. Many countries and the European Parliament acting on behalf of almost half a billion EU citizens have only recently declared a climate emergency.

Implementing the EU taxonomy creates opportunities as sustainable finance goes beyond just green investments related to energy and transport. The wider European Green Deal remains vital. It stretches from agriculture, foods, manufacturing, real estate to large infrastructure projects including the health care sector and medicine innovation projects co-financed by the European Investment Bank.

A global approach is indispensable to achieve a meaningful impact. The EU launched an important International Platform on Sustainable Finance (IPSF) which already includes some of the largest countries. In parallel, the G20/OECD are working with asset managers on a sustainable infrastructure report to be presented to G20 Finance Ministers mid 2020.

A global rapid response on sustainable finance is required to limit the catastrophic impact and the optimal solution is reached through international solidarity. ●

Ingrid Holmes

Director, Head of Policy & Advocacy, Federated Hermes – International

EU sustainable taxonomy: a good start but only part of the jigsaw puzzle

The EU's sustainable taxonomy has attracted criticism for reflecting only a narrow set of economic activities being undertaken by an even narrower slice of financial markets. However, such criticism is misplaced. The taxonomy is a work in progress and reflects only one piece of the broader financial market reforms put in place as part of the EU's Sustainable Finance Action Plan.

The taxonomy is needed because many financial market participants do not understand what sustainability, or 'net zero,' means in the context of specific climate-related economic transition. Such a lack of understanding is equally true amongst many corporates and policy makers too. Academics have referred ▶

to the taxonomy as a 'boundary object': common information that can span a range of intersecting communities. In this case investors, corporates and policymakers. It is facilitating a common understanding of the characteristics our future 'deep green' economy needs if we are to make a success of the Paris Agreement on Climate Change.

Developed in consultation with a broad-based group of experts, the taxonomy is an impressive piece of work. It not only defines in detail our 'deep green' future, it also helps users of the taxonomy to think through how they need to balance the different facets of a truly sustainable economy.

The EU taxonomy should be embraced by all governments/regulators as a basis for a global conversation and serve as the basis for an emergent set of integrated sustainability expectations. Continued development of the EU taxonomy should be supported, free from political pressure. The EU taxonomy represents expert views on what European economies need to achieve to be considered, truly sustainable. It needs to be outcome based – rather than reflecting the different transition pathways each member state might take.

> *The taxonomy is a work in progress and reflects only one piece of the broader financial market reforms*

The next step in the taxonomy evolution will be its adoption and implementation by the investment community, where it will serve as a new reporting tool for clients to better understand how aligned, or not, different products and firms are to the taxonomy. The decision by the European Commission to link the taxonomy to the Non-Financial Reporting Directive reporting requirements was critical to ensure necessary data flows, as one of the challenges the investment community would have faced is that companies currently are not required to report on their economic activities at the level of detail envisaged by the taxonomy.

There is anecdotal evidence real economy firms affected by the climate transition are already using the taxonomy to consider forward capital expenditure planning – and this can only be a good thing. The window of opportunity to manage climate change is less than a decade, and it is critical that both companies looking to access capital markets, and investors looking to encourage sustainable investments, consider whether their forward operations and strategies map to the taxonomy. ●

Takanori Sazaki

Regional Executive for EMEA, Mitsubishi UFJ Financial Group (MUFG)

The road to responsible decarbonised banking

The end goal of the energy transition to a net zero world is clear: creating a sustainable world for future generations by preventing an increase in global warming by 2° Celsius. We all have a role to play as we try to achieve this goal in the coming years; no single company, industry sector, government or community can do this alone. Each stakeholder has a different responsibility when it comes to the energy transition and we should acknowledge that there are limitations to what each organisation - including banks - can contribute.

Banks' role in the energy transition

Banks have and will continue to play a crucial role in financing the economy. They also help providing solutions for social issues and can help build a sustainable society where clients can achieve sustainable growth. For banks operating globally, sustainable strategies will have to reflect the interests of all stakeholders; national policy makers, central banks, the industry, regulators as well as the public. Each economy has their own starting point, their own energy mix and their own unique incentives and ability to transition to a net zero world. Most banks support a wide range of companies and industries, including those in areas which are reliant on oil, gas and even coal for the most basic needs of heat, food and shelter. This will not change overnight. The key for these sectors is to become more energy efficient and banks can encourage these efforts by adjusting their individual ESG policies and procedures. However, they must do so in a responsible manner to ensure the energy transition runs a smooth course without unnecessary disruption to the financial system and the real economy.

> *Any taxonomy with the aim to define sustainability of all economic activities should have the aim of becoming a global solution to avoid fragmentation along jurisdictional lines.*

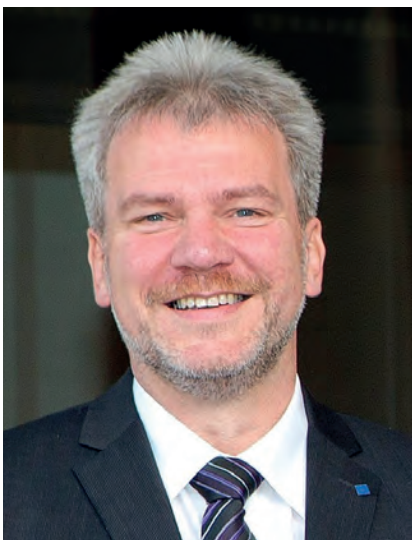
Regulatory framework and the transition

Climate change is a global issue and several important global initiatives have been developed to further monitor, facilitate and regulate the contribution from the financial services industry. The EU taxonomy is an important first attempt to draw a clear line between which economic activity is sustainable and which is not, and it creates incentives for investors to move towards ▶

more sustainable solutions. The transitional path is slowly becoming more clear due to improved reporting, enhanced risk management and more coherent public policy frameworks. And while climate change is a global phenomenon, the energy transition also has a dynamic nature given the various geographical, social economic and technological dimensions that need to be taken into consideration. Any taxonomy with the aim to define sustainability of all economic activities should have the aim of becoming a global solution to avoid fragmentation along jurisdictional lines and at the same time able to evolve dynamically, taking into consideration technical innovation in energy efficiency, energy consumption patterns and market dynamics in new energy sectors.

Working together to support the transition

Achieving net zero targets, even with the resources, talent and technology available today, is going to be a tremendous challenge. Societies at large need to work together to explore opportunities for new energy solutions. All GSIB banks are focused on understanding and managing the risks arising from climate change, including active engagement with clients. It is important that governments are transparent about what is achievable for each sector in the economy and this path forms the basis of a responsible road to decarbonised banking, allowing for a balanced road to Paris.



Gerhard Endemann

Head Sustainability, Head Environment, Wirtschaftsvereinigung Stahl (German Steel Association)

Challenges to introduce sustainable finance and taxonomy into the steel sector

EU Steel companies produce according to legal requirements, and often go beyond. Existing processes have been optimized why an increase in efficiency and reduction in environmental and climate-relevant effects is hardly possible within existing processes and plants.

Correspondingly, all companies search for new and modified processes in order to gradually enable the path to a CO_2-free and sustainable future.

The steel sector fundamentally supports the approach of sustainable financing and the goal of the change to a sustainable and CO_2-free society. But, an appropriate and solid design of sustainable finance rules is inevitable. A holistic approach is essential that takes full account of the specifics of a basic industry, its significance for the value-added networks and its enabling properties for sustainable activities.

The transformation within sectors will not happen overnight. New technologies must be developed and implemented. In the meantime, existing plants that have not yet reached the end of their life will continue to be operated. In order to rule out negative (environmental) effects during continued operation, these existing plants must be kept in optimal condition and be adapted to the best available technologies and processes must be further developed.

> *Transformation requires parallel financing of new technologies and further development of existing technologies.*

As a result, there is a need for financing both – 1. the further development of existing systems and processes and 2. the desired transformation itself. The financing must be ensured in parallel. These are transitional activities in accordance with Article 6, Paragraph 1a of the "Regulation of the European Parliament and of the Council on the introduction of a framework to facilitate sustainable investments".

While the taxonomy for future low-carbon technologies is defined by the "Taxonomy for Sustainable Financing" in both EU legislation and ISO standardization procedures, the conditions for the transition activities and a transformation taxonomy are still widely unclear.

Several points must be considered in a transformation taxonomy. Transformation must be accompanied by simultaneously securing the financing of both new technologies and the further development of existing technologies.

This presumes that (i) currently a low-carbon alternative is technically and economically not available, and (ii) financing in existing assets neither hinders the development of new low-carbon alternatives, nor (iii) retains carbon-intensive assets beyond the transformation period.

Therefore, companies will demonstrably create and follow a CO_2 reduction plan while aiming for continuous improvement across all existing and future processes. The industrial emissions directive is applied, and facilities are adapted to best available technology.

In principle, the same basic conditions with regard to climate protection/adaptation, emissions, water protection, nature conservation and CE shall be used for the transitional activities as for climate-neutral activities, but – except of being among the best 25% of the sector in Europe – no stronger thresholds should be set.

Due to above mentioned big challenges, setbacks in continuous improvement for technical reasons as well as setbacks because of legal or political changes must not be borne by the affected sectors.

Gerry Cross

Director of Financial Regulation, Policy and Risk, Central Bank of Ireland

The Taxonomy – the cornerstone of the Action Plan on Financing Sustainable Growth

When considering the impact of the Taxonomy and how its role could be expanded, we should firstly acknowledge, from a financial regulation point of view, the highly ambitious work set out in the European Commission's *Action Plan on Financing Sustainable Growth* and the influence it hopes to have on the financial services industry, investors and of course, regulators. It is obvious that this is an area of financial regulation that is developing rapidly. It is important for regulators and financial market participants to be well sighted on the changes. Not only on the relevant details - though these are of course very important - but also on the underlying direction of travel. What we are seeing is a material evolution in financial regulation. One which is consistent with a change in how a well-functioning economy is perceived and understood, with sustainability one of its determining features. The development of a Taxonomy of sustainable economic activities it is an essential step in supporting the flow of capital into sustainable activities in need of financing and plays a critical role in progressing towards that well-functioning sustainable economy.

Secondly, it should be acknowledged that the role the Taxonomy will play in other areas of financial regulation, most notably disclosure, will be crucial in protecting investors. Under the Regulation on sustainability-related disclosures in the financial services sector (the Disclosures Regulation) where a financial product promotes environmental or social characteristics or has sustainable investment as its objective, the financial market participant will be required to disclose information as to how those characteristics are met. The Taxonomy now extends this obligation by requiring financial products which invest in an economic activity that contributes to an environmental objective to use the criteria set out in the Taxonomy to include detailed information on that environmental objective, and describe how the investments underlying the financial product invest in activities captured by the Taxonomy.

> *A taxonomy of sustainable economic activities it is an essential step in supporting the flow of capital into sustainable activities.*

For this to work, data about company or issuer performance against the Taxonomy activity criteria will be required. So, it is timely that the European Commission is currently consulting on enhanced ESG corporate disclosure under the Non Financial Reporting Directive to target an estimated 6,000 large listed companies with a view to enhancing their delivery of high quality environmental-related reporting.

While we are still in the early stages, we can broadly see the development of a sustainable finance eco-system with the Taxonomy as the common feature. Lastly, we know the European Commission has mandated work in relation to Ecolabels for financial products and Green Bonds. The Taxonomy will, of course, play a crucial role in the development of these labels, and, it would seem fair to suggest, will continue to underpin future sustainable finance regulation. ●

Eurofi would like to thank very warmly
the Croatian EU Council Presidency
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ESG challenges for small and mid-caps

Mario Nava

Director Horizontal Policies, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

European Commission work on non-financial reporting

The European Green Deal has put Europe on the path to become the first climate-neutral continent in the world by 2050. The Commission recently took a big step in that direction by unveiling its proposal for the first ever European Climate Law.

By the end of 2020, the European Commission will also put forward a new Sustainable Finance Strategy, as well as proposals to revise the Non-Financial Reporting Directive.

Currently there is a sustainability reporting gap. The needs of investors for corporate sustainability information are increasing faster than any improvements in company reporting. There is plenty of evidence that the non-financial information reported by companies is not sufficiently comparable, reliable or complete.

Non-financial reporting from investee companies will need to improve to enable the financial sector to meet its own legal obligations to report certain sustainability-related information under new European laws – in particular the taxonomy Regulation and the regulation on sustainability disclosures by investors.

At the same time, the current situation is also unsatisfactory for reporting companies. They face uncertainty and complexity when faced with an array of overlapping and inconsistent private non-financial reporting standards and frameworks. And they are under pressure are under pressure to respond to additional demands for non-financial information from sustainability rating agencies, data providers and civil society, irrespective of the information that they publish as a result of existing European reporting rules.

In parallel to the development of a legislative proposal to revise the Non-Financial Reporting Directive itself, Vice-President Dombrovskis, has announced the launch of a process to develop European non-financial reporting standards. Not every detail can – or should – be fixed in law. There is also a need for clear reporting standards for companies to apply.

The EU cannot develop such standards on its own. While we are well placed to take the lead, the EU will need work closely with existing private standard-setters such as the Global Reporting Initiative and the Sustainability Accounting Standards Board. We will incorporate the best and most widely accepted elements of existing standards, even though none of them on their fully meet European needs. This cannot be a question of reinventing the wheel.

Our work on non-financial reporting will have to strike a balance between the information needs of users, primarily the investment community, and the ability of investee companies to collect and report such information. We will need to play close attention to the potential costs of stronger non-financial reporting requirements, and compare them to the costs of not taking action.

We have contracted consultants to gather better data on the costs of non-financial reporting. We will also gather feedback from a major online consultation that is open until Mid-May, and from a separate survey targeted to SMEs.

Our aim is to enable the financial sector and companies to realise their full potential as catalysts for the transition to a sustainable economic system in Europe. ●

Yann Pouëzat

Director for Corporate Financing and Financial Markets, French Treasury, Ministry of Economy and Finance, France

Policies challenges for addressing standardized ESG adoption

Since the Paris Agreement in 2015, various institutional and normative initiatives have emerged to foster more transparency and long-termism in the economy. The fight against climate change requires to involve the financial system into the path of energy transition.

The ambition to redirect financial flows towards a more sustainable economy has been partly made more tangible. However, the absence of convergence around a common definition of 'sustainability' prevents companies from appropriately disclosing the degree of environmental sustainability of their economic activities. In this regard, the future adoption of the European Taxonomy in 2020 - classifying the economic activities regarding their sustainable impact - has a strategic role to play in helping investors define their investment policies accordingly. Thus, this common language and the associated regulatory efforts are essential ▶

to tackle the existing challenges regarding the corporate issuer's disclosure of environmental, social and governance (ESG) information and consequently sustainable investing.

The European Union, through its Action Plan for sustainable finance has incorporated some new reporting requirements on the sustainable impact of investments in the existing regulations applying to financial markets. However, the multiplicity of non-comparable ESG information reflects the different approaches to corporate issuer disclosure and scoring system frameworks. European public policy initiatives shall help to streamline the number of different corporate disclosure frameworks which – as strong as they may appear – blur the readability of the ESG information among different corporate issuers and incur significant costs. By delivering some proportionate policy measures to corporate issuers, the EU shall focus, as first step, on promoting a better global alignment of the different ESG indicators. Nonetheless, the normative character of the EU future policies will have to avoid the risk of excessive granularity and the restriction over investors or rating agencies' innovation upon indicator measurements.

This common sustainable reporting framework makes it necessary to adapt this requirement to the capacity of each corporate issuer. As clear disclosure from small and mid-caps becomes scarce, the reliance by investors or insurers on every kind of data can give rise to a somewhat misleading image of smaller companies' ESG criteria adoption. The establishment of a pragmatic common reporting framework consistent with corporate issuers' resources is a key success factor for the development of sustainable investment.

> *The multiplicity of ESG information reflects the different approaches to corporate issuer disclosure and scoring system frameworks.*

The common objective to achieve a higher quality and comparable ESG data cannot be disconnected from the ambition to adjust our real economy. Europe must be able to respond to the concrete expectations of its citizens with regard to the energy transition. To this end, the social dimension, as one of the pillar of the ESG criterias, should be acknowledged through the simplicity of the ambitious framework required. This makes it necessary to take into account operational complexities for the incorporation of ESG information in order to consider the sustainability impact as a key element of the corporate strategy. ●

Carmine Di Noia

Commissioner, Italian Securities and Exchange Commission (CONSOB)

No obligations but market-based drivers to successful ESG adoption by SMEs

The publication of non-financing reports among listed SMEs is still limited. Lack of communication obviously doesn't necessary imply absence of adoption, but it would appear quite bizarre a company embracing ESG philosophy in its internal processes then "forgetting" to ride the wave of current ESG hype.

Integrating ESG factors into managerial thinking, however, is a revolution under way, not a simple fad. Temptation to "prompt" revolutionary change in business by means of rulemaking is always around the corner. No surprise that the Consultation Document on the Review of NFRD, thus, proposes, as one possible response to the lag in non-financial reporting, the enlargement of the disclosure duties also to small/unlisted undertakings.

I do not think this is the best way to convince SMEs of the potential embedded into a shift of their strategic planning towards a long-term, sustainable horizon. Regulatory actions, with its unavoidably but burdensome solutions, should leave the floor to sound and progressive market-based evolutions. EU Institutions have already put in place the regulatory framework to favor spreading of ESG-compliant strategies (also) among SMEs: this is Capital Markets Union.

> *Demand for ESG values from long-term investors is the best way for SMEs towards sustainability.*

The initial 2015 Action Plan strongly addressed SMEs funding needs by

proposing measures aiming at broadening market-based financing. The goal to enlarge the so-called "funding elevator" was pivotal in the Action Plan, with particular regard to the equity side (venture capital and private equity) and, more in general, the supply of "patient capital" suitable for convincing (small) companies to abandon short-term approach for a more sustainable ▶

management. 2017 Mid–term Review went further on outlining that a "deep re-engineering of the financial system is necessary for investments to become more sustainable and for the system to promote truly sustainable development from an economic, social and environmental perspective". Recent Report of The Next CMU High-Level Group stressed the sustainable character of CMU to the point that proposed a re-branding the entire project "Savings and Sustainable Investment Union".

Tools to spread ESG among SMEs are already present in the CMU logic and measures. A full deployment of the regulatory actions, reinforced by a strong injection of fiscal incentives, should boost long-term investment by both institutional and retail investor. This should in turn bring to light the need for a longer-term orientation of the goal of small firms: a sustainable strategy, an improved governance and a management focused on social and environmental targets. A successful development of market–based sustainable finance, in conclusion, is the market response to the problem: favoring demand for ESG values and data from sustainable long-term investors is the best way to persuade innovative SMEs to take meaningful steps towards sustainability. ●

Christophe Bourdillon

Chief Executive Officer,
CDC Croissance

ESG integration by small- and mid-cap companies: a difficult yet essential transition

The major movement to promote the imperatives of an ESG approach in the contemporary economy now seems to be irrevocably under way. The European Union aims to play an important role in this transition, by pursuing a proactive soft power strategy for green growth, as recently adopted by the Commission. Sustainable finance is the key lever for action in this area.

For several years, the EU has been engaged in work to gradually establish a framework, including a taxonomy and guidelines, aimed at encouraging investors to systematically embed the analysis of multiple ESG factors in their asset allocation decision processes. National authorities throughout Europe have reaffirmed this approach, which has already been taken on board in the large-cap sector, where many companies have put in place substantial measures to ensure better dialogue with the financial ecosystem (stock exchanges, investors, issuers, NGOs, rating agencies, regulators, etc.).

The situation is entirely different for small- and mid-cap (SMID) companies, which tend to be more varied in terms of capitalisation (from several hundred thousand to about five billion euros) and available resources. Investors are becoming more aware every day of just how much this sector, with a few brilliant exceptions, is failing to embrace such an approach. The reasons for this astonishing unpreparedness range from a lack of knowledge to an existential fear brought about by developments confusedly perceived more as threats than as opportunities. Companies in the sector are discouraged by the methodological complexity (with a multitude of factors to be analysed and reported) and the cost of the transition to a business model that includes ESG considerations.

But the stakes could not be higher, since it is SMID companies, and more generally SMEs, that are the backbone of the European economy. There is thus a risk that, in the absence of proportionate action, these companies could be eliminated in coming years from asset allocation strategies, raising crucial financing issues for them and endangering their very survival. The same is true for intermediaries specialised in the SMID sector, already deeply affected by the transformation of the investment research industry due to the arrival of MiFID II.

> *The firm is studying the feasibility of an ESG fund based on a "best efforts" investment philosophy ...*

As a leading investor in French SMID companies, the equity fund management firm CDC Croissance, a subsidiary of the state-owned Caisse des Dépôts group, has decided to opt for a persuasive approach. The firm is studying the feasibility of an ESG fund based on a "best efforts" investment philosophy, rather than the more commonly applied best-in-class approach.

The aim will be to select listed companies not among the top ESG performers, but instead having prepared for ESG integration only to a minimal or moderate extent and that will agree to engage in a gradual and measurable adaptation process.

The fund, with a target size of €100 million, is expected to begin operations in mid-2020 using a specific methodology. It is anticipated that its launch will coincide with that of an ESG SMID index, designed by Euronext NV and the Ethifinance rating agency.

This new fund should thus become part of an intense mobilisation effort driven by European and national authorities to implement a distinct and gradual adaptation process for SMEs, in order to support their transition towards more sustainable business models. ●

Rami Feghali

Partner, PwC

There is still a long way to go

Sustainable Finance is considered as a central tool to drive the real economy towards sustainability targets such as carbon neutrality by 2050. There is still however a long way to go. The share of ESG financial assets is currently less than two percents of total financial assets. Time is also running out, if we want to meet the carbon neutrality target by 2050 then the required infrastructure investments which are long term by nature must be fully sustainable by 2025. Significant investments and progress are therefore needed within the next five years. A key underlying building block of sustainable finance is however missing. The transition of the 98% remaining financial assets can not be achieved without the availability of appropriate ESG data. There is a wide recognition among financial institutions that ESG data are incomplete, not comparable and of poor quality. This is true for all categories of ESG data, environment, social and governance, and it also true for all categories of companies although the issue is more acute for climate related data and for SMEs.

The gap between financial institutions regulatory requirements on climate risk and the ability of these institutions to comply with them based on the information they have at their disposal will be hard to close. The transmission mechanism can then be broken and instead of steering transition, finance might ultimately exclude those companies that need most support on a fair transition journey: environmental sensitive companies and smaller companies.

No one would think of a financial ecosystem operating without financial statements. We need a non financial reporting framework of the same quality as the financial reporting framework. This would be beneficial for the development of sustainable finance, but it will also be key to structure the transition journey of the real economy. Non financial information is actually more diverse, granular and complex than financial information. It requires a reporting on a set of relevant exposure indicators, ideally by sector, location and company, and even ultimately measuring the impact of such indicators through the whole value chain. It took hundreds of years to build the financial statements that we currently use, by capitalizing on best practices and adopting progressive standardization. We only have five years ahead of us.

> *Sustainable Finance can not be successful without the appropriate non financial reporting framework.*

The revision of Non Financial Reporting Directive is a unique opportunity in that respect, provided it includes a binding standardization of a minimum set of ESG indicators and an appropriate accountability framework. Given its leadership on sustainability and its political legitimacy, the European Union is best placed to build on the multiple existing reporting frameworks and find a solution. This solution can later be refined and form the basis of a global reporting framework. It is not a matter of sovereignty, perfection or excessive regulation. It is a matter of urgency and efficiency. ●

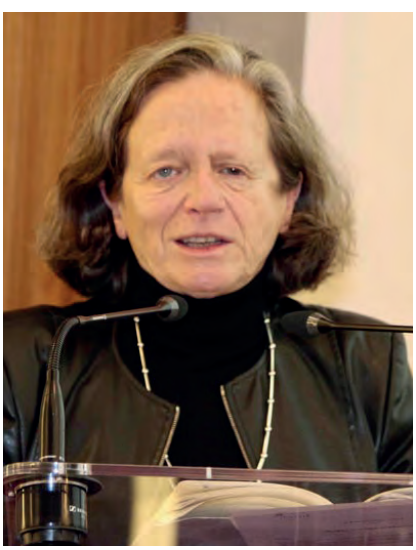
Pervenche Berès

MEP from 1994 to 2019,
European Parliament

Why Small and Mid-caps should welcome non-financial reporting

EU non-financial reporting is this part of information that financial reporting in itself cannot deliver even though they are key to value security and stability of financial markets. The answers to the Covid-19 should not water down this need. In its February 2020 consultation document on the review of the non-financial reporting directive (NFRD), the Commission questions (cf. 40) expending the "scope to include all EU companies with securities listed in regulated markets, regardless of their size". Earlier, the Commission had acknowledged that to widen the scope of the directive "could reduce the burden for companies of having to respond to individual requests for information from sustainability rating agencies and data providers".

But before answering the scope, one should consider aspects affecting any companies. The development of non-financial reporting should not be seen as a way for green washing or to develop ▶



a new hierarchy regarding financial reporting. The quality of the latter is a pre-condition for the former. The current legal tool is a directive with options for Members States. There are now strong arguments to move to a regulation. For example, one area where this option regime has proved to create damage and confusion is when it comes to the control regime.

The proper format should be a compulsory control by third-party independent bodies. The foreseeable review of NFRD is also an opportunity to clarify what is the standard for this reporting, to start with the format including obligation related to prospectus or key information document. But this could also be an opportunity to build a common culture around the Task force on climate related financial disclosures (TCFD) recommendations taking into account the entry into force of the taxonomy. One of the questions that will need to be answer is how to increase comparability and consistency between companies reporting without jeopardizing innovation or capacity of a reporting format to capture the specificity of a business.

> *It would be in the best interest of Small and Mid-Caps to enter the scoop of non-financial reporting because more and more investors will ask for it.*

Currently NFRD only applies to Public-interest entities with more than 500 employees, large banks and insurances listed or not. It allows Member state to define a wider scope, option that has been used by some Members states. In terms of competition and internal market, it would be more appropriate to close this option with a regulation. Regarding Small and Mid-Caps, one could argue that it would be in their best interest to enter the scoop of non-financial reporting because more and more investors will ask for it, it will become part of a business model and it will help the due diligence process when, following the OECD guidance, "entreprises should carry out to identify, prevent, mitigate and account for how they address these actual and potential adverse impacts in their own operations, their supply chain and other business relationships".

The question could then arise, should this be accompanied by three categories standards: compulsory, recommended and encouraged to adjust the proportionality argument? One could also consider in which sector the Mid cap is active to define its obligations. But in the end, it should be recall that nature of risk doesn't always relate to the size of the business, this is true for financial risk, no doubt it is also true for non-financial ones. ●

Anamarija Staničić

Head of Division, Policy and International Cooperation Division, Croatian Financial Services Supervisory Agency (HANFA)

SMEs and ESGs – what is in it for me?

Small and medium enterprises (SMEs) are the backbone of the EU economy. In 2015, just 0.2 % of all enterprises had 250 or more persons employed and were classified as large enterprises. If the EU wants to move towards a sustainable future, SMEs have to be a large part of the agenda. Another consideration is – if a thriving SME sector is an engine for growth, what impact will the adoption of Environmental, social and governance (ESG) criteria have on the business performance of SMEs, and consequently on the growth of the EU economy?

The existing subset of already ESG conscious SMEs aside, when taking up ESG criteria, a natural question will be – what is in it for me? Long term, there may be benefits for SMEs to adapt their business model to the new framework, but taking the long view may be difficult for a small business trying to keep its head above water, especially in the context of the on-going crisis.

Here, the key will be setting up the right incentives. The first step was the sustainable finance package – the taxonomy, the disclosure framework for financial market participants (FMPs) and the changes to the benchmark regulation. The second will be the changes to the Non-Financial Reporting Directive (NFRD), where the Commission is consulting on broadening the scope of the NFRD to SMEs. Short-term, this implies an increase in the reporting burden for SMEs, which should be accompanied by an equivalent regulatory burden decrease elsewhere.

> *The success of the sustainability agenda depends on the EU being able to explain to SMEs how they will profit from the take-up of ESG criteria.*

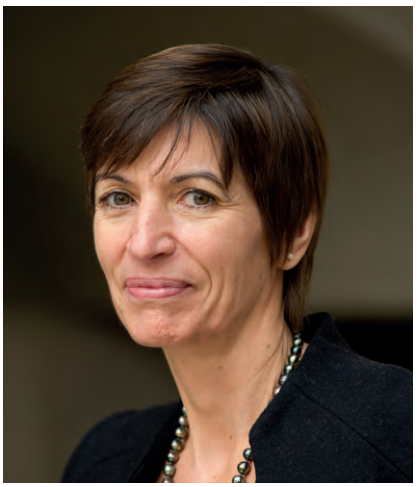
SMEs will also need a robust support network to help them adapt, both on a national and on an EU level. This is an opportunity for financial intermediaries to branch out and offer support to SMEs, both in implementing ESG strategic planning and external reporting, and getting SMEs the funds they need to do this while growing their business.

The larger issue is that SMEs need to see what the advantages for them are, and they need to see them now. We need to figure out how to make the ESG transition profitable for SMEs. Consumer demand for sustainable products and services will be a main driver for ▶

change in business models, and the market does not naturally reward sensible behaviour, nor do consumers naturally flock to more socially responsible firms. The supply and demand chain does not have in-built ethical considerations and is an engine devoted to making a profit. If we want to change that, we will have to build-in counterweights to the bottom line motive, through appropriate policy choices, including tax incentives and disincentives in national frameworks, as well as impacting the behaviour of FMPs when they market products to their clients, or decide on what business ventures to fund. An example of how to build in incentives for FMPs can be linking prudential requirements to ESG criteria, including an assessment of their business and what they fund against an ESG compliant standard. We also need to acknowledge that there is a reason why SMEs are more reluctant to access the capital market in the EU than in the US.

A new concept is needed for SMEs – a market that would be adapted to their needs and free of the many regulatory burdens that are appropriate for larger, more mature firms, while also incentivising the take-up of ESG criteria with the profitability goal in mind. The benefits of the sustainability agenda need to convince SMEs, or the future of the project remains uncertain.

Mitigating climate risk in the financial sector



Nathalie Aufauvre

Director General Financial Stability and Operations, Banque de France

Climate change: a global issue at the top of the European regulatory agenda

Central bankers and supervisors should consider financial risks related to climate change in order to ensure the resilience of the financial sector as well as the accurate pricing of these risks. This has been the stance of the Network for Greening the Financial System, co-founded in 2017 by the Banque de France, who hosts its secretariat, and which gathers now more than 60 members around the globe. This "club of the willing" called standard setters for action and led the way by providing some strong analytical foundations and practice oriented deliverables. In 2020, it will release a guide for banking and insurance supervisors on how to integrate climate-related and environmental risks in their work, as well as a set of reference scenarios capturing the macro-financial impact of transition and physical risks related to different transition pathways. The NGFS will also publish a report on the current practices of financial institutions in monitoring these risks, highlighting the challenges arising from the lack of homogeneous taxonomy.

The European Union understood well the need for a green taxonomy, with the related regulation being officially released soon. This taxonomy, if complemented in the future by a "brown" one to classify assets with a negative environmental impact, will be a building block for supervisors to tackle ESG[1] risks. On the banking side, the EBA released in December 2019 an action plan for sustainable finance which entails in particular reports by 2021 and 2022 on the inclusion of ESG risks into the annual supervisory review process (SREP) and then into the pillar 3 disclosure framework. The EBA will also assess the relevance of applying a different prudential treatment on assets from a sustainability perspective by 2025. The EIOPA is addressing ESG risks for the insurance sector as well. To foster internal risk assessment by insurers, the EIOPA will finalize scenarios of climate related risks by the end of 2020. Both ESAs will conduct sensitivity analysis related to the impact of climate change on the insurers and banks' balance sheets. In the EBA exercise, participating institutions will identify the share of their exposures consistent with the European taxonomy.

At national level, the ACPR launched in 2020 a pilot exercise (with no impact on capital requirements) for banks and insurers, aiming at measuring the impact of various transition scenarios on the French financial sector. On the other hand, in 2019, the ACPR established a Consultative Commission on Climate and Sustainable Finance to monitor commitment taken by financial institutions, in particular to reduce the financing of carbon intensive activities.

The next challenge to face is to integrate climate risk into the international standards. In this perspective, the new High Level Task Force on Climate Related Financial Risks established by the BCBS is a very positive first step to ensure a more homogeneous understanding of climate related risks by institutions and supervisors. Standard setters should preserve this momentum despite the current crisis, as the risks created by climate change are still ahead of us. ●

1. Environment (including climate-related), Social and Governance risks.

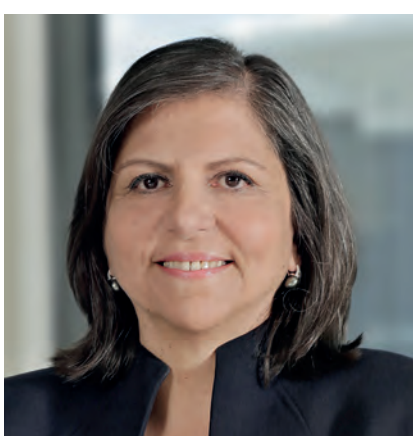
Diony Lebot

Deputy Chief Executive Officer, Société Générale

A fair regulation for sustainable finance: balancing constraints with incentives

Integrating ESG considerations into the banks' strategy and governance becomes increasingly important in view of the climate emergency but also as shown by the Covid-19 crisis. In this context, two major issues arise: the first relates to the risks carried by banks, while the other is on the role banks play towards the economy, their employees and all related stakeholders.

New banking regulations will help clarify and harmonize at EU level the existing ESG approaches implemented by banks. These should cover both risks and financial stability issues and provide the right incentives to allow for a real shift towards sustainable investments. ▶



Firstly, while there is no doubt that climate risks could be a source of financial risks, ensuring a harmonized approach as well as tackling methodological issues are a prerequisite before any specific prudential treatment of exposures is agreed. In this respect, the Network for Greening the Financial System is doing essential work to provide a harmonized supervisory toolbox to define risk management mechanisms. The climate scenario analysis that will be conducted as of 2020 by supervisors should also help in developing a consistent approach. However, key challenges of methodological nature still need to be addressed with respect to data availability and consistency, mismatches of time-horizon between sustainable investments and loan maturities, and the complex integration of banks and clients' long-term strategies, as well as regional discrepancies while operating global businesses.

Secondly, many European banks already have made strong commitments to speed up the redirection of capital flows, by agreeing to the Principles for Responsible Banking or by progressively realigning their portfolio with the Paris targets. Going further, the EU taxonomy should help the identification of activities which are aligned with those commitments. A clear concern however is that the framework's narrow restriction to activities that could be carbon neutral in the very short term could undermine banks' capacity to finance transitioning sectors or companies that are well engaged on a decarbonization path.

Thirdly, data availability is a pressing issue: only EU large corporates are subject to non-financial reporting requirements. To avoid undermining banks' capacity to finance SME as well the development of emerging economies, the framework will need to consider how this data gap should be reflected into banks' own reporting requirements.

Finally, while the spotlight is currently on the climate emergency, sustainable development must also address social impacts. The pace of the transition will not be the same in all geographical areas: this calls for a differentiated treatment as clearly stressed by the Paris agreement at its inception. Indeed, banks play a decisive role to ensure that the energy transition is as fair and as inclusive as possible. Social considerations should be carefully evaluated for each new regulation including environmental ones. In that respect, governments will have to increase their commitment and accompany the necessary transition, and collaboration of private and public sector is of essence.

Daniel Hanna

Global Head, Sustainable Finance,
Standard Chartered Plc

Understanding, mitigating and tackling climate risk and climate change

Regulators are rightly concerned by the potential risk to financial stability posed by climate change. We are very supportive of their efforts. We are also mindful that while everyone in finance has a collective duty to protect the financial sector from climate risk, we must not lose sight of the critical role finance needs to play in preventing climate change itself. This is especially true in Asia, Africa and the Middle East, where we do most of our business. These markets face the greatest risk from climate change and the greatest opportunity to leapfrog to low carbon infrastructure and technology.

We believe that focusing purely on protecting the financial system, excluding considerations of how we finance the transition to low carbon, could even lead to an unintended consequence of making climate change more likely by raising the cost of private sector finance and locking countries into higher carbon pathways. We believe that transitioning to a low carbon future shouldn't come at the expense of lifting living standards, especially in countries where millions who remain in poverty have contributed the least to climate change and are the most vulnerable to it.

Capital and innovation are currently not moving fast enough or to the right places to support the needed transition to a low carbon world. Our recent Opportunity2030 study highlights a $10 trillion opportunity to support sustainable growth in emerging markets. In line with our findings, we've set ourselves ambitious targets to finance and facilitate $75bn of clean technology, renewables and sustainable infrastructure by the end of 2024. We have also framed our lending around the SDGs as evidenced in our Green & Sustainable Product Framework.

The lack of reliable data is a key impediment to tackling climate change. Data, like the information presented in Opportunity2030, is important to understand the potential risk around climate change, the opportunity to invest in the transition, and to track our progress in tackling both. This is one of the many reasons that we have long supported TCFD reporting. However, the uptake in many markets remains slow and carbon data for most of the real economy, especially in unlisted sectors and emerging markets is still absent.

Consistent and trusted frameworks help markets develop. Green bonds have grown more than six times in volume since the announcement of the Green Bond Principles for example. However, given how fast our understanding of ESG is evolving, we should be careful not to overly focus on nomenclature at the expense of impact. A transition bond helping an emerging markets energy company pivot away from coal may well be more impactful than a European green bond backed by retrofits of commercial real estate. A consistent framework for measuring transition and impact is critical.

Ultimately, a global challenge requires coordinated solutions. Developments like the NGFS and IPFS are positive signs that regulators are thoughtful about bringing together global standards. We would welcome the same partnership across private and public sectors to ensure that we can develop the right data and standards to encourage transition to happen during the 2020s, the decade of delivery.

Elizabeth Gillam

Head of European Government Relations and Public Policy, Invesco

Redefining risk and reward for the climate transition

Addressing climate change will require significant and sustained deployment of capital to finance the transition to a sustainable and climate neutral economy. In Europe, the fund, insurance and pensions sectors represent €17tn, €10tn and €4tn respectively of patient capital to be deployed to achieve this goal. In seeking to leverage these pools of capital to support the climate transition, we need to give equal weight to both the risks and opportunities relating to climate change.

A core function of markets is pricing risks. But assessing the financial impacts of climate risks represents a unique challenge – how to price in a risk where the timing and impact are uncertain. The usual disclaimer that "past performance is no guide to future performance" has taken on a whole new significance in the debate around climate change. Firms and supervisors are increasingly turning to scenario analysis to address these challenges by allowing firms to model the financial impact of different climate transition pathways. However, undertaking scenario analysis is a complex exercise, and is only as good as the assumptions underlying the scenarios against which a portfolio is assessed. The Network for Greening the Financial System is showing leadership in this area and we look forward to the publication of their work on scenario analysis in due course. This is uncharted territory for firms and supervisors alike, and an area where public-private collaboration and capacity building would be of mutual benefit as we seek to chart a path through the uncertainty.

Encouraging early action on climate change is critical to avoid the "tragedy of the horizons" described by Mark Carney. To achieve this, we need to crowd-in investors and companies that are heading in the right direction and ensure that such actions are rewarded in the markets. We are increasingly seeing markets pricing in a so-called "green-ium" for companies that are actively taking steps to transition to a net zero world. The Taxonomy could accelerate this trend by providing investors and companies with a common, science-based framework to assess which activities are compatible with the Paris Agreement. However, the strong price signal that European investors can send by coalescing around the Taxonomy risks being diluted in a global marketplace. Other jurisdictions are also developing their own tools, as well as the many industry-led initiatives such as the Transition Pathway Initiative and Science-Based Targets. The International Platform on Sustainable Finance could play a key role to play in the next phase of the Sustainable Finance Strategy to begin building international convergence in this space.

> *...public-private collaboration and capacity building would be of mutual benefit as we seek to chart a path through the uncertainty.*

To accurately assess both risk and reward, reliable data is critical. The Task-Force for Climate-related Financial Disclosures has quickly become the key reference framework for climate-related disclosures for over 1,000 global organisations representing $12 trillion of market capitalization. However, as laid out in its latest progress report, companies are still not disclosing enough decision-useful information. Addressing the data gaps will be of vital importance both for investors and supervisors to better assess both the risks and opportunities inherent in the transition to a net zero economy. ●

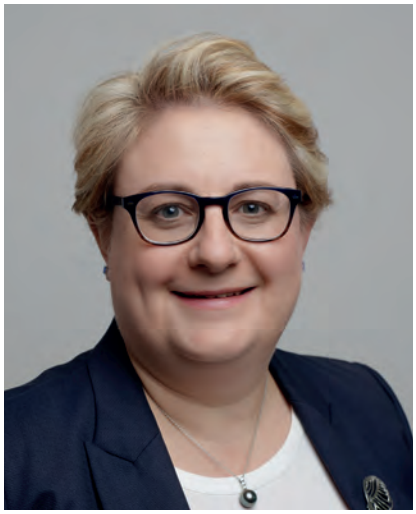
Eugenie Molyneux

Chief Risk Officer Commercial Insurance, Zurich Insurance

ESG considerations, business and regulatory challenges and opportunities

Environmental, social and corporate governance (ESG) considerations increasingly influence insurance companies in their role both as investors and as underwriters. Defining the ESG topics to focus on is a challenging ask and an extensive process. As views of internal and external stakeholders (investors, customers, employees, regulators) diverge, Zurich drives a data driven materiality analysis and a three-staged approach to identify, assess and develop sustainability risk positions on difficult ethical issues.

Sustainability risk positions are implemented and operationalized in the business and translated into underwriting practices, recommended business actions and along the product development process. Because we do not to underwrite or investing in thermal coal, oil sands/shales and banned weapons businesses, balancing our own ESG considerations against ▶



those taken more broadly by the market is challenging. Indeed, if the market and/or country, are not yet also focused on the transition to a low carbon economy, it can create the environment for poor relationships with those stakeholders and a difficult business environment. Therefore, Zurich Insurance believes it is key that companies across all sectors of the economy start to analyse and understand the impact climate change could have on their business.

This is an ongoing process and the development of the EU taxonomy will help all sectors comprehend sustainability risks. Zurich Insurance Group supports the international and European initiatives focused on promoting sustainable policies and a progressive transition to a low-carbon economy. However, limiting climate change to 2°C or below will lower physical climate risk, the technological and policy changes required create their own set of risks. Some potential drawbacks can arise from legal uncertainty and complex regulatory requirements resulting in insurers being subject to unnecessary liability risks and clients and investees having difficulties in applying them.

> *Achieving a transition to a low-carbon economy will require fundamental changes to our society and economy.*

Consistency needs to be ensured between the increasing number of reporting and investment regulation (the revised EU Non-Financial Reporting Directive, the Sustainable Finance Action plan and the EU Green Deal). Flexibility in implementation and an adequate level of details in ESG disclosures are required to avoid creating an additional level of barriers. Information overload, duplication, prescriptive and overly detailed ESG disclosures should be avoided. Sound risk assessment should underpin every investment decision.

Green or sustainable investments are not necessarily less risky than more traditional investments. Hence, Zurich does not support a 'green supporting factor' or a penalising 'brown factor'. We would prefer to price externalities at their source, not through insurers capital requirements. When inadequate they may also have the unintended consequence of slowing down the transition. New green industries due to the degree of uncertainty around new risks might require additional capital loading. The cost of insurance and/or appetite of insurers would then impact negatively the transition. It is vital for insurers to manage their total exposures to protect both the company and its customers. Data currently not easily accessible are crucial to invest and to underwrite. Policymakers could play a crucial role in designing mechanisms improving data availability, quality and comparability. ●

Stefanie Ott

Head Group Qualitative Risk Management, Swiss Re

Accelerating sustainable progress in the financial sector and beyond

Sustainability has become a strategic, long-term value driver in the financial sector. By managing and monitoring risks and opportunities associated with environmental, societal and governance (ESG) issues, Swiss Re helps to accelerate the transformation towards a more sustainable economy. Among the wide array of sustainability topics, climate change remains one of the key topics for the industry.

Tackling this topic effectively is challenging and needs a true multi-stakeholder effort. We therefore set an emphasis on our own risk research and partnerships, on product solutions to adapt to the effects of climate change (through e.g. NatCat protection) and low-carbon transition opportunities (through e.g. wind and solar power plants).The topic remains relevant for our re/insurance business, our investment side as well as for our operations. To take a concrete example the wildfires in Australia, Canada and USA increased in frequency and have been linked to climate change. While not a systematic loss in respect to scale, the fires proved that climate change can have effects not considered before. Over the past years, we have witnessed the initial incorporation of sustainability into prudential and conduct regulation across the financial sector at international and regional levels across the globe. From a global perspective, we are part of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) which has developed a set of recommendations to ensure consistent climate-related financial risk disclosures by companies to the market and continues to push for widespread international voluntary adoption of this standard across all financial services sectors.

> *Sustainability is a strategic, long-term value driver in the financial sector. Swiss Re supports the transformation towards a sustainable economy.*

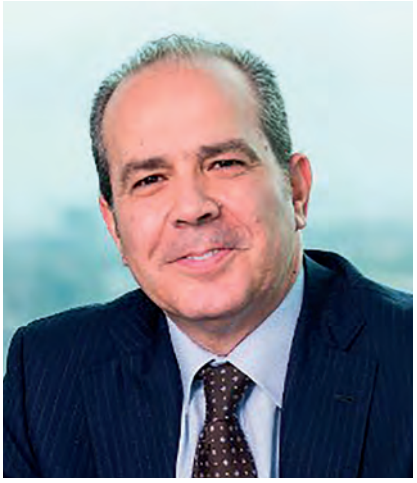
The International Association of Insurance Supervisors (IAIS) together with the Sustainable Insurance Forum (SIF) has been supporting the TCFD's work and is raising awareness of the challenges presented by climate change for insurers and supervisors, mapping out how these issues could be tackled. More recently, Central Banks and Supervisors established the Network for Greening the Financial System (NGFS) which aims to mobilise capital for green and low-carbon investments and identify what ▶

measures are needed to manage financial risks related to climate change.

In most cases, such emerging regulation includes disclosure requirements for insurers' exposure to climate change risks. These efforts intend to achieve more transparency about how sustainability issues affect an organization's businesses, investments, strategy and financial planning.

The regulatory response to the climate change threat is often driven by the political situation in the respective jurisdiction. Political forces increasingly exert pressure on regulators to move capital to a low-carbon economy. Voluntary disclosures of climate-related financial information will likely become mandatory in a couple of years. However commendable this may be, fragmented or overly onerous requirements should be avoided. Consequently, what our industry needs is a harmonized and gradual implementation and therefore an intense discussion of decision-useful disclosures.

We believe that climate-related financial disclosures should be aligned across different regulatory jurisdictions in order to enhance the transparency and comparability between firms operating across different geographies, to ensure a level playing field and to reduce the operational burden on global firms. We will support mandatory disclosures after they will have become decision-useful and best-practice learnings / experience from the industry have become more established. ●



Fausto Parente

Executive Director, European Insurance and Occupational Pensions Authority (EIOPA)

Climate change: the role of insurers in mitigating risk

Sustainability, and in particular climate change, has been a very important part of the political agenda for some time and the success of the sustainability agenda depends to a great extent on the capacity of financial market participants, including insurers, to incorporate the expected long-term consequences of climate change and environmental, social and governance issues into today's risk measurement and decision-making processes.

EIOPA has been working on a number of policy proposals, tools and methods for identifying and managing sustainability risks, including climate change. Without doubt climate change brings considerable challenges to the valuation of assets and liabilities, underwriting and investment decisions and risk measurement. This is because climate change increases the uncertainty about the occurrence and the impact of physical or transition risks, which can happen at any time and suddenly, with far-reaching consequences. Hence, undertakings should not be complacent about these risks.

EIOPA has therefore also included natural catastrophe scenarios in its stress testing of the insurance sector in Europe and our most recent stress test, completed in 2018, participating groups demonstrated a high resilience to the series of natural catastrophes tested, showing the importance of the risk transfer mechanisms, namely reinsurance, in place.

Another element of EIOPA's work has been to integrate environmental, social and governance factors into existing regulations. Regarding Solvency II, in our Opinion, published in September last year, EIOPA addresses the integration of climate-related risks in Solvency II Pillar I requirements.

Overall, Solvency II - as a risk-based, forward-looking and market-consistent framework - is well equipped to accommodate sustainability risks and factors and the Opinion outlines how insurers can contribute to identifying, measuring and managing risks arising from climate change, through their investment and underwriting activities. It is for this reason therefore that insurers and reinsurers should implement measures linked with climate change-related risks, especially in view of a substantial impact to their business strategy and in this context EIOPA has stressed the importance of scenario analysis in the undertakings' risk management.

Insurers can also mitigate the risks of climate change by considering the impact of their own underwriting practices on the environment. In this way, insurers can increase market and citizens' resilience to climate change.

> *Insurers can play a stewardship role. As large investors, insurance groups are well-placed to incentivise and engage with business to act responsibly.*

Above all, insurers can play a stewardship role. As large investors, insurance groups are well-placed to incentivise and engage with business to act responsibly and ensure long-term value creation, playing therefore an important role in the gradual transition to a more sustainable and resilient economy. This stewardship role is more important than ever in contributing to climate change adaptation and mitigation.

Meeting the challenges of climate change requires concerted action from all players and EIOPA will continue to a role to secure a resilient and sustainable industry that is for the benefit of consumers. ●

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Sustainability investment challenges
Small & Midcaps ESG challenges
New technologies (cloud, AI, DLT...)
Crypto-assets and payments
Operational resilience

V. NEW TECHNOLOGIES IN FINANCIAL SERVICES AND PAYMENTS

Issues at stake

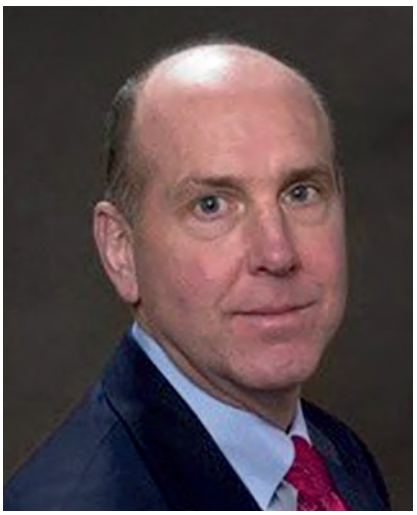
Technology is transforming the provision of financial services and many elements of the current financial system. All financial activities are concerned and can potentially reap the benefits of digitalisation and fintech.

Technologies such as DLT, cloud and AI help to improve existing financial services and processes, increasing their efficiency, agility and transparency, facilitating their cross-border provision and supporting risk management. These technologies also facilitate financial innovation, with the introduction of new services and operating models, enhanced personalisation, the reduction of time to market and the entry of new players into the market. The Covid-19 crisis shows that digitalisation may also be a safety net against operational risks. Furthermore, technologies such as AI and ML facilitate reporting, supervisory processes and support AML and fraud detection.

These new technologies may however pose new challenges in terms of cyber-security, accountability or fair competition and raise issues with regard to appropriate data use, sharing and sovereignty. Their cross-border development in the EU may also be hindered by insufficient harmonisation of legal requirements. This requires taking the necessary steps to ensure the right conditions are in place to take advantage of digitalisation and manage any related risks. Several initiatives are underway at the EU and global levels to address these new challenges, e.g. with the new Digital Finance Strategy proposed by the Commission.

Content

Impacts of digital technologies on financial value chains



Frank Fallon

Vice President Worldwide Financial Services, AWS

Enabling the digital transformation of the European financial services sector

Financial institutions are facing considerable pressure to provide enriched and frictionless customer experiences, while fulfilling their regulatory mandate to ensure that the national and global financial systems that they operate in are secure and resilient. In this context, organisations are seeking alternatives to "business as usual" and legacy technologies. Cloud technology is now at the forefront as financial institutions grapple with these issues. Why? The answer is simple: cloud allows financial services firms to be more agile, protect their customers with enhanced security and get access to the most advanced analytical services, all while reducing costs.

We have seen established organisations ranging from the largest global banks, insurers, asset managers, market infrastructure and financial solution providers take a sharp shift away from the undifferentiated heavy-lifting of managing on-premises data centre infrastructure and embracing the cloud to innovate and enhance resiliency. Indeed, agility, enhanced security and resiliency, and the ability to innovate quickly are today the top drivers for financial firms' cloud programs.

In today's competitive market, financial institutions are looking for ways to differentiate themselves. Leveraging cloud technology provides three key benefits that enable innovation: extracting new insights from traditional and alternative financial data; providing the scalability and agility to respond to market and business changes; and reducing the time and resources needed to manage and maintain technology infrastructure, all while operating with the highest security standards available.

Cloud solutions provide scalability and increased resiliency and security compared to what financial institutions have previously been able to achieve. For AWS, security remains "job zero" and we take active measures to minimise the impact of potential events such as the ongoing COVID-19 crisis, and maintain our security and resiliency through a variety of ways. Our long-standing business continuity plan enables us to respond rapidly in a coordinated manner to potential events and crisis. More broadly, to diffuse the potential for systemic risk in any industry or location, we build our cloud infrastructure in diverse geographic regions with multiple availability zones per region.

Looking ahead, we expect to see increased automation in security through infrastructure and application controls that will help enforce security and compliance policies continuously while reducing human configuration errors. These improvements will allow financial institutions to maintain the data confidentiality and integrity that their customers demand, while maintaining timely and accurate reporting required by industry regulators. As we continue to innovate and roll out more services, financial institutions will see these new services and applications change the way they interact with customers and do business. For European financial services institutions looking to remain competitive in the global market, cloud is undoubtedly an enabler and driver for these organizations to innovate and become more agile.

> *...agility, enhanced security and resiliency, and the ability to innovate quickly are today the top drivers for financial firms' cloud programs.*

As the European Commission develops its Digital Finance Strategy, ensuring that financial institutions can avail themselves of modern technologies including cloud and machine learning is crucial for the future competitiveness of the sector. For future regulatory initiatives, it remains important for policy makers and regulators to carefully consider an approach that recognises the operational resilience, security and innovation benefits of cloud, and enables firms to make the most of that opportunity. ●

Sophie Heller

Group Chief Operating Officer for Retail Banking & Services, BNP Paribas

New technologies are fostering new forms of cooperation between industries

First impact of new technologies is on the way the bank is acquiring and serving its clients : Banks are responding to new customer expectations as digital players set new standards, and also to increasing concern for security:

- Choice: customers want to be able to rapidly compare and subscribe to online financial solutions
- Simplicity: customers expect simple & clear journeys
- Personalization: customers expect their Bank to use the huge quantity of data it holds, for their benefit and security : take into account their personal context, demonstrate anticipation, protect them against fraud, and be relevant
- Immediacy: 24/24 7/7 becomes the new normal as well as instant payment ....
- Security : customers expect their bank to protect not only their money but also their data and privacy. This concerns becomes more and more critical as cybercriminality develops along with usage.

Customers positively react to these innovations : More clients are onboarded digitally, most of usual operations such as transfers, card limit management are done digitally - 89% of French people who have downloaded a bank app (55% of French people) check their app at least once a week.

Second, this digital transformation enhances the "human part" of advisors' role while digital channels play a big part in day to day finance management. This shift in advisor role is helped by:

- More time to focus on value-added services as some tasks are handled by customers themselves or drastically eased with RPA or AI for instance,
- A better customer knowledge through real time and comprehensive information
- New platforms for contact management that allow to understand clients requests in natural language and address them to the most relevant available person, independently of its location.

Third, Digital Transformation is about transforming skills, mindset and culture, IT architecture as well as ways of working for everyone from front to back office including functions, it implies for example :

- Fostering an end to end process culture, with a strong focus on operational excellence,
- Developping in big numbers digital and data capabilities across the organization
- Upgrading IT architecture and infrastructure to be able to fully leverage new technologies in particular Cloud and AI.
- Expand Agile ways of working across the whole organization to be able to adapt faster and better to customers' rapidly evolving expectations and have happier teams. It is the necessary shiftfrom product- to customer-oriented organizations so that teams are actually centered on understanding consumers and designing products and services around their needs.

Finally, what goes for the retail banking industry regarding digital transformation is also true for all industries. As each industry becomes centered on delivering an end to end digital experience in a specific set of needs (such as my home, my mobility , my health etc..) , the question of who are you competing or cooperating with, becomes crucial : Big techs, Fintechs but also other incumbents from various ecosystems together such as energy, retail, mobility...

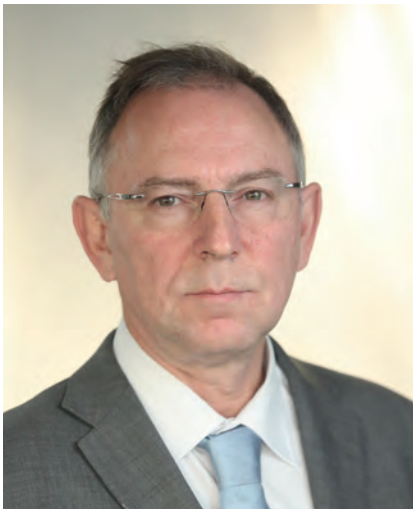
> *New technologies change how customers use services and the nature of the services themselves thanks to new forms of cooperation.*

Retail banks collaborate with Fintechs or integrate GAFA services into theirs (eg Apple Pay or Google Pay). Retail banks have specific competitive advantages:

- Strong banking expertise in all financial areas (consumer finance, investment...) and strong relationship with institutions and corporates
- Loyal customers
- Secure their customers' sensitive data

These advantages, combined with the ones of the players and incumbents from other ecosystems using digital-enabled technologies can create unrivalled propositions for consumers. This is what happened in the mobility ecosystem in Italy for instance, where BNL has created a partnership with Telepass to create a new app allowing consumers to access to all their transportation and shopping services and manage associated payments, all through a single access mobile gateway.

What we see happening for banks is new cooperation acrossindustries in order to design innovative, simple and outstanding new services. ●



Santiago Fernández de Lis

Head of Regulation, Banco Bilbao Vizcaya Argentaria (BBVA)

Competition and innovation in a changing world: a key role for public policy

The steady evolution of financial services can make it easy to forget that the sector has always been shaped by the adoption of new technology. The information and communication innovations of the 20th century brought waves of digitalization: the move from paper to electronic records, credit cards, ATMs, electronic trading, and eventually wider access to internet banking at the turn of the millennium.

But the latest changes in technology have spread more quickly than those before and have transformed more rapidly the economic and social landscape. In the space of little more than a decade some 3 billion people have acquired a smartphone and always-on internet access.

One of the most striking consequences has been the supercharged growth of a new digital platform economy, with the breaking and rebuilding of value chains across almost every industry. And much of the new value has come from being able to capture, analyse and put to use the data generated by the huge increase in digital interactions.

According to an often used metaphor data is the new oil. The metaphor is misguided (among other differences oil is scarce and data grow exponentially), but in any case, data is at the heart of the digital economy and its use - and reuse - will continue to be central to innovation and value creation across industries.

The good news for the financial sector is that new digital channels, data sources and analytical techniques can offer an opportunity to better reach customers and improve services. A more complete picture of customers' needs and behaviours could allow for personalised products and more holistic financial advice. The right datasets could allow credit risk models to be refined, offering the possibility of expanding credit to underserved customers like SMEs, or the development of new green financial products, aimed at helping customers with their transition to a more sustainable economy.

However, to deliver this, firms face the challenge of a new, uneven digital playing field. One where customer relationships are shaped by and channeled through dominant platforms and ecosystems, and where useful data is not always able to flow to where it can deliver the most value for customers.

Public policy has a clear role to play here. And the European Commission has recognised this, with its digital and data strategies and AI white paper published in February 2020 forming key pillars of its support for Europe's digital transformation. The execution of this strategy is now key.

First, the Commission should take robust action to safeguard future digital competition and innovation, with new ex ante rules for significant digital platforms. This should include guaranteeing fair terms of access for other firms, including to hardware functionality, and greater control for users over their data. Individuals and firms should be able to share their platform data easily, securely, in real-time and on a recurrent basis with whom they wish. This would reduce lock-in effects and facilitate data reuse in other sectors.

> *Firms face the challenge of a new, uneven digital playing field.*

Second, the Commission should apply this sharing principle to other valuable personal data such as data from utilities and smart home devices, by implementing its proposal for enhanced personal data portability in the forthcoming Data Act.

PSD2 has enabled this kind of sharing in the financial sector for payments data. And although it is still bedding in, it offers a useful lesson: standardised, dedicated interfaces, such as APIs, are key to secure and effective sharing.

Finally, the EU should focus on supporting the development of AI applications in Europe, as it is essential to a competitive economy. The EU regulatory framework is already comprehensive. Authorities should therefore avoid the risk of over-regulation and concentrate on solving concrete problems, such as clarifying how to meet existing requirements and supervisory expectations on unfair discrimination, explainability and interpretability.

The European financial sector will continue to build on a long history of innovation and adapting to change to deliver value for its customers. The right policy measures now can help to ensure that this is a success. ●

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Cloud based platforms

Lie Junius

Director of Government Affairs and Public Policy, EMEA, Google Cloud

Solving for better financial services for the European consumers: technology trends and policy considerations

The use of cloud-based technologies is a key pillar of the digital transformation of the economy, driving competitiveness and generating significant economic and social benefits[1].

Trends and benefits

Ultimately, it is the European consumers that stand to benefit the most from cloud-enabled financial services. Innovative financial services providers can create experiences that more closely resemble the best digital ones in other industries.

Today's digitally savvy banks are using the cloud to process vast quantities of information to rapidly construct and sell financial products that differentiate themselves in a highly competitive market. Cloud is reshaping the technology landscape, and it has the potential to transform financial services beyond core infrastructure.

One of the main challenges that the financial industry (and their regulators) is working to address, with the help of cloud, is management of the extremely large volumes of data across the organizational silos and accelerating time to insights.

Also the financial sector can utilise the cloud to become more capable at combating fraud and money laundering. By using more dynamic artificial intelligence (AI) and machine learning (ML) models, rather than static rules-based systems—combined with transactional and behavioral data—banks can now more accurately detect evolving fraud patterns while avoiding costly false positives.

As a recent development, COVID-19 is rapidly changing how financial services institutions serve their customers, empower their workforce with remote work capabilities, and adapt to new market and economic risks.

Challenges to adoption

It is important to take into consideration that most financial institutions across Europe and globally, are at an initial stage of their cloud journey. And the vast majority of initial application of the technology is happening in the area of non-material outsourcing, as confirmed in a recent report by the Financial Stability Board[2].

Whilst financial sector institutions have traditionally been early adopters of the private cloud, they have been relatively slow to migrate to the public cloud due a variety of factors including the complexity of the regulatory landscape and difficulties associated with migrating from legacy infrastructure. These issues are compounded by the concerns over the risk of the vendor lock in, and a variety of perception challenges including around data residency and access. Understanding and navigating change management and upskilling workforces, as well as raising the cloud-specific expertise and trust levels within senior decision makers and board-level stakeholders, are two other critically important factors that cannot be underestimated.

Nevertheless, adoption of public cloud services has gradually increased over the past few years, as financial institutions have realized the business and security benefits of making the shift, and many initial concerns were eased by the cloud service providers' stronger compliance programmes. Banks like Lloyds, Deutsche Börse Group, HSBC are accelerating their cloud innovation, in partnership with Google Cloud.

> *Cloud adoption in finance is accelerating, but further efforts are needed to raise trust and understanding of security and operational resilience of the cloud.*

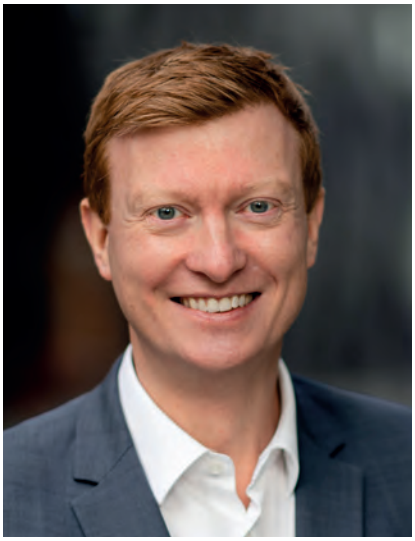
Security and operational resilience of public cloud

The adoption of public cloud technology can augment security. Recent research from McKinsey[3] concludes that organisations expect to double their public cloud adoption due to the growing understanding that cloud platforms' security capabilities have surpassed those available on premises.

Similarly, cloud providers that develop and offer to their customers highly redundant and resilient systems by design, are well prepared to cater for the business continuity and disaster recovery needs of the financial institutions.

Application of multi-cloud strategies also supports financial institutions in addressing vendor lock-in concerns and enhancing operational resiliency capabilities. ●

1. Deloitte: https://www2.deloitte.com/content/dam/Deloitte/es/Documents/tecnologia/Deloitte_ES_tecnologia_economic-and-social-impacts-of-google-cloud.pdf
2. https://www.fsb.org/wp-content/uploads/P091219-2.pdf
3. McKinsey. Making a Secure Transition to the Public Cloud: https://www.mckinsey.com/~/media/McKinsey/Business%20Functions/McKinsey%20Digital/Our%20Insights/Making%20a%20secure%20transition/Making-a-secure-transition-to-the-public-cloud-full-report.ashx



Kaj-Martin Georgsen

Head of Corporate Responsibility & Public Affairs, DNB Bank ASA

A future-proof, customer-centric banking system needs to tap into the cloud

Reaping the benefits of cloud computing is a prerequisite for providing customers with the services they expect in 2020. Banks and regulators need to work closely together to address the requirements for both security, competition and competitiveness.

Physical data centres and other physical IT infrastructure represent are costly, inefficient and often redundant: Since they need to be scaled for peak demand, much capacity will remain idle for most of the year. The result: sunk investment and high maintenance costs.

In realizing this redundant capacity could be leased off to others, Amazon kicked off the cloud revolution which has swept the world of IT in during the last decade, including, to an increasing extent over the last few years, financial institutions.

For banks, in the face of new competition for the end-the benefits of cloud computing are numerous. Moving data and service into public clouds enables us to build new solutions more quickly and deploy at greater scale while reducing costs. At DNB, our P2P payments app Vipps was one of our first major venture into the public cloud in 2016. We haven't looked back since.

Cloud infrastructure allow us to source single-purpose functionality from third parties into both backend and customer-facing applications almost instantly, enabling a more agile development approach.

Third-party solutions from smallish fintech partners provide the APIs behind our PSD2 integrations, the voice authentication we are piloting in our call centres, the face recognition for our ID app and the invoice scanner in our mobile bank.

Between these specialized applications and the underlying infrastructure services, today we rely on more than 50 cloud services that allow us greater speed, flexibility and security.

This migration into the cloud does not come without risks. Having fewer companies provide a deeper stack of services inevitably means concentration risks, which regulators are increasingly focusing on. Lock-in effects pose real risks to competition and vendor diversity.

> *Regulators, cloud providers and financial institutions need to work closely together ...*

Regulatory authorities are right to be vigilant about these new risks. DNB have maintained a close dialog with our chief regulators, the Norwegian FSA and the Bank of Norway. Our thinking has evolved on both sides of the table as we have gained more experience with the upsides and possible downsides of outsourcing systems of varying degrees of criticality.

Fortunately, thinking has evolved among the cloud providers we work with, too. Thanks to close dialogue with our national regulators and some of the major U.S.-based service providers, we have secured a greater degree of transparency and audit rights than seemed possible a few years ago.

Cloud providers that barely had a national presence in many EU countries, are engaging with both clients and regulators in Europe, and display a better understanding of European concerns about issues such as privacy, competition and security.

Certification and licensing regimes might be useful in certain scenarios, but current rules e.g. for payment providers means licensing regimes are already in place. Taking a risk-based approach, regulators should focus on the main platforms than entail systemic risk, as well as those that provide core financial services.

Applying stringent licensing requirements for all suppliers means erecting barriers to entry for new actors as well as many of our current providers, many of whom are precisely the kind of small, tech-savvy start-ups we should be encouraging.

In seeking to mitigate the risks of the cloud through regulatory measures, EU legislators and regulators need to be careful not to throw the baby out with the bath water. Regulators, cloud providers and financial institutions need to work closely together to ensure the European financial industry is able benefit from the power of the cloud. ●

Slaven Smojver

Director, Information Systems Supervision Department, Croatian National Bank

Use of cloud services: opportunities are clear but challenges still abound

Cloud services undoubtedly offer numerous opportunities to financial institutions. Some of the more important ones are greater efficiency in cost management, flexibility in the provisioning of computing resources and the ability to use modern technology stacks. However, the financial institutions' perception of risks related to the use of cloud services and regulatory scrutiny have stymied wider adoption.

Croatian banks have taken a cautious approach toward implementing cloud services and until now have primarily focused on the collaboration and support tools. The complexity of the cloud service providers' (CSPs) infrastructure, long supply chains and the opaqueness of their internal control mechanisms have made risk assessments quite challenging, particularly in relation to the regulatory requirements.

Recognition that small errors in the configuration of cloud environments can have an outsized negative effect (e.g. public disclosure of personal and financial data), uneasiness about CSPs' use of client's data and the need for new threat models also negatively influence information security assessments. Information asymmetry and differences in size between the dominant CSPs and their smaller clients (such as Croatian banks) further exacerbate challenges for risk assessment and relationship management.

The European Banking Authority (EBA) has defined regulatory expectations related to the use of cloud services in the banking sector in the Recommendations on outsourcing to cloud service providers and Guidelines on outsourcing arrangements. These documents recognize the use of cloud services as outsourcing. Major CSPs have recently enabled the addition of financial services addendums to their standard contracts that, as they claim, fulfil regulatory expectations. However, hurdles in the exercise of audit rights, vagueness of the shared responsibility model and uneasiness about vendor lock-in and geopolitical risks still impede a wider adoption of cloud services.

> *The financial institutions' perception of risks related to the use of cloud services and regulatory scrutiny have stymied wider adoption.*

Various developments that might mitigate some of the risks are under way. The European Commission's FinTech Action plan recognizes the need for the development of standard contractual clauses for cloud outsourcing. These would alleviate some of the issues but require further development. The initiatives such as the Gaia-X Project might reduce vendor lock-in and geopolitical risks but are still in the early phases of development.

The EBA's Guidelines on outsourcing arrangements mandate that institutions should provide competent authorities with a register of all outsourcing arrangements, which – in turn – might enable the identification of systemic risks. It is reasonable to assume that a well-thought-out framework for independent, standardized, continuous and in-depth assessment of the adequacy of CSPs control environments and the related certification and accreditation regimes would go a long way in mitigating many of the identified risks and challenges. ●

Alban Schmutz

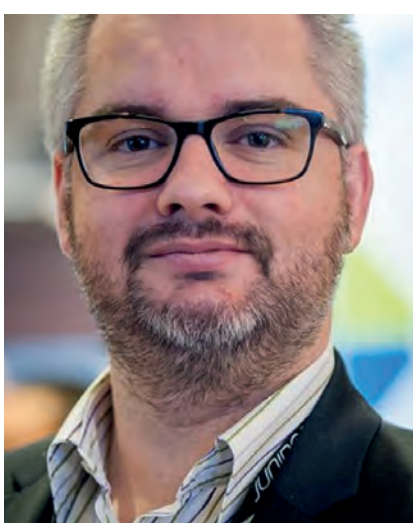
VP Strategic Development & Public Affairs of OVHcloud and Chairman of CISPE - Cloud Infrastructure Service Providers in Europe

Towards a European framework on cloud for financial services

Banks are essential to our economies. Indeed, their continued strength together with the sovereignty of our financial infrastructures are essential for Europe's success. Who controls IT infrastructure today has become a major geostrategic question. At the same time, for the financial sector it has become key to have the ability to use massively the cloud to take advantage of greater efficiency, innovation and competitiveness.

Ongoing discussions on technological sovereignty over 5G infrastructures or on more localised production of pharmaceuticals, exacerbated by the Covid-19 emergency, remind us that the ability to control our critical infrastructure and supply chains is vital for the EU and our future.

This is why a Europe-wide framework applicable in all Member States ▶



is essential. This should first deal with the reversibility and portability of infrastructure and applications to allow a rapid change of provider and easy data portability. The freedom of the financial sector to leave cloud providers quickly and seamlessly, without harming production constraints, is a key element of this sovereignty.

Second, a European framework on cloud for financial services should encompass and make explicit the necessary privacy requirement under the GDPR, particular transparency in data storage and processing locations, to ensure we are working through shared European values.

Third, such a framework has to be future proof, ideally anticipating upcoming legislation of relevance, such as the EU's Revised Payment Services Directive and other European laws that affect the ability of the financial sector to develop new value-added services that benefit companies and citizens alike. For this to succeed, a collective effort and broad public consultation is necessary.

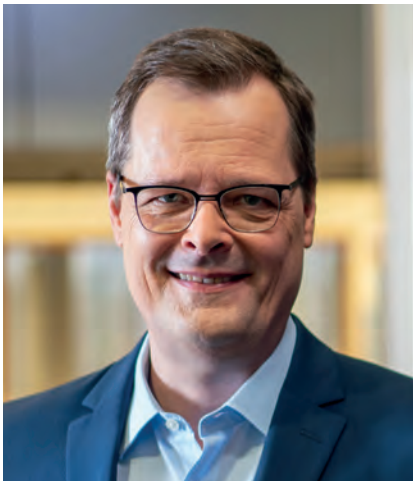
> *Designing a robust time-to-market solution to deliver that new framework is of the utmost importance.*

The association of Cloud Infrastructure Service Providers in Europe (CISPE) is already engaging beyond financial services with European and Member State authorities to address the above challenges and to create the right environment to support businesses and customers. For example, CISPE co-chaired, together with the European association of CIOs (EuroCIO), the Working Group on a Reversibility Code for Cloud infrastructure services, which the European Commission facilitated.

Since the financial sector is a regulated sector, co-ordinated efforts between cloud service providers, European banks and EU authorities are paramount to identify the right regulatory framework. This will, in turn, foster the much-needed developments in the cloud industry, AI and other enabling technologies that are required as we move forward.

Designing a robust time-to-market solution to deliver that new framework is of the utmost importance. This is why setting up a round table between cloud service providers and European banks in close co-operation with EU authorities is very much needed to underpin the financial industry's resilience and enhance the growth potential of European economies. ●

Is AI use growing in the financial sector?



Joachim Wuermeling

Member of the Executive Board,
Deutsche Bundesbank

How can AI change banking and what will this mean for supervision?

Artificial Intelligence and Machine Learning (AI/ML) will fundamentally change the financial sector in the medium term. AI/ML may undermine one of the foundations of banking business: banks' privileged access to their customers' financial and risk information. In that respect, AI is comparable to financial innovation in the nineties: Whereas derivative instruments have made local risk globally tradeable, AI/ML makes banks' specific local information substitutable and therefore globally accessible and processable.

At the same time, AI/ML offers many opportunities to banks as well as to their new competitors: it enables the financial industry to exploit masses of information in order to improve their risk management and decision-making processes. Therefore, banks are encouraged to use AI/ML where this leads to improved service to their clients and better risk management, or, in a word: more effective and efficient banking operations.

However, a lesson from the past is that innovation unfolds its benefits only if its major implications are well understood. By construction, in AI systems there exists a strong nonlinear relationship between their input and output. This, along with tremendously increased computing power, is what makes them successful: a huge amount of data can be processed quickly, and its inherent information extracted. However, this feature also marks the flip side of the coin: it is hard to understand their "reasoning". Morever, the sheer amount of data utilised raises ethical questions about its rightful usage.

The application of AI/ML can create considerable risks for banks as well. It is often difficult to know (i) how reliable the inferred relationship between input and output is and (ii) which causality exists between them. This is called the explanatory gap of AI. There are many situations where the explanatory gap does not matter. In those cases, all we need to know is that AI works as expected, and that, if it stops working as expected, this can be detected and fixed quickly. In such cases, we will not need specific regulatory safeguards.

Supervisors have a task when the outcome of an AI/ML method is critical for the functioning of internal controls, for compliance with external requirements or for banks' relationship with their customers or counterparties. In these cases, banks have to fulfil requirements for their AI/ML methods similar to those for any other quantitative model used in risk management: sound modelling practices, reliable processes surrounding the methods, rigid and effective validation, and appropriate management of the inherent model risk.

In a nutshell, the supervisory approach should be to look first at the scope of application of an AI/ML system. If an AI/ML application turns out to have a severe impact on informed decision-making, sound risk management, or otherwise a bank's fundamental functions, supervisory action will clearly be required. The aim is to keep operational risk reasonably contained.

Therefore, both supervisors and banks face challenges and opportunities alike. Supervisors have to adjust their approaches and skills to escort the introduction of AI/ML in banking. Banks have to give supervisors sound explanations of what their AI/ML systems actually do, as well as to what end. ●

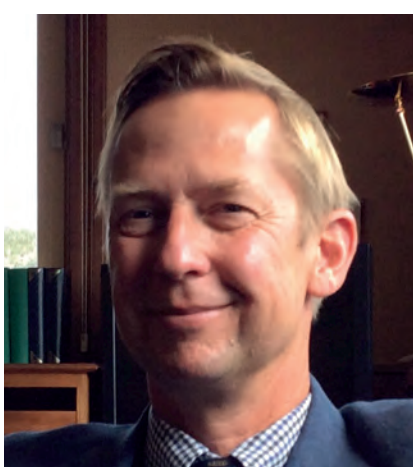
Pēteris Zilgalvis

J.D., Head of Unit, Digital Innovation and Blockchain, DG Communications Networks, Content and Technology & Co-Chair, FinTech Task Force, European Commission

The European approach to Artificial Intelligence in Fintech: current efforts and ambitions

There are prominent synergies between Artificial Intelligence (AI) and the financial services sector as emerging technologies rapidly extend their impact on the financial industry. This reality is reflected in and addressed by the European Commission's new Digital Strategy (2020), the European Data Strategy (2020), the White Paper On Artificial Intelligence - A European approach to excellence and trust (2020), the SME Strategy (2020), the eIDAS Regulation, Payment Services Directive 2 as well as non-legislative financial services initiatives such as the FinTech Action Plan (2018).

In the financial sector, AI solutions are already being used to enable personalisation of financial services and products, ▶



better anti-fraud protection, and faster and more reliable credit assessment. The 2020 Digital Strategy lays out the ambition to create a new regulatory and policy framework for digital finance addressing crypto assets, cyber resilience, as well as a strategy for an integrated pan-European digital payment infrastructure. These efforts are part of a broader EU objective to deepen the Single Market for digital financial services and promoting a data-driven financial sector in the EU, in which AI will play a critical role.

Europe is well-positioned to tap into the potential of AI by capitalising on Europe's competitive industrial and professional markets, including financial services, and its digital innovation and research capacities. At the same time, building an ecosystem of trust is essential. A European approach to AI should ensure that machine-based learning technologies are human-centric, ethical, sustainable and respect fundamental rights and values.

It is important to recognize that while AI can do much good, including by providing better access to finance, reduce costs, and increase efficiency, it can also have negative impacts. It is therefore imperative to mitigate unintended consequences, in particular the risks of data bias, which may arise in the financial services and other sectors. The integrity of the data is paramount, as is the design of AI applications with fundamental rights protections in mind (especially personal data and privacy protection, and non-discrimination).

The Commission is addressing these challenges through a variety of efforts and initiatives, including providing guidance in its AI strategy (2018), Coordinated Plan with the Member States, the Guidelines on Trustworthy AI published by the High-Level Expert Group (2019), and most recently the Commission White Paper on Artificial Intelligence (2020).

For any future EU regulatory framework on AI it will be important that it strikes the right balance. It would need to be effective to ensure the protection of fundamental rights and consumer protection, while encouraging innovation and investment in AI and not imposing a disproportionate burden on developers or business.

A relevant approach in ensuring the protection of fundamental rights and consumer protection is that of regulatory sandboxes. In the SME Strategy for a Digital and Sustainable Europe, it was stated, 'The Commission will encourage Member States to develop proposals for regulatory sandboxes by launching a pilot.' Regulatory sandboxes in the financial services area give opportunities to firms to live test applications, pursuant based on a specific testing plan agreed and monitored by a dedicated function of the competent authority, such as innovative financial products, financial services or business models. Another pertinent and related approach is that of innovation hubs. Innovation hubs provide a dedicated point of contact for firms to ask questions to competent authorities on FinTech related issues and to seek non-binding guidance on regulatory and supervisory expectations, including licensing requirements.

As foreseen in the FinTech Action Plan, the Commission has set up a EU Fintech Lab. The EU FinTech Lab provides a regulators forum to discuss regulatory and supervisory issues regarding new technological applications that are on the market with experts. The Lab has met four times so far (1x cloud, 2x artificial intelligence, 1x RegTech/SupTech), the last time in December 2019 (on AI). ●

Patrick Montagner

First Deputy General Secretary,
Autorité de Contrôle Prudentiel
et de Résolution (ACPR)

Promoting responsible innovation in finance through AI multipronged evaluation

Increasing technicity

Supervisors' technical expertise needs to follow market innovations in AI. Ideally, it would mirror - both in breadth and in depth - the tradecraft of those implementing the systems: just like supervisors hired statisticians to master the intricacies of internal models developed for banks by quants, their staff should include AI experts.

We propose grounding AI evaluation on four pillars: performance (minimizing prediction errors), fairness (yielding decisions, which do not discriminate against individuals or groups), stability over time, and explainability. The latter is particularly prevalent nowadays due to the regulatory context but also as an ethical duty. This implies being able to "open the black box" enclosing any algorithm whose output directly impacts individuals. Thus, the supervisory method itself should evolve: supervision must become more technically-oriented and cross-disciplinary.

As for fairness, the world we live in is full of biases. Those biases are by definition reflected in – and often reinforced by – ML algorithms. The emerging research domain of bias mitigation aims to alleviate discriminatory and unethical outcomes from their output. At any rate, algorithms and data must be evaluated hand-in-hand. Hence, a proposed dual approach to empirical evaluation of AI, based on challenger models and benchmark datasets, will be subjected by the ACPR to feedback from a public consultation.

AI supervision has much to gain from defining methodological best practices, which would cover the entire lifecycle of AI, from data preprocessing and model selection through industrialization to stability issues.

Promoting responsible innovation

On the other hand, the speed of AI adoption in finance should not be overstated: few ML (Machine Learning) algorithms are in production, and those few are rarely the more advanced kind, especially in highly regulated domains or client-facing tasks. Reasons for excessive caution in AI implementation include its operational and compliance risks. ▶

▶ Indeed, as AI strives by nature towards autonomy, the most prevalent threat beyond generic cybersecurity and ML-specific threats is a loss of control, whether by dearth of skills or inappropriate oversight.

Supervisors should thus encourage the positive effects of its widespread usage. Hence one of our key missions: to foster responsible innovation – in other words remove undue obstacles and ensure proper interpretation of the regulation, while also ensuring proper risk management and customer protection.

Co-designing supervisory technology

ACPR SupTech strategy builds around mastering AI technology, which enables us to dialogue with the marketplace, anticipate emerging risks, and enhance our own methods and technologies.

We rely heavily on networking for this: bilateral exchanges with national, European, or international authorities and working groups. Such dialogue may result in proposals for regulatory amendments, but also in more technical deliverables, such as data exchange protocols or software code sharing: for example, pseudonymization (a common GDPR requirement) benefits from all financial supervisors contributing their country- and language-specific expertise. ●

Nausicaa Delfas

Executive Director of International, UK Financial Conduct Authority

AI – managing the future for firms and regulators

Artificial intelligence (AI) has increasingly been used in financial services over recent years. At the FCA, we are considering how we can design a regulatory framework that ensures sufficient oversight, manages the trade-offs firms may need to make, and allows consumers to benefit from the efficiencies AI can bring.

An optimal regime should avoid being tied down to specific technologies. We believe that an outcomes-based and principles-based approach is more conducive to regulating areas that are rapidly evolving. Few of our rules are technology-specific. Detailed and overly prescriptive rules run the risk of becoming quickly out of date and of stifling desirable innovation which can benefit markets and consumers.

Accountability is key when we consider how firms should manage their application of AI. We believe human beings should remain responsible, and accountable, for the technology they use. In the UK, our Senior Managers and Certification Regime is designed to achieve this. But what does accountability look like in the world of AI deployment? As AI technology applications become increasingly advanced and complex, there may be fewer experts who truly understand them. There is also a risk of growing divergence between the experts and senior managers. Senior managers will need to address this.

Effective accountability should support more transparent and explainable use of AI. The use of AI may force firms and regulators to make new types of trade-offs. For example, it can allow more data to be considered in a consumer's credit application, or help provide consumers with products suited to their needs, but it can also incorporate errors and amplify biases. Firms should manage such risks effectively and be clear with consumers about how their data are used. We are currently running a research project with the Alan Turing Institute in the UK to consider how AI could improve outcomes for consumers and support regulatory initiatives.

Machine learning and other AI applications can also be used by malicious actors; for example, to facilitate cyberattacks or financial crimes that spread quickly, are difficult to detect, and cause damage. Firms need to ensure that they are operationally resilient, are vigilant against financial crimes, and can prevent, respond to, and recover from such incidents. Some firms are already using machine learning to combat cyberattacks and money laundering.

The FCA is exploring how we can utilise machine learning to support us in carrying out conduct and prudential regulation. We are investing to become an even more data-driven regulator, enhancing our ability to monitor, predict and respond to firm and market issues. With the Bank of England, we are also setting up a joint AI Forum to gather industry views and share information on safe adoption and usage of AI in financial services and in regulation.

We remain committed to working with international regulators and standard-setting bodies to support an approach to AI that promotes the interests of consumers and is fit for purpose in a fast-changing world. ●

Bruno Scaroni

Group Strategy & Business Accelerator Director, Assicurazioni Generali SpA

Promoting responsible Artificial Intelligence in insurance

As a representative of Assicurazioni Generali, I recently had the privilege of participating in the Geneva Association Working Group on how to promote the responsible adoption of Artificial Intelligence in the industry. I would refer to them as those intelligent systems that automize routine tasks or assist human decision-making along the entire value chain. Such systems may combine new types of learning algorithms with the analysis of data from new types of data sources, such as online media data and IoT data. Natural language processing is surely an AI revolution for the industry: it enables intelligent systems to 'talk' and interact with humans, and Insurers are increasingly using chatbots that can identify and respond to ordinary customer queries that are available 24/7.

While working in Europ Assistance some years ago, we pioneered the use of natural language processing for the delivery of Motor Assistance and towing services in Europe: by establishing a chatbot to manage ordinary assistance request calls, we succeeded ▶

▶ in improving customer service and responsiveness of the call center operations, whilst preserving operational efficiency. Computer Vision technology is also an AI application that can materially improve how Insurers manage claims with faster and more accurate responses: intelligent systems can detect and recognize objects in pictures, extract related information and provide guidance on the claims management. Such an approach is present tense in some markets, especially in the Motor Other Damage servicing.

In addition to such cases, intelligent systems can detect patterns and correlations in complex data in ways never thought possible before, and set the basis for analytical tasks such as classification, regression and clustering that are crucial in the insurance business model. Compared to traditional modelling that generally relies on linear models, intelligent systems have the potential to provide more complex non-linear relationships between variables and consequently better risk modelling. The Geneva Association working group identified three socio-economic benefits of AI:

- Expand the scope of risk pooling, by extending coverages to new and previously uninsured customer segments, and by widening the range of risks for which insurance is available
- Reduce the cost of risk pooling, by decreasing the cost of the value chain through automation of specific activities, reduction of moral hazards and adverse selection
- Mitigate and prevent risks by better modelling and enabling predictive capabilities that can avoid or reduce losses.

However, in all contexts AI is based on data, and data represents the key factor that allows intelligent systems to consequently progress. Insurers need to master data and earn customer trust to utilize their data in to maximize the benefits of AI. To gain such trust is crucial to clarify AI benefits, provide undisputed value to customers and manage data responsibly. In order to achieve customer confidence and reap maximum benefits from AI, Insurers should adopt clear guidelines on how to implant intelligent systems in their value chain, and how to appropriately make use of its capabilities. In conclusion, Internal guidelines and policies play an important role in raising the awareness of the benefit–risk trade-offs in the use of AI in insurance.

From a regulatory perspective, the definition of ethical principles for the use of such technologies can be a key initial step in supporting both technological progress and the industry evolution. Such principles would also be guiding stars for other technologies that will arise in the future, and pose similar benefit-risk trade-offs. (Reference: The Geneva Association - Promoting Responsible Artificial Intelligence in Insurance, January 2020). ●

Diana Paredes

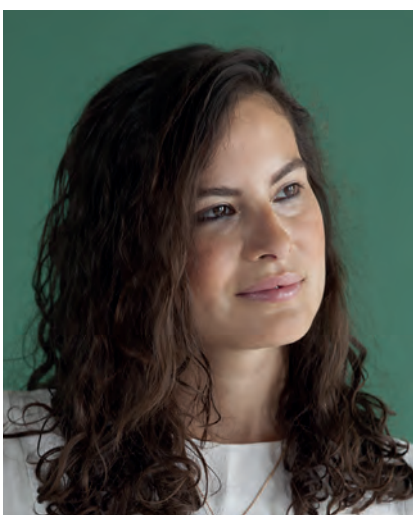
Chief Executive Officer & Co-Founder, Suade Labs

Basel IV, Common Data Standards and Artificial Intelligence

Artificial intelligence (AI) and machine learning (ML) in the RegTech industry are disrupting regulatory compliance. By creating a common data standard, RegTech companies can leverage AI and ML tools to perform analysis on standardised data to spot discrepancies faster and more accurately. Where regulation was previously a cost centre for financial institutions, compliance functions can now create value by cutting costs and producing highly accurate data that financial institutions can then use to make strategic business decisions. Institutions that employ such software are already enjoying cost savings, whilst investors, the public and supervisors can benefit from standardised, highly accurate regulatory submissions.

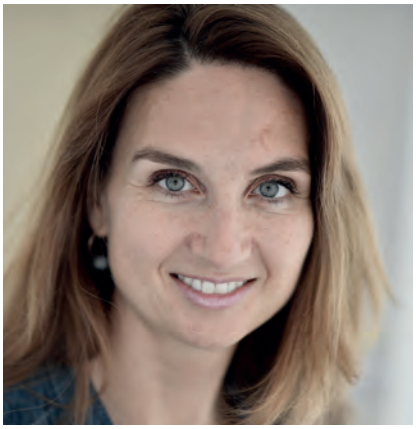
The Basel Accords provide a good example of the benefits of standardisation in regulation and compliance. With Basel III, the Basel Committee on Banking Supervision (BCBS) introduced new capital, liquidity, and leverage requirements following the financial crisis of 2007/2008. For most financial institutions, this meant significant added expenses on consultants, manual processes, and contractors who were hired to cope with regulatory demands. The manual processes and disparity among contractors' approaches resulted in discrepancies in compliance with Basel III among financial institutions. To address this, the BCBS introduced Basel IV in 2017 to restrict the use of internal models for calculating capital at financial institutions. Standardisation was the ultimate objective.

The RegTech industry can help financial institutions capitalise on increased standardisation in financial regulation. It can transform financial institutions' disparate data through a common data standard into an easily machine-readable format. AI and ML advancements can then use this data to produce the highly accurate regulatory submissions that the BCBS were after with the introduction of Basel IV. The



RegTech industry's ability to leverage AI and ML is the best way of achieving uniformly high standards in capital, liquidity, and leverage, and ensuring a stable and secure financial services industry that is effectively supervised. Those financial institutions that entrust their compliance to the RegTech industry can set precedent for RegTech innovation and compliance in the years to come. ●

Leveraging DLT in the securities market



Natasha Cazenave

Managing Director, Head of Policy and International Affairs, Autorité des Marchés Financiers (AMF)

How can the EU take full benefit from the development of blockchains and smart contracts?

With distributed ledger technologies and smart contracts, we are moving to the next level of Internet: the "Internet of Value". What the Internet has made possible for information transfers now seems possible for value transfers, i.e.: virtually free, almost instantaneous, anytime, cross-border, secure exchanges of any type of value: virtual currencies, loyalty points, coupons for future services, representation of physical goods. In recent months, we noticed a growing interest in the representation and transfer of securities.

DLT present a number of benefits for the competitiveness and integration of EU securities markets. On the issuance side, digitalisation or "tokenisation" could reduce the total cost of the transaction and facilitate the exchange of illiquid assets. It could also allow the emergence of new asset classes and facilitates cross-border trading. On the secondary market side, the use of DLTs and self-executing contracts (smart contracts) eliminates the need for reconciliation, which can reduce back office costs by a factor of up to 3. Finally, the direct publication of financial information on the blockchain network makes it possible to carry out almost instantaneous transactions between two counterparties compared to the two business days required for traditional settlement. Automation of back-office processes (settlement, cash flow payments, etc.) would also be possible for repurchase agreements, margin calls on derivatives and the exercise of options, thanks to the use of smart contracts.

As a regulator, it is our duty to be aware of these changes and possibilities and to ensure that our regulatory frameworks remain appropriate. These frameworks must allow us to manage risks and protect users effectively, without losing the benefits of innovation. Against that background, the AMF examined the legal obstacles to the development of security tokens that mainly stem from EU regulation and presented its analysis in a recent paper[1].

To overcome these obstacles, we recommend the creation of an « EU digital lab » allowing national competent authorities (NCAs) to remove, in return for appropriate safeguards, certain requirements imposed by European regulations and identified as incompatible with the blockchain environment, provided that the entity benefiting from this exemption respects the key principles of the regulations and that it is subject to increased oversight by its NCA. The AMF also published a position to clarify the notion of trading platforms and bulletin boards.

Where tokens do not qualify as financial instruments, pending the creation of an EU framework, the French "PACTE law" adopted in 2019 introduced in France an optional visa regime for fundraising in crypto-assets (ICOs) and an optional license regime for digital assets service providers (DASPs) supplemented by a mandatory regime that imposes to DASPs due diligence in the fight against money laundering and the financing of terrorism. Only crypto-assets that are not considered as financial instruments are eligible to these regimes. The creation of these new regimes and interaction with numerous professionals for two years before the law was passed has helped us improve greatly our understanding and develop specific and more tailored requirements. As for the implementation, the AMF gave its first optional visa for an ICO in December 2019, and some players have expressed interest in the DASP optional framework. The two first DASP registrations were granted mid-March. It is too soon to learn all the lessons, but we are convinced that only a bespoke, flexible and attractive framework can work at this stage for the European Union. ●

1. See : https://www.amf-france.org/en/news-publications/news/legal-analysis-application-financial-regulations-security-tokens-and-precisions-bulletin-board

Glen Fernandes

Group Strategy, Euroclear

Embracing the DLT (r?)evolution

Over the past years, DLT has emerged as an important piece of technology that promises to transform capital markets by delivering a real-time, transparent, Peer-to-Peer(P2P) and inclusive experience. It enables a real-time view of activity and positions across a business network. Making it possible to detect, assess and react faster to threats and opportunities. Participants can share and trust in a single source of truth, increasing transparency and reducing reconciliation. Because of its distributed nature, participants can directly hold and transfer value in a P2P manner, but still retain the possibility to be serviced by a third party without mediation of information or network. This allows for greater direct inclusion to capital markets.

Inspired by this promise, a number of the DLT based PoCs have now moved to a project phase and aim to go live soon. Post Trade FMIs & intermediaries also fully acknowledge this transformative potential. Hence, they have not been a passive observer and have already launched dozens of projects with DLT or invested in FinTechs for use cases related to issuance, settlement, asset servicing, funds distribution, collateral management etc.
The journey for most industry initiatives, however has been a very long and arduous one and the path to mass adoption ▶

▶ is not yet obvious. It is clear that the mere use of DLT is no longer a sufficient condition to expect success.

"Will DLT introduce additional risks and costs?" or "Will it deliver benefits materially beyond what we have today?" are questions that often get asked, but the answers are not obvious. For example, DLT instant settlement does reduce counterparty risks but also increases liquidity costs with no netting and pre-funding before trade-execution. Similarly, decentralization brings with it significant governance and legal risks. And participating on a DLT network isn't cheap. Not everyone can afford the node setup, licensing fees, upskilling efforts etc.

So when seen in context of EU capital markets that have gone through an era of transformation to deliver market-wide efficiencies, lower risks, greater legal certainty and interoperability, the material benefits in return for undertaking such costs and risks are not always apparent.

Meanwhile market actors assess whether such goals of efficiency, transparency etc. could be more easily achieved using other new technologies such as AI, Robotics, API and Cloud.

While such questions will possibly get ironed out over time by lowering costs, skilling more staff, etc. what certainly is required at this stage is greater legal and regulatory certainty. An EU-wide legal classification and a technology neutral regulatory framework is thus an important first step to support market adoption. Moreover, it is important that regulators take a "substance over form" approach leveraging existing safe & robust regulatory and risk frameworks, but applying them proportionally to allow innovation to thrive.

> *The path to industry-wide adoption of DLT isn't yet obvious. How can regulators and market actors help the industry embrace in its future evolution?*

Such logical supportive steps from both public authorities & market actors will help the markets embrace the DLT evolution rather than impede its radical revolution. FMIs, given their decades experience in driving safety and efficiency and their committed experimentation will certainly be key enablers in this journey. ●

Andrew Douglas

Managing Director Public Affairs and Regulatory Relationships, Europe & Asia, The Depository Trust & Clearing Corporation (DTCC)

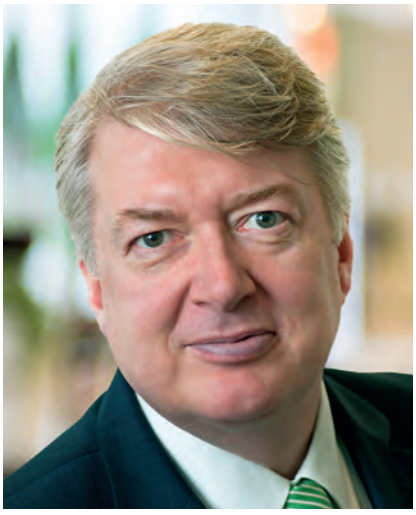
Slow down to speed up: DLT reaches potential through collaboration and standardisation

The technology adoption life cycle – often referred to as an S-curve – has four stages – innovation, syndication, diffusion and substitution – and there is also usually a period of hype early on, when a new technology is introduced.

Distributed ledger technology (DLT) is sitting firmly in the syndication phase, during which technology is demonstrated and a small portion is commercialised, with the potential for immediate utilisation. True to a typical technology life cycle, DLT did experience the intense hype phase, however recently, the industry has taken a more considered position as to how it may benefit financial services. That said, for DLT to be accepted more widely in financial markets, certain areas need to be addressed.

> *The industry needs a standardised approach to security to ensure the integrity and availability of an organisation's DLT operations.*

A key issue is security. As addressed in our recent whitepaper, Security of DLT Networks, the industry must develop a comprehensive and standardised approach to security to ensure the confidentiality, integrity and availability of an organisation's DLT operations. There is no 'one size fits all' approach but there is an optimal model: the development of a reliable and comprehensive industry-approved framework. A critical component of this framework is the development of industry standards,



which enables interoperability between multiple DLT implementations and therefore reduces risk and cost for market participants by preventing a fragmented industry eco-system.

DLT standards would also facilitate the sharing of information between market participants and vendors, which would improve understanding of the benefits and risks of the technology, knowledge ▶

likely to the speed up adoption. Standards can help with other critical security issues such as data governance, which often delays the implementation of new technologies such as DLT. Via the development and adoption of a principles-based framework, firms are better able to identify potential weaknesses in their DLT projects. Further, a universally accepted framework will provide regulators with a consistent approach to assessing the potential strengths and weaknesses of different DLT implementations.

Effective and efficient collaboration between relevant stakeholders - clients, regulators and vendors - is another benefit of developing standards that is critical to the successful implementation of DLT. For example, it is important that the industry collaborates with policymakers to ensure that the case is well-made around how new technology implementation can safely serve the public, as well as the clients and the industry.

Regulators and policymakers must consult and collaborate on new technologies, such as DLT, at the global level to better understand how the technology can improve the functioning of financial markets without putting safety at risk. Standard setting bodies (SSBs), such as the Financial Stability Board and IOSCO, have an important role to play in that process.

Now that the initial excitement about DLT has died down, it remains clear that the technology holds potential value for the industry. Benefits include, processing efficiencies, operational capacity and scalability, as well as maintenance of data integrity. In order to realise this value, there must be a standardised approach to DLT security via a comprehensive framework most effectively achieved through collaboration between the industry, market infrastructures, policymakers and vendors. ●

Morten Bech

Head of Secretariat,
Bank for International Settlements (BIS)

Tokenised securities and the future of settlement

Distributed, "tokenised" securities could be the future

For years, financial authorities have warned the general public about cryptoassets' severe price volatility and consequential lack of safety. Yet the underlying distributed ledger technology (DLT) could have useful applications. Although cryptoassets and stablecoins focus on creating new types of money and means of payment, another area being explored is for securities and their settlement (Bech et al (2020)).

Today, most securities are book entries, with their ownership electronically recorded at some entities. The most common setup is an indirect holding system, where an intermediary (such as a custodian bank) holds securities on behalf of its clients with central securities depositories (CSDs). This arrangement, where securities are transferred through "book entries" across accounts at a CSD and intermediaries, minimises the management of information by CSDs, yet also fragments ultimate ownership records. This can add complexities and costs for end users.

The technology underlying cryptoassets could help through "tokenisation". A number of projects around the world are transforming securities into digital tokens – representations of value not recorded in accounts. This would mean that, in the future, equities and bonds could exist on distributed ledgers held across flat networks of owners. This could make ownership records more transparent and settlement much faster.

Yet tokenisation is not that simple

If this sounds too good to be true, it is. Not only are there technological challenges to tokenising securities, but serious trade-offs in the management of risks. Although ownership records can be distributed with DLT and some functions automated with "smart contracts", transactions still need to be validated and updated by all parties, rather than centralising these processes at CSDs and big intermediaries. Intermediaries do not just play a purely operational role either; they smooth trade flows and provide credit, making settlement more efficient overall.

Faster settlement is not without its challenges, or costs. A traditional settlement cycle (eg T+1 or T+2) allows more participants to trade and reduces the amount of securities that market-makers need to store in inventories. Faster settlement could also increase the likelihood of trades not settling, resulting in time and effort resolving disputes about failed settlements.

> *The more open and interoperable a tokenised securities system can be, the better.*

And the future is likely to see a transition, not a big bang

Tokens and DLT offer a number of benefits for securities, but they come with costs. It is therefore very unlikely that a large-scale coordinated move will take place any time soon, or simultaneously. Therefore, as new assets and securities become tokenised, they will need to interoperate with existing account-based cash and securities systems. The more open and interoperable a tokenised securities system can be, the better. ●

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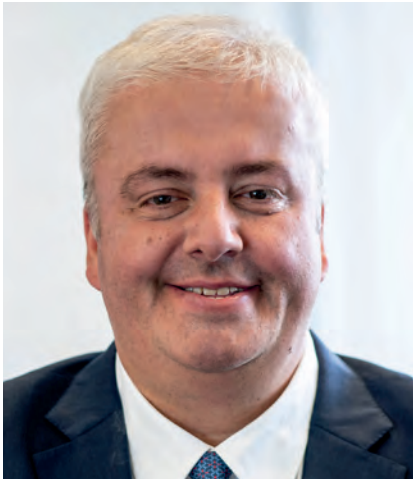
Data sharing and sovereignty issues



Burkhard Balz

Member of the Executive Board, Deutsche Bundesbank

Effective data sharing requires data sovereignty

We have recently discovered a new world: the digital world. This entails both great potential and great risk at the same time. On the one hand, the combination of increasing amounts of data and advancing technical possibilities leads to added value in the use of personal data. This includes, for example, discounts on products and seemingly free usage of digital products. On the other hand, there are risks of becoming dependent on data companies, losing our data sovereignty, and facing monopolistic market structures. These dangers arise in particular due to the growing role of platforms.

The recently emerged platform economy, with its small number of large and often global network companies, warrants special attention in this regard. Personal data in combination with machine learning may be used to gain the upper hand. For instance, data could be used not only to assess a potential borrower's creditworthiness, but also to identify the highest rate that they would be willing to pay. It is even more concerning that this discrimination may not necessarily be intentional. A sophisticated algorithm may be biased by finding an underlying cause.

In order to protect the right to informational self-determination, regulators have introduced a variety of rules. The most prominent of these, the GDPR, sets out a legal framework for data protection. Its major achievements are the required express consent for the collection and usage of data as well as the right to demand the deletion of personal data. However, the practical implementation of these provisions presents a number of challenges. Therefore, in order to achieve full data sovereignty, further steps may be necessary. Developing a user-friendly technical tool that allows users to conveniently control the usage of their own personal data could be one potential solution. Based on a secure and neutral data infrastructure, the data owner would maintain the right to decide independently on the use of their data and would be able to fully or partially share their data with companies or authorities for a designated period of time. This would potentially ensure that data access and usage can be tracked and controlled effectively and that property rights, such as deletion of data, can be exercised with ease. Such a facility would not block data sharing; instead, it would facilitate it under fair conditions and therefore help to increase competition.

Beside this new digital world, existing market structures appear to be disrupted. Data is collected at near-zero marginal cost, which means that new services are easily scalable. Once sufficient scale has been achieved and a captive ecosystem established, potential competitors have little chance to catch up. This restricts innovation and competition. A legal framework is necessary to create a level playing field. PSD2 has successfully established such a framework for financial institutions. Banks have to share their data with certified companies if this has been authorised by the customer. In order to create a level playing field for data sharing in other markets as well as between different markets, a legal framework analogous to the PSD2 model should be established at the European level. ●

Carsten Hess

Head of Digital Policy, Banco Santander

Five principles for an innovative European data economy

For the EU's economy to remain competitive on the global stage, Europeans need to turn the necessary digital transformation of its traditional industries into a global advantage.In Santander we support the EU Commission's plan to create a 'data agile economy' where data and fair rules around its sharing and usage are key to create a more innovative digital economy.

However, we believe it is critical to accelerate on an open cross-sectorial data framework that, while empowering users and putting them in the centre to control the data they generate, would contribute to developing a level playing field in all sectors. We strongly support the vision of a single European data space where personal (and non-personal) data is secure and where businesses (including SMEs) also have easy access to industrial data. While empowering users and putting them in the center, opening cross-sectorial data would also multiply the opportunities for disruptive innovation and contribute to developing a level playing field in all sectors and with platforms that leverage in data from diverse markets and contexts. We therefore support the horizontal ambition of the EU's data strategy.

When it comes to banking, more data, and especially data that is uncorrelated ▶

▶ with the traditional one, can help improving services in the benefit of customers and trigger innovation, just as it happened some years ago with PSD2. Non-financial data has a huge potential to improve banks' predictions and thus enable customers access to finance. It will also trigger similar levels of innovation outside the financial space.

In order to create these conditions for success, we propose a set of five principles creating a data agile economy by contributing to opening-up data across sectors in a way that individuals and business users can benefit in fair manner. Those principles will also help providing choice within a secure framework to make their choice to share data from all sectors with their chosen providers.

1. Give control to the user by creating a framework that is consumer centric. People and businesses, as owners of their data must be in control and decide freely with whom and for what purpose they share it.
2. Create the right conditions for the secure transmission of data. APIs are the preferred method for this as they are safe, efficient and provide access to data on an immediate & ongoing basis. In addition, access can also be easily stopped whenever the user decides to.
3. Clarify the different nature of data to be shared. Users are the owners of their raw & observed data; but companies building "value" around the data need to be able to retain this value. Elaborated or inferred data should not be mandatory shared.
4. The data regulatory framework should enable greater access to data improving services to the benefits of users. The focus of any future data sharing framework should be put on the revision of the online intermediation services regulation, since this is where most amount of data lies.
5. A fair cross-sector approach is also needed to ensure maximum benefits to our society. No mandatory data sharing should be triggered in a sector (banking) where players from other sectors also compete but don't have similar requirements. ●

Tsvetelina Penkova

MEP, Committee on the Internal Market and Consumer Protection, European Parliament

The EU towards data sharing economy

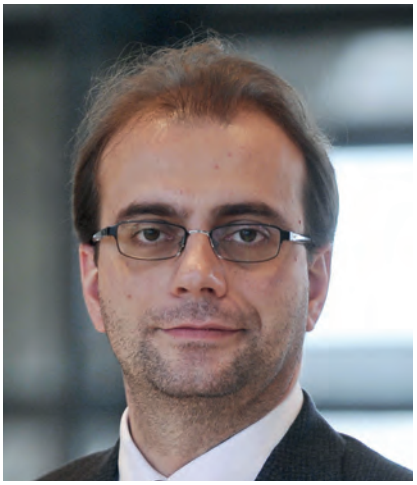
Globally, there are deeper and deeper concerns regarding the market dominance of tech giants. There is a continuing and ever increasing corporate concentration, where governments have explored different measures, from breaking up tech giants to creating public alternatives to exercise strict controls and transparency. In Europe, a number of measures to tackle competition have been adopted, non-exhaustively in industries like telecoms or energy, however, when it comes to the 'Big Tech', experience has shown that ex-post measures like fines imposed by the European Commission have neither restored fair competition, nor avoided growing market dominance. This is a reason why, in the Group of the Progressive Alliance of the Socialists and Democrats in the European Parliament, we call for a review of the EU competition rules, which should take into account the future competition in the digital economy, including market-dominance driven predatory pricing strategies, and which should allow for preventive measures to tackle uncompetitive behavior and guarantee a level-playing field.

> *Taxes should be paid where the profits are generated.*

Such companies are accumulating huge amount of data and often prevent others, including the data subjects, from accessing and using it. GDPR and the ePrivacy directive provide users with the right to access and use their data but there is often a lack of tools and standards to do so in a practical way. The European Commission is trying to address these issues, i.e. through data interoperability and governance, in their newly published European strategy for data. As much as this strategy brings revolutionary initiatives like common sectorial data spaces, also for the finance sector, it brings a number of questions and challenges. What would be the incentives for companies to share data, especially rare or important data? What data could be shared? Is there a price for this data? The Commission believes that there is a merit in thinking about extending the approach taken in PSD2 to other sectors, thus extending open banking to open

finance. This brings additional questions with regards to the scope and application. In any case, the experience with the PSD2 can serve to future debates on the need for a standardised approach for sharing data and a high level of trust among actors.

Finally, we are also of the view that the way added value is created through digitalization and tax regulations should be adapted accordingly. While huge profits are global, some companies optimise their profits in only a few tax advantageous countries. This is unfair to both the consumers and the competition. Taxes should be paid where the profits are generated. ●



Sébastien Raspiller

Head of Department, French Treasury, Ministry of Economy and Finance, France

A sustainable European data ecosystem at the service of the financial sector

The EU financial area could only stand out from the crowd with a well-protected, well-regulated, well-advised while highly open, sovereign data ecosystem.

When it comes to financial data, the GDPR is broad in scope and also has a large set of sector-specific requirements in terms of security. Some of them (e.g. from payment cards) are undeniably considered "highly" personal given their criticality and the GDPR provides for some ex-ante measures such as the conduct of a data protection impact assessment in the case of personal data processing likely to generate risks for consumers.

Whether sectoral or not, a safe and secure environment for data and high-value information is at the heart of the Single Market concerns. Initiatives ranging from e-IDAS regulation and EBA Regulatory Technical Standards (RTS) to the trades secret European directive allow for a common area of data where citizen's rights are preserved, consumers are highly-protected and the non-EU investors or suppliers are truly welcome as long as the EU requirements are fulfilled.

The core EU values could be undermined or weakened notably by an increasing reliance on systemic non-EU third-party providers of crucial services such as data (including cloud computing) or even cybersecurity and algorithms This raises the question of the supervision of non-financial players and the robust assessment of the systemic risks linked to their use as much as taking into account intertwined public policy objectives such as financial stability, fair competition and its implications for the free flow of data, portability, personal and non-personal data business models.

The cross-borders nature of data also hampers information and data sharing through the creation of determined circles of trust that are essential to build a sovereign European data ecosystem, but eminently remains a puzzle hard to solve. At the meantime, conflicts of sovereignty could occur regarding sensitive data location such as computer vulnerability data (e.g. bug bounties platforms) or highly personal ones and non-EU domination of certain activities (e.g. security standards, sovereign rating agencies) with a serious lack of European counter-models, that is damaging not only in terms of international outreach but also for the full control of our critical infrastructures.

However, it is clear that transboundary and cross-sectoral issues require both EU and international responses and enhanced synergies between public and private players in correspondence with EU rules and values. A well-designed common European financial data space and a high-reaching European Strategy for data (European Commission) would be a promising step ahead in that sense. ●

Kostas Botopoulos

Advisor to the Governor of the Bank of Greece & Former Chair, Hellenic Capital Markets Authority

Data restrictions in times of emergency

The extraordinary times we are living in because of the outburst of the coronavirus pandemic have an impact on nearly every aspect of private and public life. This is also true for the field of data protection: instead of debating on data sharing and the impact of technology on European financial markets, as we were supposed to be doing in Zagreb, we are suddenly confronted with two completely different, and much more problematic, sets of issues: on the one hand the very survival of the European financial markets, and on the other the legality and legitimacy of restrictions of data protection which are already taking place all over Europe in the effort to combat and contain the pandemic. Leaving aside the economic consequences, which would perhaps merit a special Eurofi conference once the nightmare is over, I would like to highlight some of the legal and operational aspects related to data restrictions.

The data-protection framework in the EU is comprised by three sets of principles: constitutional provisions in some member states (for example, Art 9A of the Greek Constitution), the "horizontal" GDPR provisions and relevant national legislation enacted on the basis of the GDPR. All three sets of provisions enshrine a robust protection of privacy and personal data but also cater for exceptions. The principles of legality and proportionality

apply in the constitutional framework, be it on the national level (Art 25 of the Greek Constitution) or through the EU Charter of Fundamental Rights. In the EU we have, since 2018, the GDPR, as ▶

complemented by relevant provisions of Directive 2002/58 on the protection of privacy in electronic communications. Art 6, 1, e (and also whereas no 46) of the GDPR provides for exemptions from consensual processing for the protection of vital public interests (among which health is first and foremost), whilst Art 9,2, i specifically mentions health issues as providing an exemption whereby even sensitive data (such as health data) may be processed without consent. This does not mean, however, that said processing may be done in contravention of the fundamental principles laid down in Art 5 of the GDPR: legality, limitation of goal, minimization, exactitude, limitation of storage, confidentiality.

Consequently, measures taken by public authorities, such as compulsory data gathering, processing and exchange of data between member states and authorities, would be admitted if based on a specific legal act setting out the conditions and the duration of the emergency (in the case of Greece it took the form of a so-called "act of legislative content", a presidential decree ratified by the Parliament on a later stage and used only in exceptional and urgent circumstances) and respect of above DGPR core principles.

Private sector entities, usually regulated by the relevant national legislation such as Law 4624/2019 in Greece, can, in principle, also impose restrictions on data protection, based on a specific national legal base and respecting the core GDPR principles. Statistical use, such as the one made by some member-states but also requested from the Commission, is also permitted under the proportionality and anonymization conditions. For every processing act the possibility of judicial action against measures considered as contravening the core protection principles should be guaranteed by member states. On all those issues, the European Data Protection Board rendered a public statement on the 19th of March 20120. Obviously, full protection, sovereignty, and even use of technology are secondary in times of such emergency. Even in such times, however, the European state of law remains in place. ●

Benjamin Angel

Director for Direct taxation, Tax coordination, Economic analysis and Evaluation, DG Taxation and Customs Union, European Commission

New challenges lay ahead, prompted by financial innovation

Recent scandals have put the financial sector under scrutiny by legislators. For the last decade, the fight against tax evasion and avoidance has been a priority for governments around the world. From the strengthening of anti-money laundering requirements to the automatic exchange of financial account information for tax purposes, financial institutions were called upon to strengthen their procedures and share customer information with the authorities.

In 2016, for the first time, EU financial intermediaries were required to collect and report customer information to the tax authorities. The alignment of the Directive on Administrative Cooperation to the OECD common reporting standard ensured the minimisation of the potential burden for EU financial institutions. This Directive was recently amended and will require that intermediaries, including financial intermediaries, report aggressive tax planning schemes.

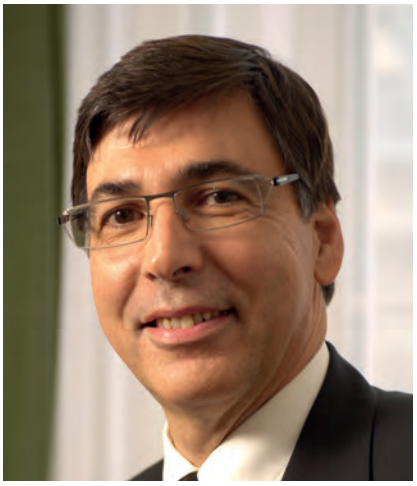
However, new challenges lay ahead, prompted by financial innovation. Innovative financial technologies and products bring efficiency gains but also new demands for the industry and legislators. Due diligence and customer identification obligations set forth in legislation still rely mainly on traditional requirements, while technologies such as electronic signatures and seals or even biometric data sensors recognition are being considered by the industry. In this context, the regulatory framework will need to remain fit for purpose while both governments and financial institutions must ensure the protection of clients' data and its security.

New financial products such as virtual assets are now under the scrutiny of legislators. What started as a minor alternative means of payment has now been taken up by key market players, often outside the boundaries of the financial industry. Such "outsiders" are not subject to as stringent regulatory framework as the financial sector, which may lead to a biased playing field. The financial sector will need to reinvent itself while ensuring it keeps its competitiveness in an ever-changing environment. At the same time, as it evolves from simple low-value payments into a means of investment and storage of value, virtual assets are relevant for taxation purposes as well as other areas such as the fight against money laundering.

Lastly, a comprehensive review of the taxation of Multinational enterprises is ongoing within the OECD. It remains unclear how and to what extent it will affect the taxation of the financial sector. The latest draft notes that most financial services are supplied to commercial customers and therefore not within scope, but only goes so far as to say that there is a "compelling case" for consumer-facing services to be excluded, on the basis that they are already subject to heavy regulations.

Any legislative action must foster innovation in the EU, or at the very least not impede it. The way forward must keep up with innovation and new financial realities, while relying on the synergies between the different legal frameworks. A "whole-of-government" approach is the only way to avoid the duplication of procedures and avoid unnecessary costs for governments and economic operators. Action in the area of taxation, anti-money laundering and financial regulation needs to be consistent and mutually reinforcing. ●

Stablecoins and crypto-assets



Denis Beau

First Deputy Governor, Banque de France

Crypto-assets, acknowledging the potential benefits, tackling the actual challenges

In the past 10 years, a new class of assets has emerged, the so-called crypto-assets. If the first generation, like the Bitcoin, was essentially of speculative nature, we are now seeing a number of market initiatives, still building on the potential offered by the DLT technology but based on mechanisms designed to ensure the stability of their value, and for this reason generally referred to as stablecoins.

These initiatives are diverse in their nature and features, but aim at bringing improvements in payments. Some intend inter alia to make cross-payments quicker and cheaper and to improve financial inclusion – and progress is indisputably needed there. Others tend to pave the way for faster settlements between financial intermediaries. As such, the various projects must be looked at with lucidity and technological neutrality.

At the same time, we must be fully aware of the challenges they raise. The stablecoins indeed form settlement assets that may compete against commercial and central bank money at the center of our payment systems. As many central bankers have stressed, today's crypto-assets do not satisfactorily offer the qualities expected from a settlement asset to be used interchangeably with commercial bank and central bank money. This highlights the misleading nature of the name of "crypto-currency".

From that perspective, as pointed out by the G7 in its October 2019 report under the French presidency, stablecoins of potential large size and reach may not only pose risks in terms of legal certainty, money laundering and terrorist financing, consumer and investor protection, but also raise additional challenges to competition policy, financial and monetary stability.

The preferred response should be to establish appropriate regulations to reconcile the need to address risks and the preservation of the potential for technological innovation offered by crypto-assets. This has to be done according to the "same business, same risk, same rule" principle so that a risk-based and proportionate regulation and oversight be applied to stablecoins.

We need proper regulation and oversight to make them part of the solution, not part of the problem. At global level, the Financial Stability Board has been mandated to assess potential regulatory and supervisory gaps and to suggest a potential way forward to handle them.

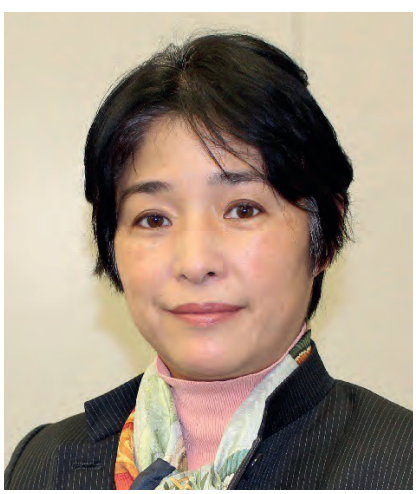
This does not mean that the sole response from the public authorities should be defensive. Where innovation helps the financial system function more efficiently, it must be supported, as central banks have kept doing since decades. The private sector, to the extent that it does bring improvements without inducing unaddressed new risks, is of course best placed here, be it for front-end or back-end payment solutions. Central banks have also a role to play, as issuers of the reference settlement asset and operators of critical payments infrastructures. This is why Banque de France will experiment a wholesale Central bank digital currency, with a view to fooding Eurosystem thoughts. This is why also it fully supports - and actively contributes to - the G20 roadmap on the improvement of cross-border payments. ●

Yuko Kawai

General Manager for Europe,
Bank of Japan

Covid-19, digitalization of payments, and the crypto assets

The outbreak of Covid-19 and subsequent lockdown of many societies have reinforced the necessity to promote digitalization in payments. Today, as of the end of March 2020, one-third of the global population is said to be under some sort of lockdowns, and any payments using physical measures are subject to significant constraints. Some retailers try to avoid touching banknotes and coins. Bank checks are subject to the delivery constraints. Furthermore, even for the electronic remittance by corporations and financial institutions, physical security measures such as token devices, or a dedicated computer terminal with an exclusive IP address, which are kept or installed in the office premises, prohibit the parties from making remittance once their employees are suddenly required to work from home. I believe that people who felt inconvenience will look for the digital solutions. ▶



▶ Should we consider the crypto assets, including the stable coins, in our new regime? Why not. Once such time comes, we will need to use every piece of wisdom to recover from the consequence of this pandemic. If the decentralized and digital encryption features, which are common in many crypto assets/coins, can serve the purpose of elimination of physical devices with good security, it is worth pursuing.

Having said that, I also would like to pay attention to the risks. The obvious challenges to crypto assets are the cyber security, AML checks, and the backstops when things go wrong. Also, the stableness of the stable coin may be questioned during the severe market turmoil. In fact, some of so-called stable coins experienced unusual value fluctuations in March 2020 amid the spike of the volatility in financial markets. These issues also lead to the question about the consumer protections.

Also, if we assume the wider usage of stable coins operated outside of the banking system, it may reduce the presence of the banks, then we will need to consider who will replace the functions banks are currently providing. For example, under the current crisis, in order for the financial compensations to support curtailing the social contacts, or, in later days, to support the recovery of damaged economic sectors, data to identify the most needed recipients and the swift and effective measures to remit money to them are vital. The substantial part of this financial support is expected to take the form of loans, the traditional bank products. In countries where digital neo money platforms are already in full broom, these functions maybe supplemented by them, but I myself am not sure whether the currently suggested stable coin frameworks will function in a similar manner.

As discussed above, I believe the current crisis will make us think more about the digitalization of payments, which may include the crypto assets, but the risks and points of governance will not change in crisis from the peaceful time. I hope that the discussion about the crypto assets, or more specifically about the embedded decentralization and digital encryption technologies will help us to improve the efficiency of the incumbent payment system as well. ●

Nicole Sandler

Head of Digital Policy, Barclays

Stablecoins – refining the regulatory landscape of crypto-assets

Blockchain and crypto-assets have changed the way people think about money, and this technology is a focus area for policymakers globally. To date there exist over 2000 different types of crypto-assets, with no precise definition of what these are, rather there are a variety of terms that describe more or less overlapping phenomena. The understanding in regulatory terms of what we are dealing with is varied, with some current classifications, commonly used by EU policymakers ie exchange/payment, security and utility tokens, being too broad and requiring further clarification based on a token's characteristics.

Today, the United Nations recognises 180 currencies worldwide from the US dollar to the British Pound to the European Euro, and more, with these currencies being used to buy goods and services. The value of most of these currencies is subject to minor changes on a daily basis, for instance a pint of milk will standardly cost £1 in the supermarket and one does not have to worry that it will be £2 on any day that same month. However, one of the criticisms of a number of cryptocurrencies (a sub-type of crypto-assets) as a means of payment, is the volatility in price fluctuations – the same pint of milk could cost anywhere between 20p - £10 in a given week.

'Stablecoins', another subset of crypto-assets, have characteristics that distinguish them from the categories mentioned above, most notably their stabilisation functionality with underlying or reference asset - what that underlying or reference asset may be varies from coin to coin. To date, the key distinctions among stablecoins have been the governance and the mechanisms for maintaining stability. However, it is important to flag that there are many different types of so-called stablecoins with some being neither stable nor a coin. That aside, the main benefit generally associated with stablecoins, is that depending on how and what they are pegged to, they may not be subject to the extreme price volatility that other crypto-assets are affected by.

In addition, they could potentially offer decentralisation, and in some cases global reach, with the ability to help the unbanked. These reasons are why this class of crypto-assets are seen by some as an attractive means of payment. Whilst there are a lot of discussions about the use of stablecoins, particularly from a policy perspective, the majority of industry participants are not yet launching anything in this space, primarily because of the lack of regulatory clarity on how such assets should be treated. Whilst there are benefits which warrant further discussion, this does not mean they are free from risks.

These include (i) risks to consumer protection, data privacy and financial stability, (ii) they could promote illicit activities, (iii) threats to weaker currencies and (iv) banks may lose their place as intermediaries if they lose deposits to stablecoin providers. The current financial markets uncertainty (brought upon by the COVID-19 crisis) has the potential for changing habits across all society in looking for technological 'safe havens'. While this may hasten some of the debate and support for certain crypto-assets, this still needs to be a measured and strategic response.

It is important that given the cross-border nature of many types of crypto-assets, that the industry and policymakers work together across jurisdictions to have agreed definitions and regulations to minimise the risks and maximise the benefits. Further, it is essential that the approach policymakers take is a uniform one that applies the principle of 'same activity, same risk, same regulation' in order to avoid fragmentation and allow market participants to benefit from scaling effects. ●

Pan-European retail payments

Ulrich Bindseil

Director General, DG Market Infrastructure & Payments, European Central Bank (ECB)

Key requirements for a future-proof European retail payments market

The transformation of the retail payment landscape is driven by technological progress, legislative and regulatory action and cross-industry initiatives led by large global digital firms. Keeping step with these developments puts established banks and payment service providers increasingly under pressure.

In Europe, the payments industry is at risk of losing its economic edge. Whereas a fair level of progress has been achieved at the back-end of the retail payments chain with harmonised SEPA standards and pan-European settlement, the customer front-end, in particular for point-of-sale and online payments, remains fragmented along national borders. This predominance of country-specific solutions hinders competition and stifles innovation at the pan-European level.

In addition, a growing dependence on non-European global players creates the risk that the European payments market will become susceptible to external disruption. Furthermore, global service providers with market power may not necessarily act in the best interest of European stakeholders.

The only effective remedy to this situation is the development of an industry-led, pan-European retail payment solution that facilitates instant, secure and inexpensive payments – both online and in brick and mortar stores. With the aim of fostering pan-European market initiatives for retail payments at the point of interaction (POI), the Eurosystem has put forward a payments strategy that provides conceptual vision as well as high-level guidance to the market. Market initiatives aiming to deliver pan-European retail payment solutions would have to fulfil five key objectives.

First, customers should be able to make POI payments throughout the entire European Union just as efficiently and safely as in their home country. To this end, pan-European reach with wide merchant acceptance is required.

Second, to achieve a high degree of customer acceptance, such a solution needs to be designed in a way that enables an easy, flexible, secure and user-friendly payment experience for both consumers and merchants. It should be flexible enough to allow the use of different payment instruments, initiation channels and technologies.

Third, a new European payments solution must comply with all relevant legal and regulatory requirements. To boost consumer confidence, it should provide the highest levels of fraud prevention and offer consumer protection with robust complaint and refund procedures.

Fourth, it should aim to foster European identity by using a common brand and logo. A European governance structure would enable European payment stakeholders to have direct influence on the strategic direction and business models.

Fifth, to reinforce economies of scale and domestic adoption and to keep step with other global solutions, a new European solution should also be accessible to merchants based outside the EU.

European stakeholders are invited to step up their collaboration and act together. ●

Stéphanie Yon-Courtin

Vice-Chair & MEP, Committee on Economic and Monetary Affairs, European Parliament

The pan-European payments market: innovative competition and protective autonomy

A pan-European market for payments is at the heart of the EU promises to consumers and businesses. It should at the same time allow for innovation through competition on a level playing field and build autonomous capacity in the EU in light of growing global fragmentation and economic stimulus needs post-COVID crisis.

Decisive EU action to open competition in the retail payment space, in particular thanks to open finance pioneered in the Payment Service Directive (PSD2), has brought about innovation to the benefit of European consumers. Digital services offered by innovative players – for example on international transfers or currency conversion – have eased the daily ▶

lives of citizens travelling across the European continent and abroad. Through price transparency, consumers have been empowered to start a new dialogue with incumbent providers on payment services and associated charges. Consumers can also rely on price regulation when transparency is not enough to ensure they receive a fair treatment.

> *A pan-European market for payments is at the heart of the EU promises to consumers and businesses.*

This welcome innovation should however not be at the expense of the protection guaranteed to all EU citizens. The EU rulebook on anti-money laundering, security, privacy, and consumer protection should be respected with the same level of ambition when the nature of services is comparable, regardless of the provider and with an equal level of protection across the EU. When exploring new payments solutions, we should also remain mindful of citizens that are less digital literate and that could encounter accessibility challenges.

European businesses have also benefited from the gradual buildup of an efficient payment system for the single market. The Single Euro Payments Area (SEPA) and the most recent TARGET Instant Payment Settlement (TIPS) have already shown the benefits of EU action to accelerate C2C, C2B and B2B transactions within the Eurozone. Cryptocurrencies could further smooth payment operations in the future. Enhanced individual portability of data access and reuse could also fuel innovative business models at all levels of the payment value chain.

European autonomy should be the cornerstone of all future EU initiatives, to preserve European sovereignty in the current crisis context. We need more action to reduce the knock-on effects of dependency on non-European card schemes, in order to preserve the independence of our foreign policy decisions and of our ability to finance economic recovery.

Similarly, the emergence of new actors, including BigTechs, in the payment and currency areas begs the question of the powers for European regulators to control the impact of these new ventures on the European economy, as we grow more reliant on access to digital services in our day-to-day lives.

The European Renaissance will require pan-European payment systems bringing innovative solutions for consumers and businesses. These new infrastructures and services will ensure that Europe remains autonomous in the wake of post-COVID recovery and with the disruption of economic models that digital innovation creates. ●

Burkhard Balz

Member of the Executive Board, Deutsche Bundesbank

Forming a competitive European payments market that benefits society at large

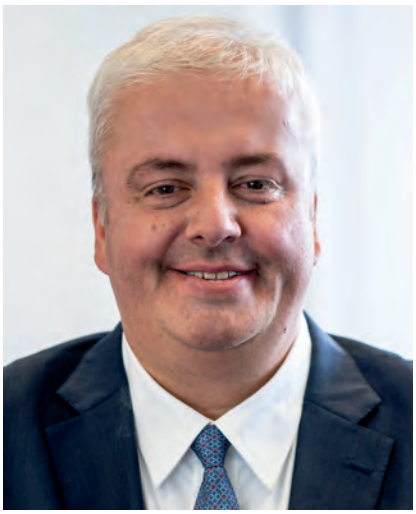
Cashless payments are becoming ever more common place. In the EU, around 140 billion non-cash transactions were processed in 2018, up 8.8% on the year. Market intelligence is projecting further annual expansion rates of 8.5% up until 2022 and expecting associated revenues to grow by around 6% p.a. through to 2028.The bulk of global revenues is generated by card payments, which currently account for 62%.

However, incumbent banks appear to be capturing less of the revenue growth than their rivals. The last few years have seen digital banking and smartphone banks burst onto the scene and global technology firms, BigTechs, make inroads into the payments and banking space. These firms can leverage their platforms and capitalise on extensive network, scale and scope effects to enhance their market power. Considerable changes in user preferences are fuelling this development.

> *Now it's time to make a pan-European payment solution a reality.*

While consumers undoubtedly value the convenience of global platforms, there are some challenges for European societies as a whole. Platform economies tend to favour monopolies, so as BigTechs gain ever greater shares of the payments and banking business, the contestability and competitiveness of European markets will diminish.

Furthermore, banks face the risk of being disintermediated by platform solutions as they lose their direct links with their customers. Consequently, they might end up as mere commodity suppliers of back-end banking infrastructure and regulatory compliance on behalf of digital solutions.



So their margins and revenues are at stake. In addition, European providers usually manage payments and other banking segments as a profit centre activity. That means putting a price tag on account-providing and payment services. For most platform models, though, it's the data analytics that tend to be monetised. Given the above-mentioned monopolistic tendencies, consumers should continue to be able to choose whether they wish to depend on data-driven models or accept a fair price for using services that ▶

▶ minimise the collection and use of their data.

Against this backdrop, European authorities are calling for a compelling pan-European payment solution that addresses these challenges. National central banks on the continent have responded by defining five key objectives that this solution would need to satisfy: 1) pan-European reach and uniform customer experience; 2) convenience and cost efficiency; 3) safety and security; 4) European identity and governance; and 5) global acceptance in the long term.

Now it's time for European market players to make this solution a reality. A number of building blocks, like instant payments and the necessary infrastructure, are already being rolled out. Others, such as standardised request-to-pay and confirmation messaging, as well as common security mechanisms, are still lacking. Moreover, European providers need assurance that payments can remain an attractive business. Also, it is crucial for them to have a level playing field with their new rivals, like in terms of having reasonable access to technical interfaces such as NFC. Ultimately, though, the industry will need to forge a compelling solution for all the different payment situations – one that will be to the taste of European consumers. Otherwise, consumers might ultimately turn away. ●

Carlos Carriedo

Senior Vice President & General Manager, Global Commercial Services Europe, American Express

European retail payments – the EU's defining moment

In the last decade, Europe has been a global pioneer and a standard-setter in terms of payments. The second Payment Services Directive ("PSD2") in particular has been one of the most revolutionising pieces of legislation in decades, especially when it comes to boosting innovation. Implementing all of its estimable objectives, however, has proven harder to achieve than many would have thought, and these shortcomings provide valuable lessons for the future.

Indeed, Europe's future as a world leader in this area is anything but certain. Today, the region is part of a highly connected world, where physical borders matter less than ever. When shopping online, today's consumers want limitless options. They expect to be able to buy from any EU Member State, Asia or the United States, with no or few restrictions. All the evidence suggests that these expectations are even more pronounced among millennials, who pay little heed to the provenance of the goods or services they select. They just want the best online service they can get.

These generational changes imply both risks and opportunities for companies, regardless if they are European or non-European. One thing, however, is certain: companies which can match consumer expectations with global market realities, while providing the seamless and fast service consumers want, and the security they demand, are the ones that will succeed.

Yet over the last two years, the EU has advocated for a pan-European solution in the payments market, with many policymakers calling for more investment in domestic solutions. On the face of it, a pan-European scheme would increase competition and provide consumers with a new choice in an otherwise duopolistic card payments' market. This increase in choice is something we would welcome. However, in a world where consumers wish to shop globally, any domestic or regional solution must be able to meet their needs by offering not just speed and reliability, but true global interoperability. Without this, no amount of political support will be enough to ensure a new, home-grown European scheme can succeed.

While considering the development of pan-European solutions, we believe there are also other paths the EU could, and should, consider to increase competition even further. For instance, PSD2 - as well as PSD1 - focused on measures that sought to encourage competition, by facilitating the entry of non-bank players to the market. The EU should assess how to replicate similar measures, for instance by broadening the scope of open banking to open finance, bring into scope the full range of financial services – from insurance to savings and pensions products – that European consumers and small businesses crave.

> *Any domestic or regional solution must be able to meet their needs by offering not just speed and reliability, but true global interoperability.*

By the same token, it is incumbent on the EU to address the shortcomings of existing pieces of legislation, most notably the Interchange Fee Regulation (IFR). That Regulation, too, was intended to boost competition, but instead reinforced the existing duopoly by focusing almost entirely on price reduction – a savings which has yet to be truly passed on to consumers. Any future review should bring back genuine competition to the heart of the IFR, by making it easier for new and small players to enter and to thrive.

The stakes could hardly be higher. For whatever path is finally chosen, it will have the potential either to secure or to scupper the EU's place as a global competitor. ●

Roeland Van der Stappen

Head of Regulatory Affairs, Europe, Visa Europe

European retail payments at a crossroads

We are at crossroads in the payment and banking sector, driven together on one side by innovators and disruptors in the FinTech world and governments and regulators who see an opportunity to put the consumer in control of their money and financial data.

Open finance is where they converge, all centered on putting consumers in control of their money and their financial data. This opens the banking market to new players, services and possibilities while giving consumers more choice than ever imagined.

Europe is at the leading edge of that change. European regulation, such as the revised Payment Services Directive (PSD2), through a focus on open access and standard-setting, has paved the way for open finance to flourish and created new opportunities for innovations that consumers need and want to adopt.

Importantly, the design of the PSD2 regulation has enabled businesses to innovate in an unfettered and consistent way across the single market. It has allowed consumers to benefit from the best of what the world has to offer, and empowered consumers to make that choice for themselves.

In a world that is moving fast and digital, Europeans continue to have high expectations for security, reliability, control and protection. They want choice and simplicity as they manage their financial lives.

When we think about the future of payments, we should stay grounded in consumers' expressed needs and on enabling choice to maintain a level playing field and continued innovation, without prescribing operational solutions and technology.

There are also inherent trade-offs if infrastructure is local or regionalized rather than global. International payment networks offer some of the highest levels of cyber –and operational resilience.

The ability to route data through multiple data center around the world, with instant fail-over capabilities, contribute to best-in-class operational resilience. At the same time, access to global data for cyber threat analysis allows for the detection of fraud/scams outside of Europe in order to react faster to threats to European citizens.

> *When we think about the future of payments, we should stay grounded in consumers' expressed needs and on enabling choice to maintain a level playing field and continued innovation, without prescribing operational solutions and technology.*

If Europe wants to stay ahead in payment innovation and encourage the emergence of FinTech players, it is better to promote innovation and set common and open standards that facilitate change, rather than build new European-only infrastructure.

This approach would support operational and cyber resilience, while expanding the opportunities for competition, growth and innovation – which drives the best results for consumers. This will be ever more important as we move towards open finance. ●

Mikael Svensson

Head of Public Policy, Europe, Government Affairs and Public Relations, Mastercard Europe

Increasing competition in the European payments market

Over the past years, the European retail payments market has gone through significant transformation. Thanks to technological innovations, consumers and merchants now have a wide range of payment methods they can choose from. The change in consumer habits, in particular the growth in cross-border and online commerce, has changed the dynamics of payments and how they enable new and different shopping experiences that benefit the consumer and the retailer.

In addition to these consumer- and technology-driven developments, Europe has been at the forefront of regulation to boost electronic payments, reduce end-users' costs, prevent fraud and disable barriers for new players entering the market. The EU Interchange Fee Regulation and 2nd Payment ▶

Services Directive (PSD2), which are inherently linked, are still having a huge impact on the market and the full effects are yet to be seen. Indeed, Europe is the region with the lowest payment acceptance costs in the world and the PSD2 continues to drive further competition in the European payments market. As the PSD2 opens the payments market to new entrants, it also leads to greater choice for consumers and businesses by enabling them to use third-party providers to manage their finances and initiate payments on their behalf.

Even if most in-store transactions in Europe are still conducted with cash, the increased competition has resulted in consumers having access to multiple payment methods including cards, cash, mobile phone payments, payments through wearables, such as watches or wristbands, voice-enabled devices or other new payment methods that use (often instant) credit transfers directly from their bank accounts. With the increased use of smartphones and apps, further growth of innovative payment methods is expected.

> *Legal certainty is paramount for new and existing players to develop innovative solutions that meet consumers' and businesses' needs.*

New alternatives also mean that consumers and retailers use multiple payment methods depending on the situation they are in. This leads to payment service providers increasingly competing for consumers to use their payment solution at the point of sale, in store, or online. Innovation, convenience and safety are fundamental in this.

As the effects of existing regulation are further unfolding, one can expect these trends to continue. Also, digital wallets are expected to be used more broadly by consumers. Instant payments, often enabled by third parties, QR codes or Near Field Communication (NFC) will also offer new alternatives. These trends mean that the market for retail payments is likely to continue to deliver good outcomes in terms of efficiency, innovation and choice in the future, provided that the right regulatory framework is in place.

Legal certainty is paramount for new and existing players to develop innovative solutions that meet consumers' and businesses' needs. Further legislation should therefore only be considered once the full effects of existing rules and regulation are known and a need for further regulation has been identified. This is the best way that innovation and competition continue to flourish in this sector across Europe. ●

Dr. Joachim Schmalzl

Executive Member of the Board, Deutscher Sparkassen- und Giroverband (DSGV)

Payments in Europe - set the course now!

The increasing momentum in the payment transactions sector has accelerated significantly in recent months. But what are the drivers that have caused payments - an area which might previously have been considered boring - to reach the attention of decision-makers in the banking industry? The answer to this is complex: the rapid technical development seen over the last few years has been a global driver, enabling an increasing number of new services in this area and leading to dramatic changes in existing payment offers and the processes behind them.

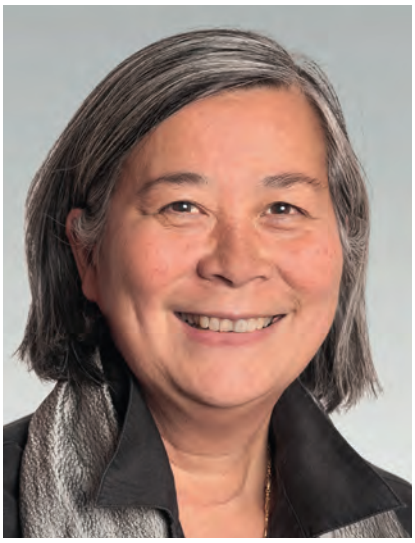
Closely linked to this are the entirely new customer requirements and the resultant offers in the area of payments and additional payment services, for example in the area of data usage. Whereas payment business was previously the domain of banks or bank-related service providers, there are now a large number of providers in the market which are outside the banking sphere and which just a few years ago played only a minor role. These not only damage the banks' position as payment service providers, but also their important role as account managers, because third-party providers will foreseeably expand their services, which are currently still based on payments, to other lucrative business areas. This gives the subject a completely different, existential dimension in addition to the purely financial consideration: the anxious question that arises for the banks is whether they will continue to be the account-holding entity for customers in future, and thus the first port of call for financial services, or whether they will be displaced to a secondary role.

> *The German Savings Banks Finance Group wishes to play an active role in shaping European payment transactions.*

How should European banks respond to this development? Certainly not with "business as usual" as this is sure to lead very predictably and quickly to the situation described above. Despite the recent political and economic challenges, Europe is a strong continent - if it acts in a concerted, consistent and focused manner. And this is particularly true for the payments sector. Why not join forces and put all our weight behind this? With almost 513 million inhabitants, around 697.5 million current accounts and more than 112 billion payment transactions annually, the European Union has the potential to shape the European payments market with a focus on European requirements and to offer customers modern and exciting payment services. The Savings Banks Finance Group has already completed ▶

valuable preliminary work in this area. For example, instant payments were implemented very early and consistently in the Group, currently enabling around 10 million transactions (incoming and outgoing payments, as at the beginning of April) to be processed each month. In addition to this, a highly customer-oriented P2P process has been developed on the basis of instant payments to serve as the basis for further expansion stages, e.g. for P2B transactions. A further focus of activities is the provision and expansion of convenient smartphone-based POS payment solutions, whether based on credit cards or on the German debit card payment scheme girocard.

The German Savings Banks Finance Group, as the market leader for payments in Germany, wishes to play an active role in shaping European payment transactions and is therefore intensively involved in the work of the European Payments Initiative (EPI). The aim must be to create uniform payment scheme throughout Europe with the potential for innovation in all customer-relevant use cases, based on sustainable business models. This is the only way to create a successful counter-model to internationally operating and financially strong players. ●



Narinda You

Head of Strategy & Market Regulation, Credit Agricole Payment Services

Emerging payment means a myth or a reality?

Payments are and will be executed through payment accounts. These accounts were a bank monopoly but with PSD2 some new players appeared on the market under the status of Payment institutions.

These new Payment service providers are still relying on bank payment means but they could develop a certain kind of intermediation with the growth of e-money transactions in market places organised by large merchants for instance.

Banks should pay attention to this evolution because it could weaken their intermediation role and limit them to mere payment account handling considered more as a commodity than real services.

The customers be they on payee or payer side believe that their payment services are secured by their banks. They do not always realise that when using new "payment solutions" they are not in the same trust environment.

Banks have invested for decades to protect their customer data and to secure their processes.

They are under scrutiny of multiple authorities and overseers. They have the ability to monitor and report whilst it is not always the case of new players.

As the reputation and financial risks will be borne by banks they have to understand these new ecosystems, the user experience, the easiness and the immediacy that seem to become the new normal.

They also will have to examine very carefully their new clients needs: to activate/de-activate, to increase/decrease the payments amounts authorised, temporarily/permanently, specific counterparts or not, etc. It is then our responsibility to allow them to do so in the limits of our risk analysis and appetite.

On the merchant side, it is crucial for banks to be able to provide information with the right level of protection and security to allow them to develop their business and mitigate their fraud rate.

The mean of payment is not important per se. What will make the difference is whether one or the other offers more easiness and benefits to both payer and payee.

It is important too to be able to rely on sustainable providers offering security and availability.

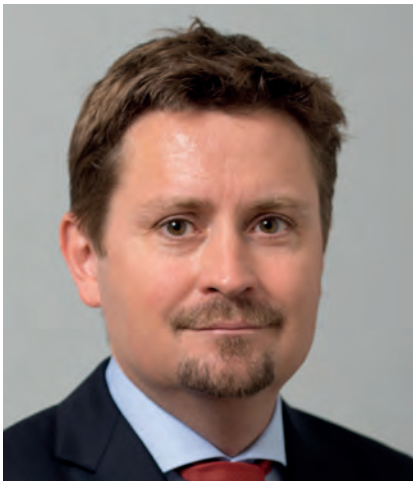
It is the ambition of 20 large banks in Europe to deliver such an end-to-end pan-European payment solution that would bundle a card (plastic) and a wallet (digital card or payment account based) relying on an interbank settlement through SCT Inst which is a genuine European scheme. The key factors of success reside in the attractiveness of the solution, the speed of adoption and deployment.

> *The crisis we experience today should intensify the work because this project could be a strategic move in the European payment policy.*

It is crucial to maintain the momentum of the EPI Project (European Payment Initiative) that necessitated nearly one year of discussions among banks but also with the other stakeholders such as the international card schemes, the non-bank acquirers and some processors and manufacturers ... and of course the regulators at national and European level.

The crisis we experience today should not slow down but, on the contrary, intensify the work because this project becomes more relevant than ever and could be a strategic move in the European payment policy. ●

Ensuring operational resilience with increasing digitalisation



Morten Bech

Head of Secretariat, CPMI,
Bank for International Settlements (BIS)

Avoiding a cyber mess

"Don't put all your eggs in one basket" is good advice for life, and for operational resilience too. The job of concentrating functions and risk in the financial system needs to be handled with care, and maximum resilience. Decades of work on financial market infrastructures have strengthened business continuity arrangements to ensure continuity of services through fires, floods and power outages, and pandemics. The eggs are safe in the basket.

Cyber risk has made keeping our eggs safe a far more complex and challenging task. Now, replicating data for a seamless failover to a backup site could help spread compromised data across all systems. It might not be obvious that any irregularities are even malicious until it is too late to share information. Outsourcing critical services might help better distribute operational risk, but if everyone uses a common service provider, then an issue can quickly become systemic. Cyber scrambled egg is a risk.

The CPMI's strategy to avoid the omelette is to "protect the core and secure the periphery". The core of the financial system comprises the financial market infrastructures that are covered by the CPMI- IOSCO Guidance on cyber resilience for financial market infrastructures, which led the way for standard setters in this field. Yet cyber defence cannot be boiled down to a pass-or-fail test; improving it requires a cooperative approach. A CPMI-IOSCO roundtable that brought together the 22 largest global and regional FMIs and their supervisors identified three key challenges that need a common solution: (i) data integrity, (ii) information-sharing and (iii) third-party service providers.

International industry-led working groups were set up to tackle each of these challenges. This is the first time this type of cooperative approach has been adopted. Each group has a tough challenge. For data integrity, or how to recover if underlying data are corrupted, there are a number of possible avenues to explore, including contingency arrangements, segregated ledgers and frequent reconciliations. For information-sharing, common protocols exist to share financial events, but operational incidents are still segregated by type of FMI, market and jurisdiction. Setting expectations and developing a practical arrangement for alerting on international operational incidents could enable faster and better-informed responses. Third-party services (eg cloud) can benefit from cooperation by users, provide a clearer view of risk management practices at the common service provider and avoid duplicating third-party risk assessments.

So, although the challenges are tough, financial authorities, infrastructure and their members all have an incentive to cooperate and avoid a cyber crisis. Working together now, to strengthen common operational resilience, can ensure we avoid scrambling our cyber eggs. If we fail to do this, we will all end up with egg on our face. ●

Simon Chard

Partner, Operational Resilience Lead, PwC

Standardised regulatory requirements can improve operational resilience

Everyone is talking about operational resilience. With a fast moving COVID-19 that may become the ultimate stress test, right in the middle of regulatory consultations across Europe, it's the key topic for firms. There is no shortage of policy areas to focus on to make both individual firms and the wider financial system more resilient. We covered a number of them in depth in our report "Operational Resilience: Time to Act" with theCityUK. In this article, I'd like to focus on four areas identified by the European Commission in their consultation: ICT and security risk management and incident reporting requirements, digital operational resilience testing and third party oversight.

The current state of ICT and security management requirements in Europe is inconsistent across sectors. While I don't believe anyone needs to be convinced that improved, consistent standards for risk and resilience across Europe would lead to ▶

an uplift in practices, let's talk benefits. Operational resilience is an outcome, not a process, function or methodology. So benefits must be evident from any initiative taken. For firms, having one standard means a level playing field in Europe, and clarity about what is expected for service chains which cross borders into different regulatory territories. For customers, improved management of risks means more reliable services and improved trust in financial institutions.

It goes without saying that even with the best risk management in the world, failure is inevitable. Industry-recognised standards on the timeliness and nature of reported incidents would enable customers to make decisions based on the relative resilience of firms. Increased consistency and transparency of reporting can also accelerate industry-wide detection of emerging systemic risks and help regulators and firms in their responses.

This understanding of emerging risks should be used to drive digital operational resilience testing. While almost all firms adhere to an operational testing regime, there is again currently no standardised framework. While such a framework may increase costs, if applied with appropriate proportionality, it could not only give firms more confidence in their own ICT and security estate but also that of other firms in their supply chain. For customers, improved and consistent testing will lead to greater confidence in the security and privacy of their assets.

Thinking about supply chains leads us to the final policy area: third party oversight. Third party failure is one of the most common causes of outages, so how well third parties are managed can clearly have a critical impact on the resilience of financial firms and markets. A common framework to manage third parties would not only reduce systemic risk by uplifting standards but also allow firms to leverage this framework to demand more of their suppliers via increased audit rights and participation in scenario stress tests.

Harmonisation of requirements across sectors in Europe can clearly be beneficial not just for customers but for firms and markets. While Brexit may create challenges for European harmonisation, we shouldn't lose sight of the fact that financial services routinely cross borders and therefore greater standardisation with shared global norms will surely be a good thing. ●

Nicola Russell

Director, Global Operational Resilience, HSBC Scotland

Operational resilience as an outcome

Technology to enable digitalisation and innovation has been a priority for financial firms as well as for financial services policy makers for some years now. However, as the financial sector becomes more digital, attention is beginning to turn in earnest to the risks posed by a greater use of technology. A renewed conversation is needed about how firms, and the financial system in general, can become more operationally resilient in the face of rapid technological change to the sector and the economy more generally.

Good risk management provides a strong foundation upon which to build resilience. While regulations for ICT risk and cyber security have existed for years, there has been an uptick in the amount of new regulation in these areas with more on the way. While necessary in the short term, eventually we will reach a point where more risk management offers diminishing returns for improving resilience. We must instead remain focused on achieving resilience as an outcome and not be distracted by a compliance driven exercise more concerned about ticking a box.

A focus on outcomes allows firms the flexibility they need to keep up with a shifting operational environment. The threat landscape for digitally-enabled businesses continues to change and the system is growing more complex, in part to deal with the expectations of consumers enabled by legislation like PSD2. This continuous change will make prescriptive regulation increasingly ineffective; for instance, a mandated risk control measure that was vital one year may be obsolete the next as the technology and threats evolve. In contrast, a focus on outcomes, monitored and enforced through supervision, allows firms to continuously innovate in risk management and resilience while ensuring that regulatory policy objectives are still achieved.

So what does the future of operational resilience look like for both firms and policy makers? All market participants including regulators, firms and policy makers have a shared motivation to ensure the financial system and its participants can continue to withstand, and operate through, disruption. As stakeholders in the financial system we must all recognise this common goal and develop more collaborative ways of working together toward that outcome if sustainable progress is to be made.

For firms, with the threats, system complexity and use of technology increasing, operational resilience must become more holistic. Firms are already shifting their focus to ensuring that they can continue to provide what is important for their customers, the market and their own operations in the event of disruption. That means ensuring the resilience of the systems, people and processes that support these services from top to bottom.

For policy makers, there is a need to step back and consider the macro context. Fragmentation has been an issue in financial regulation for over a decade. International bodies such as the FSB and BCBS have worked to address this and they will need to do the same in the area of operational regulation. Europe has a part to play in that effort. Finally, time is needed – time for current regulation to embed and begin to make a difference, and time for a new approach suited to the future financial services system to evolve. ●

VI. BANKING AND INSURANCE REGULATION

Issues at stake

The Covid-19 crisis illustrates that while the Basel III framework has effectively reinforced the EU banking system, the implementation of the final Basel III package could undermine its capacity to finance the economy, which is why it was postponed for one year by the BCBS. In the EU, given the importance of banks in the funding of the economy, the challenge is finding the right balance between the consistency with the global prudential Basel standards and being able to implement them in a simple and risk-sensitive way.

The soundness of the European banking system is also very much dependent on the completion of the Banking Union. Much progress has already been made, but substantial building blocks are still missing to deliver a sufficiently integrated banking system that each Member State can trust. In this perspective, some suggest adopting a holistic approach to the Banking Union, others are more favourable to step-by-step approaches.

The EU insurance regulatory framework is also challenged by the current context. In the short term, insurance companies will need to play a central role in supporting the relaunch of a suddenly frozen economy in highly volatile market conditions, as well as further contribute to the long-term investments needed to improve the resilience of the EU economy, given limitations in public spending. These objectives question the relevance of the current Solvency II market-valuation and one-year horizon options, which impair any long-term investment and particularly in equities. This also calls for a differentiation between liquidity and solvency needs and a clarification of the responsibilities for investment decisions.

Content

Basel III implementation challenges

Othmar Karas

Vice-President & MEP, Committee on Economic and Monetary Affairs, European Parliament

The implementation of Basel-III in light of COVID-19

We are living through unprecedented times. The COVID-19 crisis is not only affecting the health of our loved ones but also having a profound impact on our real economy and financial markets. A global challenge of this kind needs to be tackled with common, determined and coordinated action at all levels. Every one of us can, and indeed must, take over responsibility and learn the lessons for the future. If we do, then we will emerge from the crisis stronger. Robert Schuman knew this as long ago as 1950: "Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity."

Of course, the coronavirus is also impacting the EU legislative agenda, including the implementation of the comprehensive Basel-III reforms. Given the announced one-year deferral by the Basel Committee's oversight body, the legislative proposal by the European Commission – initially scheduled for the second quarter of 2020 – will be postponed according to its Executive Vice-President Valdis Dombrovskis. I very much welcome this decision since it increases the operational capacity of banks to support our real economy at these extraordinary times.

Despite the delayed implementation dates for amongst other the output floor, the revised market risk framework and the Pillar 3 disclosure requirements, the EU must remain committed to the implementation of global rules. We have learned from the financial crisis that banking regulation requires an international response and more cooperation, not less. This has proven very successful: Today, European banks are much better capitalised, have more liquidity and a higher leverage than before the financial crisis – which undoubtedly serves us well during the COVID-19 shock.

To this day, the political starting point is the European Parliament's resolution from December 2016, which urged for no significant increase in the overall capital requirements. While a "23.6 percent increase" is of course significant, the assessment by EBA needs to be seen in a differentiated way. Not all aspects are considered, such as the changes to the Pillar 2 framework. Also, the impact strongly depends on the size and complexity of institutions. In any case, not the percentage itself is the most crucial but the consequences in reality are – on financial stability, our economy, the end-users and citizens.

> *While the legislative train on Basel-III is delayed, it continues being loaded with the practical experience from all affected stakeholders.*

Above all, we must ensure that our banking sector remains safe and strong. Its diversity is a strength to ensure less vulnerability to crisis, better access to finance and more competitiveness. Both, small and large banks must continue to be able to finance our real economy, which has a different structure than other jurisdictions such as the United States. Therefore, there will be no political majority in the European Parliament without the SME Supporting Factor on board, which we have successfully extended during the last legislature.

Certainly, the biggest elephant in the room remains the output floor. While its implementation is necessary to live up to our global promise, all options on its calculation remain on the table for the European legislator. Due to reasons of a level-playing-field, the necessary financial integration, comparability and lower implementation costs, its application on the highest level of consolidation seems most justified.

Various other screws will need to be adjusted. We must find a European answer to the treatment of unrated corporates ▶

as well as equity exposures and need to take the European particularities of financing businesses into account – such as commercial and real estate loans, leasing and specialized financing. And we need to continue our progress on better regulation and proportionality while preserving our Single Rulebook and balancing the risk sensitivity, simplicity and comparability of the framework. If done right, all these principles are not contradicting, but complementing. They go hand in hand.

While the EU legislative train on the Basel-III reforms is delayed, it continues being loaded with the practical expertise from all affected stakeholders – taking also on board their experience with the current impact of COVID-19.

Once the Commission's proposal is then on the table, the European Parliament will live up to its responsibility as co-legislator to ensure the legislative train arrives safe and well.

Eva Wimmer

Director-General for Financial Markets Policy,
German Federal Ministry of Finance

Finalizing Basel III – A regulatory foundation for a resilient banking system that supports the real economy

The finalisation of Basel III is an important milestone for the European reform agenda following the global financial crisis. In December 2017, the group of central bank governors and the heads of supervision (GHOS) adopted the final Basel III reform package. The aim of this package is to complete the reforms to global banking regulation initiated after the global financial crisis. Its European implementation will strengthen the regulation, supervision and risk management of banks operating in the European Union.

The Covid crisis shows the importance of sufficient capital and liquidity buffers. Buffers help banks to withstand stressed situations and enable them to provide necessary financing to the real economy in times of crisis. We should build on the lessons from the current crisis and implement the final Basel III agreement in a consistent way.

At the ECOFIN meeting in July 2016, European Finance Ministers have already noted that the reform package is not expected to result in a significant increase in the overall capital requirements for the banking sector, therefore, not resulting in significant differences for specific regions in the world. Likewise, Finance Ministers and Central Bank Governors of the G20 concluded in March 2017 that the finalisation of Basel III would not significantly increase overall capital requirements across the banking sector, while promoting a level playing field.

For the German government, in addition to avoiding a significant increase in overall capital requirements and to securing a level playing field in global regulation, it is of utmost importance that the financing of the real economy, including the financing of unrated corporates and small and medium size enterprises, will not be negatively affected, and that the principle of proportionality is respected. The principle of proportionality is now a well-established principle in the Basel framework as well as in the EU regulatory and supervisory framework. It deals with the question how regulatory requirements to non-internationally active banks, especially smaller and less complex ones, can be tailored.

Other important topics include the implementation of the output floor, credit risks related to unrated corporates, commercial as well as retail real estate, equity and specialised lending as well as operational risks.

The aforementioned goals and topics will require further discussion once the European Commission has tabled its legislative proposal. The recent decision by the Basel Committee to postpone the implementa-tion date by one year will give us sufficient time. The Basel Committee reaffirmed its expectation of full, timely and consistent implementation of all Basel III standards. We should use the additional time wisely to enable banks to prepare for the new package as soon as possible. The objective is clear: The final Basel III package should be transposed into European law so that its stepwise implementation starts January 1st 2023 onwards until full implementation in January 2028. This will enhance the resilience of the financial system and will contribute to strengthening the European banking system.

The incoming German presidency is looking forward to the legislative proposal by the European Commis-sion and we will strive to enable constructive exchange and facilitate effective discussions within the Council of the European Union.

Alban Aucoin

Head of Group Public Affairs, Crédit Agricole S.A.

Financing the economy today, a necessity not an option

Successive reports, impact analyses and opinions on the Basel IV implementation, together with their respective figures persistently show negative and even alarming consequences for the European banking sector and for the economy. Whatever the results of these estimates, they are significant and inconsistent with the original G20 and European mandates of no significant increase in capital requirements (+23.6% for European banks).

Furthermore, Basel IV will significantly increase financing costs for European businesses and households, which will bring about costs far exceeding potential benefits. According to a recent study by Copenhagen Economics, the impact of Basel IV may reduce the credit capacity of European banks by €2,900 Bn, business investment by €700 Bn and European GDP by 0.4%.

Meanwhile we are facing a dramatic situation due to the Covid-19 pandemic around the world. The full economic impact is difficult to foresee, but it will be very substantial across the European Union. Taking into account the extent of supply side disruption in the productive capacity of countries and in global value chains (including intra-EU and extra-EU), and the severe drops in demand, we can reasonably expect this crisis to be deeper than the 2009 recession. Its long-term consequences will affect the recovery of our economies and societies, and profoundly change the economic context.

This time around, banks are neither the symptoms nor the causes of the crisis, but part of the remedy. European banks are now well capitalised and sufficiently strong, as a result of the accumulation of requirements (Pillar 2, MREL and additional counter cyclical buffers) which have no international equivalent.

In that regard, they can be relied upon when it comes to providing the necessary services and liquidity support to their clients, especially SMEs. In parallel, European and national authorities have taken extraordinary economic, supervisory and regulatory policy measures, to facilitate the steps banks needed to take to address the emergency efficiently and keep financing the economy to the best of their ability.

In the same vein, the BCBS considered appropriate to postpone for one year the implementation of Basel IV, acknowledging that it would help "to provide additional operational capacity for banks and supervisors to respond to the immediate financial stability priorities resulting from the impact of the coronavirus disease (Covid-19) on the global banking system". Additionally, the European Commission decided to use this extra time to adjust its work programme to the new priorities that would emerge from the crisis. Furthermore, in its 20 March statement, the ECB also announced a higher than expected capital-to-lending ratio to free up prudential capital: "a capital relief amounting to €120 billion could be used to absorb losses or potentially finance up to €1.8 trillion of lending".

> *This time around, banks are neither the symptoms nor the causes of the crisis, but part of the remedy.*

Somehow, both the BCBS and the European authorities admitted that, these additional requirements were likely to hamper banks' capacity to provide the adequate financial support to the economy, in response to the Covid-19 crisis.

The wake-up will be painful. Nevertheless, our collective task will be to rebuild the European economy, while drawing the lessons from this crisis. This will likely mean reviewing current policy priorities to focus on addressing the economic and social impact of the crisis. Banks are ready to keep playing their part and to provide massive funding to reach a stable economic balance. This however requires regulatory stability. The current crisis has proved the adequacy of the current high levels of capital and liquidity, and the appropriateness of the authorities' toolbox.

There is no evidence of a need for a significant capital increase, but there are clear signs of low profitability. The crisis also revealed the negative impact of pro-cyclical regulatory measures. The current situation provides the opportunity to put into perspective the EU prudential framework and the concrete evidence of the Basel IV impact to focus on what is efficient to pull the economy out of recession and support economic growth in a sustainable and less dependent way.

Stefan Simon

Designated Chief Administrative Officer, Deutsche Bank AG

Striking a balance – implementation of Basel prudential rules

The capital and liquidity reforms implemented in the wake of the financial crisis proved their value with the resilience of European Banks in the face of the economic shock caused by COVID-19. The ability of the sector to keep the EU financial system functioning through this period of stress and be in a position to provide credit to clients at their point of greatest need was testament to the work done to enhance the regulatory framework over the past 10 years. The EU banking system was less leveraged, more resilient and significantly better capitalised as a result. Average CET 1 was c.30% higher for large internationally active banks in Europe in 2020 than 2010.

The extraordinary challenge posed by COVID-19 has also highlighted how important it is for banks to be able to mobilise to provide lending support to European businesses. A less efficient, less risk sensitive capital regime might have left the banking sector less resilient and could constrain EU bank's ability to play their part in supporting recovery. The importance of striking the right balance in the implementation of prudential rules and value avoiding unintended increases in capital are clear.

It is equally clear that balance cannot come at the expense of a consistent approach to the application of standards globally. Members of the Basel Committee have an obligation to promote financial stability and enhance the quality of banking supervision in their jurisdictions. When implementing rules agreed at the international level into local legal frameworks it has always been accepted that there may be need for some deviation from literal transposition – the important point is to retain overall equivalence.

As Europe focuses on recovery in the wake of the economic shock caused by COVID-19, it will be all the more important that the final Basel III reforms are implemented without triggering unintended significant increase in capital. The desire of the Basel Committee to enhance the comparability of prudential models and reduce variability of outcomes through the final Basel III did not assume a significant shortfall in levels of capital within the banking system. However, that is exactly what the European Banking Authority's impact assessment of summer 2019 tells us will be the result of implementation in Europe, with an average increase of over 24% in the risk weighting of EU bank balance sheets. Even if a lower average of 10-15% is assumed, as suggested by the European Commission, some banks would be still seeing a much larger increase than that. Even an increase of only 10% would be seen as significant and would have direct consequences for the real economy and the proposals analysed by EBA would see European businesses find it more expensive to hedge financial risk, or to finance investment, undermining growth and investment that we all hope to see following the shock of the pandemic in 2020.

> *As Europe focuses on recovery in the wake of the economic shock caused by COVID-19, it will be all the more important that the final Basel III reforms are implemented without triggering unintended significant increase in capital*

Addressing these consequences will not require divergence from the globally agreed Basel framework, but calibration of specific rules to preserve existing risk sensitivity. In the absence of external ratings for the vast majority of EU corporates, it makes sense to look for other reference points – parent ratings, or internal model risks buckets – in order to avoid having to apply a blanket RWA that does not effectively differentiate between risks.

Equally, better aligning the capital cost of derivative exposures under the standardised approach to counterparty credit risk with the reality of risk – as has been done in other regions - would seem like a sensible approach. Avoiding the double counting of risks currently addressed through EU specific capital add-ons and aligning the scope of application for the output floor with international approaches – a so called 'parallel stack approach', would provide a further opportunity to maintain risks sensitivity.

Europe has put in place much of the new Basel framework whilst preserving sensitivity to EU specific risks. That system has so far proved resilient and we need to ensure that balance between risk sensitivity and resilience is preserved as the final elements of Basel III are implemented. ●

Dan Sørensen

Managing Director, Nykredit Bank

Time to reconsider the implementation of Basel III Finalization

The regulatory tightening of the financial sector following the financial crisis of 2008-9, with Basel III 'pre-finalisation' standards at the forefront, has made banks far more resilient and ready to face the next crisis. Right now as a result of the Corona virus pandemic, this crisis has occurred with a paralyzed real economy. This crisis may prove to be one of the fastest growing global recessions ever with long-lasting negative economic consequences.

It is therefore now that the updated framework on micro level (tightened requirements of development and use of internal risk models, better through-the-cycle provisioning and management of distressed exposures and sufficient buffers of highly liquid assets) as well as on macro level (better and larger capital base, building buffers in good times, buffers for systemically important banks and a stable funding structure) must stand the test and prove that banks are now part of the solution and not part of the problems in a global recession.

Looking forward, the final piece of new global standards in form of Basel III Finalisation is yet to be implemented in Europe. It is positive that the BCBS has decided to postpone the global implementation. However given the current 'live stress test' scenario, it should be strongly considered to assess the extent to which the already implemented Basel III 'pre-finalisation' framework will prove sufficient to deal with severe crisis situations.

The Basel III Finalisation standards have not been calibrated taking European specificities into account. In fact, European specialized low risk banking business models might end up being less resilient in a crisis. European banks have a much larger share of low-risk lending on their balance sheets compared to e.g. US banks, something that will be severely punished by the new 72.5% output floor which will greatly increase REA levels and thus capital requirements in spite of no clear risk reduction effects. An example is Danish mortgage lending with especially low risk and therefore even more susceptible to this. Danish credit institutions will need another EUR 10bn in capital – corresponding to a 34% increase in capital requirements.

Thus, with the prospect of such a massive increase in capital requirements, for many banks it would be best to drop the low-risk business activities and instead onboard far more risky exposures into the lending book.

In spite of this, EBA has made clear that they recommend a full implementation of the Basel III Finalisation standard with no accommodations to the European context and applying the output floor to the full stack of European capital requirements. This seems ill advised.

> *Specialized low risk banking business models might end up being less resilient in a crisis.*

There is no clear reason why the European financial sector – and thereby the real economy – should be treated so harshly in spite of the lower risk on balance sheets. A better solution could be implementing the output floor as a parallel backstop requirement based on the Basel capital requirements only rather than the full stack of European requirements. Such an approach would even be closer to the letter in the Basel standard and would retain the incentives for real risk management in European low risk lending.

The reforms implemented immediately after the financial crisis were well-founded and addressed fundamental lack of risk management in certain parts of the financial system. With Basel III Finalisation, this fundamental motivation for risk management is undermined and the ability of banks to make quick and flexible adjustments and support of the real economy in a crisis is reduced.

Based on the current shock to the global economy, it is time to reconsider the implementation of the Basel III Finalisation framework. ●

Jérôme Reboul

Deputy Assistant Secretary, French Treasury,
Ministry of Economy and Finance, France

How to implement Basel III finalized without deviating from the 2016 political mandate?

The upcoming legislative proposal from the European Commission will aim at transposing the December 2017 Basel III agreement into EU law. One of the stated objectives of the agreement is to limit excessive variability in the calculation of risk-weighted assets.

At the same time, G20 leaders in Hangzhou in 2016 and EU Finance Ministry in the Ecofin of July 2016 clearly set their expectations that the finalized Basel III agreement should not result in a significant increase in the overall capital requirement for the banking sector and in significant differences for specific region of the world. Finding a balance between simplicity, comparability and risk-sensitivity will be the main challenge of the European implementation of Basel III. Two main topics will need to be addressed.

First, the issue of prudential incentives.

In order to limit the aggressiveness of risk-weighted assets that stem from internal models, the Basel Committee on Banking Supervision agreed to implement a capital floor - known as the output floor -, aiming at complementing the risk-weighted capital ratio and the finalized leverage ratio. The output floor will constrain the use of internal models, partly overlapping with the TRIM exercise from the ECB and the IRB Repair Roadmap from the EBA, while reducing the risk sensitivity of the prudential framework, one of its most important pillars.

Low-default portfolios, that have hence historically received favorable risk-weighting, will be the most heavily penalized by the floor. The one-size-fits-all characteristic of the output floor may lead to an unsatisfactory and prudentially-counterintuitive outcome. This all-encompassing feature of the output floor might prove damaging taking into account the different banks' balance-sheet structures between jurisdictions.

Second, the issue of the capital impact.

Additionally, according to the EBA impact assessment, this output floor will be the main driver in the increase of capital requirements in the years ahead for the European banking sector that are estimated to be around + 24% overall. It is moreover noticeable that the impact of Basel III finalized will be unevenly distributed, the European Union being the only jurisdiction suffering from a substantial increase in own fund requirements. This directly related to the political choice that was made years ago to authorize internal models subject to strict supervisory approval and review.

Consequently, taking into account this two-fold departure from the political mandate, the postponing of the release date of the European Commission's legislative proposal should enable stakeholders to reflect on the most appropriate way to implement Basel into EU law in order to help mitigate the impact of Basel III finalized on the capital position of the European banking sector in order to stay within the remit of the 2016 political mandate. ●

Sovereign exposures and low interest rates

Rolf Strauch

Chief Economist and Management Board Member, European Stability Mechanism (ESM)

Fiscal rules and market discipline – complementing each other

The EU fiscal framework provides a line of defence against fiscal profligacy. The rules aim to limit fiscal deficits and prevent excessive government debt that risk destabilising the monetary union. Since the creation of the Stability and Growth Pact, economic and financial conditions have evolved considerably. The rules have been fine-tuned and have become more complex. Now there is an opportunity to review them. The European Commission has launched a public consultation to collect feedback and ideas.

Market discipline can help limit unsustainable public finances, but failed to do so in the run-up to the sovereign debt crisis. Before 2008, sovereign credit risk was not priced in appropriately, as government bond spreads were compressed. Markets believed that the fiscal rules would ensure sustainability or countries in distress would be bailed out. The mispricing of risk was one of the deficiencies dis-incentivising adequate fiscal policies.

In times of stress, markets can swing into the other extreme and spreads can widen abruptly. Even if market volatility is not due to fundamentals, it can have negative effects on a sovereign and aggravate a crisis. Erratic and irrational moves, particularly when driven by herding behaviour, can lead to market failure. Additionally, perceptions of redenomination risk can exacerbate contagion in the euro area. A constellation of different mechanisms can lead to pro-cyclical price spirals and market closure in crisis times. Liquidity may evaporate quickly in a sovereign bond market and this may lead to liquidity shortages across markets.

We should foster complementarities between fiscal rules and market discipline. On the one hand, market reactions can contribute to fiscal discipline because market developments inform policymakers about the consequences of their decisions. On the other hand, a rule-based fiscal framework can tame market capriciousness by managing expectations. An effective framework should encourage proper risk pricing by markets.

Fiscal rules can serve as a sign-post for markets, and flag risks to investors. More predictable and transparent rules can help the appropriate pricing of sovereign risk and temper the binary perceptions of "risk-on" vs "risk-off" mood or risky versus safe assets. Investors can anticipate and internalise ("price in") the policy reaction when rules are transparent and credible, even without disciplinary action. This works the better the more transparent and consistent rules are, and the more credible the enforcement.

More well-behaved and risk-guided markets support policy responsiveness to markets. Policy adjustment often comes too late when market moves are extreme. Signals may be there earlier, but are often blurred and the bar for policymakers to react can be high. In other words, policymakers are better informed about market signals and their implications with more predictable and credible rules giving clearer signals to investors. This creates better conditions for adequate policy responsiveness to fiscal vulnerabilities and less pro-cyclical fiscal policy.

The ongoing review provides an opportunity to improve fiscal rules. For instance, gearing rules towards observable variables can improve the clarity of the guidance both for policymakers and for markets. It also increases transparency. A number of institutions propose an expenditure rule to set operational targets, combined with a debt rule, as a fiscal anchor. This could be a way forward to explore further.

At the same time, other steps are needed to deepen Economic and Monetary Union (EMU) and increase its robustness to shocks. The completion of banking union and more capital market integration would support private sector risk-sharing. A central fiscal capacity and a European safe asset would support financial stability in the euro area and also the international role of the euro. ●

Eduard Müller

Executive Director, Austrian Financial Market Authority

"Gone concern" or "concerns gone" in the sovereign-bank-insurance loop?

Usually, there is no safer asset than government debt, hence why banks and insurance firms are among its top investors and holders. This creates a reciprocal dependency between governments and the financial sector. But where do we stand now, ten years after the Euro Area sovereign debt crisis?

Government debt stock in bank and insurance books has not decreased much since 2010, but progress has undoubtedly been made. Banks and insurance firms today have bigger capital and liquidity cushions. Tougher regulation and supervision of non-performing loans have led to a visible risk reduction, until recently somewhat aided by benign economic conditions. Importantly, the leverage ratio, implemented in the EU by the CRRII, represents an explicit own funds requirement for all assets, without risk-weights. Thus, from 2021, sovereign exposures will be encompassed by the leverage ratio own funds requirement, with banks holding larger stocks ▶

having to hold more capital. Furthermore, high concentrations of sovereign exposures on bank balance sheets undergo supervisory scrutiny during the annual SREP exercise, which feeds into the Pillar II requirement. Finally, with the Banking Union, we now have a deeply integrated supervisory and resolution system in the Euro Area, with only a common deposit insurance system missing. The European Stability Mechanism (ESM) will undoubtedly soon provide an important backup for the Single Resolution Fund and enhance the credibility of a resolution of a systemically important bank.

All measures considered together, and in light of their being fully implemented, is concern about an unaccounted sovereign risk still justified? Further analysis and data collection by EBA and ECB may allow conclusions to finally be drawn whether and what further regulatory treatment of sovereign exposures might be warranted. The fundamental question of whether a gone concern or going concern perspective is taken will shape the answer. Under a gone concern perspective, wouldn't we seek insurance against our own potential failure? By basing our regulatory framework on a going concern perspective for the Euro Area, we may be closer to a reasonable framework for treating sovereign exposures than we think.

Dis-incentivising very high concentrations and strong home bias in sovereign exposures remains an issue to address. In the short-term we could increase regulatory and supervisory scrutiny of concentration risks in Pillar II. In the medium and long-term, a Pillar I concentration risk charge to further foster diversification of sovereign portfolios should be sought at international level, while pursuing the idea of sovereign-bond backed securities, providing a much needed well-diversified safe asset to European banks and asset managers. We have achieved much, and have gone far in implementing the Banking Union, which will help tremendously to weather the current COVID-19 crisis. The Banking Union should be now completed in small, mutually reinforcing steps, based on risk-sharing and discipline.

> *We may be closer to a reasonable framework for treating sovereign exposures than we think.*

Supervisors must play an important role and should support this by providing data and analysis and ensuring a reasonable and transparent treatment of sovereign concentrations in the SREP process and Pillar II requirements. ●

Pedro Marques

MEP, Committee on Economic and Monetary Affairs, European Parliament

Complete the Banking Union to address the sovereign-bank nexus

It is a given that economies face risks and sometimes those risks materialize into an effective crisis. Either the economic crisis is originated in the financial sector, as it happened a dozen years ago, or it begins with a public health crisis, as we are experiencing now, the fact is that sooner or later a new crisis occurs.

This does not mean that crises are acts of God, something completely beyond our control and that there is nothing we can do. In fact, there is much we can do, as the timing, size and consequences of each crisis may depend on the way we manage and mitigate risks *ex-ante*.

In the financial sector, one of the risks considered among the most serious is the nexus between sovereign and banks risks, known as the "doom loop".

No matter if the original shock is initiated in the banking sector (forcing the government to issue debt to recapitalize banks) or in the sovereign market (when perceived risks of sovereign bond generates potential bank losses), the feedback relation will amplify the magnitude of the crisis in both, with spillover effects over the economy and the consequent loss of jobs and other major social consequences.

> *The tools to address sovereign-bank nexus are comprised in the Banking Union's architecture.*

Lessons learned from the financial crisis gave an impetus to the creation of the Banking Union (BU), aimed at reducing the banking sector's risks and creating

a level playing field across the euro area. The BU, however, remains incomplete.

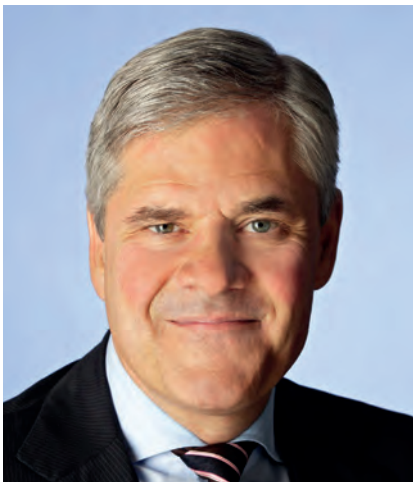
Although the effective implementation of its' first pillar, the Single Supervisory Mechanism, along with significant efforts from the Member States resulted in a sharp decrease of risks in the banking sector (e.g., the euro area NPL average came down from 6,5% in December 2014 to 2,9% in September 2019), the EU's ▶

inability to complete the BU has one consequence: risks are still out there.

In terms of the BU's second pillar, there are justified concerns that the Single Resolution Fund (SRF) does not have the necessary means to address the resolution of one or more big banks, so it is necessary to create a backstop for it, which should probably be the European Stability Mechanism. An SRF with the necessary firepower is one of the most important tools to placate the loop between banks and sovereigns, but the lack of agreement in the Council is stalling the decisions.

Finally, the third pillar, the European Deposit Insurance Scheme (EDIS), is simply missing. The creation of the EDIS would assure that all depositors receive the amounts guaranteed by the European Directive with no need to use taxpayers' money (and without affecting the sovereign).

It is not necessary to reinvent the wheel. The most effective tools to address sovereign-bank nexus are already defined: they are included in the BU's architecture and just have to be completely implemented. If we can complete the BU and work towards the creation of a European safe asset, to allow banks to reduce their balance sheets' exposure to sovereign debt, there simply won´t be any doom loop anymore.



Andreas Dombret

Global Senior Advisor,
Oliver Wyman

A European Safe Asset: don't put one step before the other

The sovereign-bank nexus has been at the core of nearly all economic and financial crises in modern times[1]. The same households and businesses that borrow from banks are paying taxes to finance the state. Banks hold sovereign paper for liquidity and investment purposes, and in smaller countries play an important role in keeping public debt markets liquid. It will therefore never be possible to "solve" the nexus by eliminating it. However, it can be damped.

Capital requirements and loss absorbency (MREL) for banks have increased markedly, and with the BBRD a comprehensive resolution toolset has been created. With the Single Resolution Board and Fund, now backstopped by the ESM, the necessary institutional landscape has been established, also allowing Euro countries to combine their firepower.

Still not solved is the effect distressed sovereigns have on their banks, which could suffer losses on public debt they hold, and whose funding costs depend on "their" sovereign. Safe or "risk-free" assets are underpinning many financial products, liquidity rules require banks to hold HQLA, which they often do with a "home bias". Despite sovereign yields across the Eurozone having converged also as result of ECB's purchasing programs, lower-rated sovereign debt remains a welcome profit source in today's "low for long" environment.

The fragmentation of the Euro system's sovereign debt market adds to other hurdles for banks' cross-border business models, for example limiting the use of Dutch deposits to fund Italian loans. Further consolidation in the banking union requires diversification. For sovereign holdings, concentration risk must be reduced, similar to long-standing practice for large exposures to private sector creditors. Differentiated risk-weights and concentration limits on sovereign exposures are thus needed to prevent banks from overexposing themselves to a particular country.

> *Banks, the economy and the sovereign will always remain linked to each other.*

In this context, a European Safe Asset ("ESA") has been suggested as a theoretical concept to further complete the currency union. Under the proposed approach of "ESBies"[2], investors indirectly hold a diversified basket of member state debt. However attractive, important side effects need to be considered. The volume of ESA issuance will be determined by market demand, potentially resulting in higher-grade debt such as Bunds being absorbed through ESAs, while more risky paper remained standalone and exposed even more. While ESAs could well weather idiosyncrasies in a smaller member state, a synchronized downturn or stress in a larger member state would cause ESAs threatening to destabilize the entire Eurozone, then requiring broad, untargeted monetary or fiscal support measures. This resulted in risk sharing among member states currently not foreseen in the EU Treaty. Also, market prices would be distorted and lose their signalling capability if a very large investor buys sovereign paper at a political price.

Key question is how large the ESA market will be compared to overall Euro member state public debt issuance. A smaller volume brings a welcome increase of the safe asset pool and HQLA[3]. With an increasing volume however, effective characteristics of ESAs get closer to those of "Eurobonds". A robust fiscal coordination mechanism, such as the Stability and Growth Pact, remain required in any case together with meaningful monitoring framework. A reinforced ESM would go into the right direction. Other considerations, like providing more fiscal flexibility at member state level, do not. Today, we should be aware of the risks of putting one step before the other. Policy makers should keep this in mind in waging the options of further strengthening the banking and currency union.

1. Laeven / Valencia (2018): Systemic Banking Crises Revisited.
2. Brunnermeier et al. (2016): ESBies: Safety in tranches
3. Grandia et al. (2019): Availability of high-quality liquid assets and monetary policy operations: an analysis for the euro area, ECB Occasional Paper Series.

Alexandre Birry

Global Head of Research - Financial Institutions, S&P Global Ratings

Banking-as-we-know-it won't prevail if long-lasting negative rates do

The current coronavirus pandemic poses much greater immediate challenges to financial stability than ultra-low or negative rates. The wide-ranging package of monetary policy measures implemented--which ultra-low rates are only part of--will hopefully help tackle some of the more imminent threats. But it remains true that, if prolonged, ultra-low rates can affect financial stability. In a European context, once the situation normalizes, durably low rates could upend the financial intermediation model. The role of banks would change as a result, and so would that of capital markets and supervisors. Ultra-low rates and flat yield curves question banks' traditional -and oft fundamental- maturity transformation profitability model.

Borrowing short-term to lend long-term doesn't pay for itself the way it used to. Assuming this monetary backdrop is here to stay, banks will have to continue to adjust their business models. One likely consequence is that banks will generally need more scale. Not just in terms of size, but also breadth of activities. This would allow banks to reduce their dependence on balance sheet intensive products such as deposits and loans.

Instead, they may develop alternatives such as asset management or other forms of off-balance sheet financial intermediation, putting stakeholders with excess savings in direct contact with stakeholders in need of funding for instance. In the context of durably slower economic growth, economies of scale are likely to remain key to banks' business model sustainability, as further cost discipline is required to buffer pressured earnings and meet shareholders' expectations.

Scale will also allow banks to invest in the technology required to meet customers' evolving expectations. What does it mean in terms of financial stability? One consequence of greater scale and consolidation is the possible emergence of even more systemic institutions. As banks become larger and more diversified to adapt to the environment, their complexity and respective importance to the local economy increase.

Against this backdrop, further progress with bank resolution--which is still very much work-in-progress-will be key to avoiding a worsening of the sovereign-bank feedback loop. Another consequence is the need for effective European capital markets, if banks' role is increasingly to facilitate direct financial intermediation. The success of the Capital Markets Union (CMU) project will therefore be critical. In addition to alternative revenue streams, CMU (including deeper securitisation markets) also offers opportunities for banks to manage their capital and credit risk more effectively. Also, lower-for-longer interest rates could reinforce the reliance of the European economy on debt. The strong preference of European corporates for loan and debt financing instead of equity financing is likely to continue unless the CMU becomes reality.

A third, related, consequence could be the acceptance that banks' role in mutualizing credit and market risks will be diminished to the extent that non-bank private sector stakeholders (eg. pension funds, insurance company, households) increasingly assume these risks directly. This would ultimately reshape the distribution of losses during crises.

> *Low-for-long can help fund transitions that are critical to the long-term stability of the financial system in Europe.*

As a result, supervisors' role as well will likely continue to evolve. As part of the risks of the financial system migrate outside the banking system, the remit of supervisors broadens. This comes on top of the need for greater use of macro-prudential tools as durably low rates typically inflate asset prices and risk appetite in the absence of a crisis.

That said, low-for-long can help fund transitions that are critical to the long-term stability of the financial system in Europe; first, the transition to greater resolvability, by allowing banks to issue at low cost substantial amounts of loss-absorbing instruments and meet TLAC and MREL requirements. Second, substantial amounts of funding are required to finance the energy transition to mitigate climate risk. Low-for-long can make this transition more affordable, and offers banks some much-needed growth relays in an otherwise low-growth environment. ●

Costs and risks of not achieving the Banking Union

Irene Tinagli

MEP, Chair of the Committee on Economic and Monetary Affairs, European Parliament

The cost of not achieving the Banking Union

The COVID-19 crisis and its devastating health, economic and social consequences have overshadowed all discussion about the future evolution of the banking union. Yet it was in recent weeks that we realized once more how important is this project, even though it is still incomplete. SSM and EBA have taken various initiatives to indicate a common path for the whole jurisdiction, thus avoiding that national measures end up fragmenting the European banking and financial system. However, this crisis will most likely show how the lack of determination in completing the Banking Union in accordance with the agreed timelines will seriously jeopardised its key benefits. Today the Banking Union means that supervisory and resolution decisions are mostly European, whilst the ultimate guarantor of financial stability remains national, with limited tools to act. This asymmetry might have serious consequences in future possible banking crisis cases, in which decisions will ultimately be redirected to Member States. Few things can be more destructive to citizens' trust in the European Institutions than threats to financial stability, perceived as risking their savings.

The completion of Banking Union is in many aspects a way to restore European citizens' confidence in the European institutions, build the necessary trust between Member States and address the rise of Euroscepticism. With the benefit of almost eight years of hindsight, it is now clear that several links and stabilising elements are missing in the Banking Union. These need to be urgently tackled.

At the top of the list, there is of course a common deposit protection system. As the ECB has shown in a study on the Commission proposal, with proper risk-based banks' contributions, an almost negligible cross-border subsidisation occurs. The fear that this kind of mechanism could imply significant transfers across countries in case of a new banking crisis is therefore unjustified.

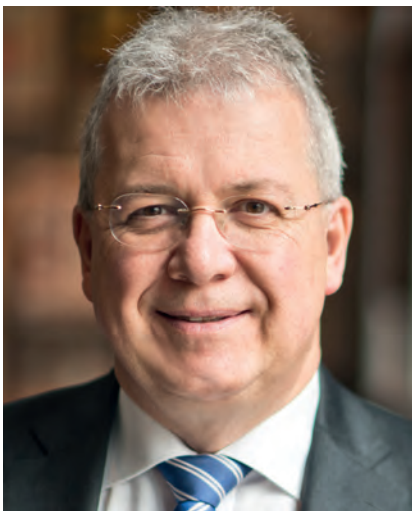
The delay in the set up a common deposit protection system has consequences also in the realization of other steps in the field of banking union. One of these is definitely the harmonisation of EU banks' liquidation regimes. First of all, because without EDIS the asymmetric social and economic impact ensuing from the failure of a bank with systemic relevance at local level would remain. Secondly, because in case of failure of a cross-border systemic relevant bank, the national DGSs would have to reimburse depositors in the subsidiary established in their respective jurisdiction, even though they are neither supervising nor resolving/liquidating the parent company. This problem risks of calling into question the single point of entry/multiple point of entry resolution model, to further strengthening of the supervisory powers of the host national competent authorities, and to make the introduction of capital and liquidity waivers extremely difficult.

> *Today, BU means that supervisory and resolution decisions are mostly European whilst the ultimate guarantor of financial stability remains national.*

Additionally, the entry into force of the BRRD has meant that, as of today, many institutions would only be deemed resolvable if bail-in would be extended to the level of senior debt or even deposits. This, in turn, has had destabilising effects, by amplifying the incentives for a bank run at the earliest sign of distress. Although this problem has been recently addressed with the BRRD review, it is simply not realistic to expect that compliance with Minimum Requirements for own funds and Eligible Liabilities can be achieved by all credit institutions in a very short time frame – especially given the current and future situation in the financial markets due to the COVID-19 ▶

crisis - without seriously aggravating their financing costs and profitability. Therefore, resolution authorities need to be able to rely on alternative sources to support resolution actions, such as resolution funds, especially in the current period of transition during which loss-absorbing capacity is not yet fully available.

I truly hope that the challenges brought about by the COVID-19 crisis will help us get out from the risk reduction versus risk sharing debate, to get back to overall objectives of the Banking Union and to move closer to the finish line that was agreed many years ago.



Markus Ferber

MEP, Committee on Economic and Monetary Affairs, European Parliament

A Banking Union for a stronger Europe

For a successful European economy that can tackle the challenges of the 21st century, such as digitisation and the transition towards a less carbon-intensive growth model, substantial investments will be needed - by the public sector as well as by the private sector. Those investments require financing via capital markets and bank lending alike. Well-functioning and competitive capital markets and European banks as well as a Single Market for banking and financial services are a prerequisite for that. Arguably, such a Single Market must contain a Banking Union and in turn banking groups that are truly active across the entire Single Market.

Over the past couple of years, we have made quite some progress towards that goal: We have established a single rulebook, effective supervisors such as the European Banking Authority and the Single Supervisory Committee, have set up a resolution regime and agreed on high standards for deposit protection. This already sets an effective framework for the Banking Union, but we also need to acknowledge that European markets are still somewhat fragmented and that the Banking Union is not yet complete.

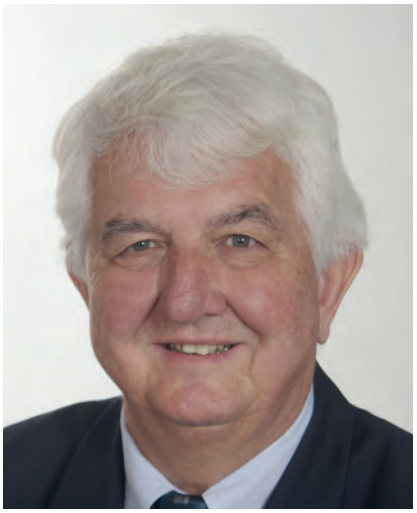
So what could the next steps towards the completion of the Banking Union look like? To put it quite clearly, a fully mutualised EDIS is not a prerequisite for the completion of the Banking Union. Having high common standards for deposit protection as well as certain safeguards in place however is important. These objectives can also be achieved by a reinsurance scheme that provides liquidity between national systems in times of crisis. Other than being the logical evolutionary step, a reinsurance scheme seems to be more viable politically in both the Council and the Parliament as well.

In order to allow for an informed, fact-based and sensible discussion about the way forward, the Commission would be well-advised to finally adopt its implementation report of the existing Deposit Guarantee Scheme Directive that was already due in summer of 2019. A thorough assessment of the status quo of the implementation that also identifies possible problem areas could lift the discussion on more solid ground.

At the same time, risk reduction measures in the banking system should continue. A framework that would facilitate selling and buying of non-performing loans on secondary markets is still missing, which prevents banks from cleaning up their balance sheets. Progress on that front is therefore urgently needed. The same goes for the issue of the regulatory treatment of sovereign exposures. As long as sovereign bonds are treated as essentially risk-free assets, the doom loop of failing banks and failing states cannot be effectively broken.

There are other elements that are holding back the Banking Union though: the lack of a harmonised bank insolvency framework poses challenges for the Banking Union in general and the resolution regime in particular. After all, the resolution regime works on the basis of the "no creditor worse off" principle, which uses the respective national insolvency regime as a reference point. As long as there is no progress with regards to the harmonisation of insolvency law, we will not be able to get rid of the inconsistencies in the resolution regime.

An established Banking Union should make cross-border activity easier for all banks. Increased cross-border activity should therefore allow European banks to grow inside the Single Market and benefit from economies of scale thus improving their competitiveness on a global level. Internationally competitive European banks are in turn an important factor for an export-focussed model of economic growth and therefore for the competitiveness of the European economy as a whole. Therefore, there is much to win if we get the Banking Union right.



Robert Holzmann

Governor, Oesterreichische Nationalbank

What are the costs and risks of a delayed compared to a half-baked completion of the Banking Union?

Against the background of the current coronavirus pandemic and its economic impact the importance of joint initiatives to complete the Banking Union in a sensible manner is once again highlighted.

In response to the economic and financial crisis of 2008 the European Commission initiated the project of creating a three pillared Banking Union back in 2012 in order to reinforce financial stability by reducing financial fragmentation and by breaking the link between banks and their national sovereigns.

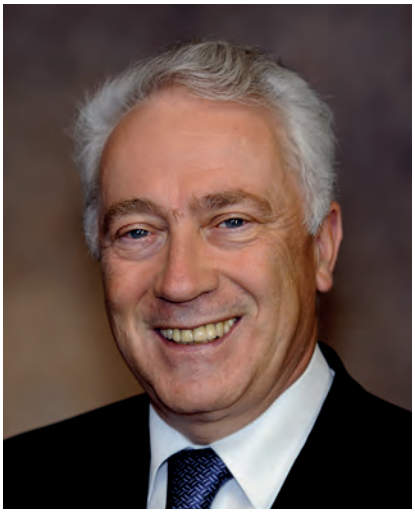
While it was possible to achieve progress on the first two pillars in a relatively short period of time with the establishment of the SSM in 2014 and the operationalization of the SRM in 2016, the finalization of the third Pillar – EDIS – is still in the making. Despite progress in the Banking Union, fragmentation is still a defining feature of the EU banking market. Fragmentation certainly has commercial motives - depressed bank valuations, the declining value of banks' retail franchises and many IT legacy issues discourage consolidation within and across borders. Even more so, policy makers have to contribute their part in completing the banking union. At this juncture, it must be understood however, that both inaction with respect to the completion of the Banking Union, as well as "face saving" half-baked compromises in this regard can entail risks and costs for the Euro area.

Let us turn to the costs of a delayed completion of the Banking Union first. In a truly integrated banking market banks would face a single set of rules and the free flow of capital and liquidity would contribute to lower costs of financial intermediation. This would in turn embolden the ability and willingness of banks to expand across borders and reap optimal returns to scale, thereby increasing the capacity of the system to absorb shocks and supporting banks' profitability. Given that European companies, in particular the large SME sector, rely heavily on bank lending to finance investment and working capital this clearly also has macroeconomic implications.

This brings us to the risks of completing the Banking Union in a way that is unfit to address the underlying challenges. These challenges relate to ensuring the right balance between home and host supervisors, achieving swift further risk reduction and breaking the bank sovereign nexus. What could go wrong? Consider cross border banking groups, whose intragroup capital and liquidity cannot flow freely today. Allowing capital and liquidity requirements to be waived could create significant externalities, as the current ring fencing comes for a specific reason - banks are still "global in life" but "national in death". Risk reduction is another case in point. If we fail to implement the right incentives to ensure a lasting effect of risk reduction on banks' balance sheets, risk sharing could prove to be the bedrock for future risk taking. A similar argument could be made with respect to EDIS. The lack of progress on EDIS is grounded on the fact that the level of riskiness differs across countries' banking systems, as does the extent to which banks finance their own sovereign.

All this shows that any solution that does not tackle the afore mentioned issues will lead to a clearly suboptimal completion of the Banking Union. The current situation caused by the coronavirus underlines the necessity of finding a coordinated answer to this problem. The immediate focus has to be on enabling the banking and financial systems to fulfil their vital role in financing the real economy also in turbulent times. Once the corona crisis has gone by, we however will have to put in place a number of requirements in order to allow an integrated functioning of banking groups while at the same time addressing legitimate concerns of home and host authorities. Banks should continue their pre-coronavirus activities to address pockets of vulnerability, build up loss-absorbing capacity and reduce undue concentration in sovereign exposures. Member States and public sector authorities should establish and enforce credible liquidation regimes for banks with predictable and fair outcomes for creditors at the different levels within a banking group. They should also introduce a last resort fiscally neutral liquidity provision mechanism for bank resolutions, enhance depositor protection in all Member States through the staggered introduction of EDIS and smooth differences in the legal practice of corporate and private insolvencies thus facilitating recoveries. In addition, alternatives to internal MREL within banking groups, e.g., cross-border guarantees based on EU law, could be explored. Progress on all these areas is interdependent.

To conclude, we need to complete the Banking Union and we need to do this in the right way. As the impact of the corona crisis teaches us, taking coordinated action and finding a common European answer is key in this regard. Otherwise financial market fragmentation in the EU will persist leading to higher costs for financial intermediation, limiting the free flow of capital and liquidity across borders, ultimately affecting economic growth and missing out on reaping the benefits of a truly single market. But we also have to take into account, that there are underlying reasons for the currently existing fragmentation in the European banking market, which need to be tackled. ●



Carlos da Silva Costa

Governor, Banco de Portugal

Safeguarding financial stability at local level within the Banking Union

Whilst we must not underestimate the remarkable progress achieved in recent years, we should acknowledge that Europe's financial architecture still needs to be completed and strengthened. Without a pan-European banking system, EDIS, and adequate resolution and liquidation mechanisms, financial crises tend to be local. The responsibility of ensuring financial stability and depositors' confidence lies with individual sovereigns, which have limited instruments and room for intervention. As we stand, effective risk-sharing mechanisms have not been put in place. The sovereign-bank doom loop – the trigger for creating the Banking Union – persists. Indeed, supervisory and resolution decisions are mostly European, whereas the ultimate guarantor of financial stability remains national: banks are European in life but remain national in death, creating a mismatch between control and liability.

As it is clear now, not all countries were ready to implement the Bank Recovery and Resolution Directive (BRRD) as scheduled. This implied that over recent years, some countries have had to resort to alternative instruments to safeguard financial stability – these decisions were met with outcry and criticism as they were perceived as attempts to circumvent the existing rules. It could be argued that the current setup made bank liquidations an easy way out for European authorities as the ensuing financial and political costs lie with national authorities. It should not be forgotten that few things can be more destructive to public trust in European institutions than threats to financial stability. In this regard, the conclusions reached by Denmark and Sweden on the (public) analysis of their possible participation in the Banking Union deserve careful consideration by having clearly identified the risk of conflict arising between the local objectives of financial stability and in the Banking Union as a whole.

Against this background, the harmonisation of EU banks' liquidation regimes has been heralded as one way forward. However, in the absence of an appropriate legal framework, liquidation might imply the immediate interruption of lending support, as well as the suspension of payments; it may have disruptive effects for creditors, depositors and other stakeholders, ultimately reinforcing the sovereign-bank doom loop.

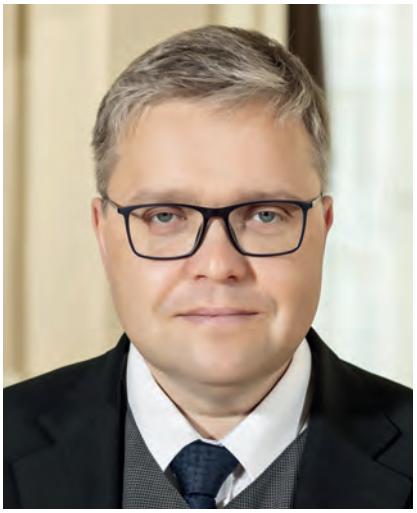
Instead of moving immediately towards such harmonisation, efforts must be made to establish an enabling framework for the orderly management of failing banks of locally systemic importance, combining elements of the resolution and liquidation frameworks, with a view to minimising losses and protecting depositors and non-financial borrowers. Such an enabling framework should include the definition of high-level principles to be agreed by all Member States for application at national level. For those banks assessed as not having (European) public interest, room for manoeuvre should be available in view of national preferences.

> *...few things can be more destructive to public trust in European institutions than threats to financial stability.*

Recourse to alternative measures as foreseen in the Directive on Deposit Guarantee Schemes or to public funds, as an ultimate backstop, should be considered in this regard. It also goes without saying that further stabilisation mechanisms – a fully-fledged EDIS, the provision of liquidity in resolution, a common euro area safe asset – and addressing home-host tensions are also needed and urgent.

This is even more so, as pressure for consolidation to increase profitability and efficiency of the European banking sector is increasing, and raises the question of how to reconcile further integration with safeguarding financial stability at local level in the current incomplete and imperfect set up.

On the one hand, supervisors and regulators should provide a stable view of the supervisory and regulatory frameworks allowing market participants to make informed decisions. On the other hand, without risk sharing and pan-European banks, sovereigns need to find the means to protect competition in their local markets and to safeguard the flow of funding to the economy when branches and subsidiaries of foreign banks exit during a downturn (as observed during the previous crisis).Summing up, decisive political will to move forward with the completion of the Banking Union is required. As the impacts of the coronavirus reverberate, this must now also be a priority for policy-makers and relevant institutions. Failure to do so can call the future of the European project into question. ●



Vitas Vasiliauskas

Chairman of the Board, Bank of Lithuania

Completion of the Banking Union calls for a comprehensive approach

Completing the banking union should remain a key priority on the European agenda. Reaching this goal would help mitigate the sovereign-bank loop, facilitate enhanced competition via expansion of cross-border banking and create additional channels for private risk sharing across the euro area. However, developing the banking union should not come at the expense of the financial stability of individual jurisdictions.

Efforts to finalise the banking union depend on solving a number of complex issues. These include creating a fully-fledged European Deposit Insurance Scheme (EDIS), dealing with some of the inherent inefficiencies in the current regulatory framework and enhancing the crisis management toolkit. In this respect, completion of the banking union should be pursued in a comprehensive manner and feature a package approach.

Some argue that in order to achieve a breakthrough in facilitating the expansion of banking activities across jurisdictions we need to introduce cross-border capital waivers. It is true that ring-fencing practices may to some extent be viewed as hindering the deepening of a single market for financial services. Yet, we also have to recognise that relaxing prudential regulation requirements in the current setting of an incomplete banking union causes financial stability concerns for host jurisdictions. With no EDIS in place, it remains primarily the responsibility of national deposit guarantee schemes to bear the financial burden if a subsidiary fails. Therefore, we need to ensure that facilitating the expansion of cross-border banking does not result in negative consequences for the financial stability of individual jurisdictions.

Against this background, any move towards establishing a mechanism for cross-border capital waivers should be accompanied by implementing adequate safeguards to credibly address the concerns of the host jurisdictions. A possible way forward could be to ensure that subsidiaries eligible for the waiver do not exceed a certain threshold, at the very least the threshold for significance set out in the Single Supervisory Mechanism Regulation. Additionally, the waiver should not be absolute and should have a built-in floor (e.g. 75%), which would in practice limit the reduction of capital held by the subsidiary.

Yet, even implementing the appropriate safeguards will not suffice to fully address the underlying financial stability concerns. This requires a return to the very fundamentals of the banking union's architecture - that is, finally putting in place its third pillar. A fully-fledged common deposit insurance scheme is essential to ensure that measures to enhance cross-border activities do not reduce the overall resilience of the euro area financial system. Ensuring that depositor protection is independent of a bank's establishment location would weaken the link between banks and national sovereigns, while at the same time providing a strong impetus for the expansion of pan-European banking.

> *Developing the Banking Union is key, but it should not come at the expense of the financial stability of individual jurisdictions.*

Furthermore, in order to enhance the financial stability of the single currency area, the current crisis management framework needs to be reinforced. Agreement on creating a common backstop to the Single Resolution Fund represents an important step in the right direction. Nevertheless, it may still not fully address the liquidity needs of a large bank or in the event of a systemic crisis. Therefore, liquidity in resolution remains an important open issue in the current crisis management framework and deserves policymakers' robust attention.

On a broader note, the expansion of cross-border banking in the European Union largely depends on eliminating the existing non-prudential barriers. These include primarily divergent national insolvency and taxation regimes. Without a higher level of harmonisation in these domains, we will still fall short of reaching a truly integrated European banking market.

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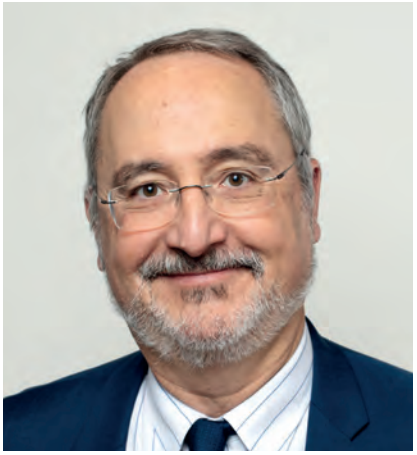
Banking Union home-host dilemma



Edouard Fernandez-Bollo

Member of the Supervisory Board, European Central Bank (ECB)

Banking Union beyond home and host

Almost six years after the establishment of European banking supervision, we still hear people talking about "home" and "host" jurisdictions and authorities within the banking union. This distinction certainly does not match the reality of shared decision-making and responsibilities within the Single Supervisory Mechanism. It does, however, reflect the continued existence of specific features in national markets, and to some extent also the regulatory framework, which continues to allow for national ring-fencing policies.

The current situation is economically and politically sub-optimal. In economic terms, ring-fencing measures hinder the efficient allocation of capital and liquidity within banking groups. They prevent European banks from fully benefiting from economies of scale and the diversification of risks within the banking union. In political terms, ring-fencing measures reflect insufficient trust between Member States stemming from past experience. Thus, any serious attempt to break the current deadlock has to start by acknowledging the legitimate arguments and concerns on all sides. While closer cross-border banking integration could bring significant benefits, it should not come at the expense of local financial stability.

Achieving the right balance may require some targeted legislative amendments to provide sufficient safeguards that the parent will provide financial support in the event that the financial situation of a subsidiary deteriorates. This may take the form of enhancing the framework for intra-group financial support agreements. However, private sector actors should not wait for public authorities to act on this front, but should make use of all the opportunities available within the current regulatory framework and discuss with supervisors how best to enhance confidence in intra-group support.

Differences in national bank insolvency regimes across the EU represent another potential obstacle to the smooth functioning of the banking union. While it seems unlikely that national insolvency frameworks will be fully harmonised in the medium term, certain targeted improvements may be feasible, for example as regards the treatment of creditors in the insolvency hierarchy. A key principle of the Bank Recovery and Resolution Directive (BRRD) is that no creditor should incur greater losses in resolution than it would have done under normal insolvency proceedings (known as the "no creditor worse off", or NCWO, principle). However, in the absence of a harmonised regime for creditor hierarchies, the NCWO principle would result in different outcomes across the banking union in the event of a cross-border group being resolved.

Another source of uncertainty relates to the situation that arises when a bank is deemed failing or likely to fail but does not enter resolution. The laws determining what happens in such cases currently differ from country to country, and this divergence needs to be addressed. Concretely, the concept of "orderly winding-up", cited in Article 32(b) of the revised BRRD, could be made more precise in order to ensure that national implementation results in a more harmonised treatment of failing banks across the banking union. There may also be a case for further clarification on the links between a failing or likely to fail decision (in the event of non-resolution), the reimbursement of deposits and the withdrawal of the banking licence. Progress on all of these fronts would allow us to move to a banking union in which a distinction no longer needs to be made between "home" and "host". ●

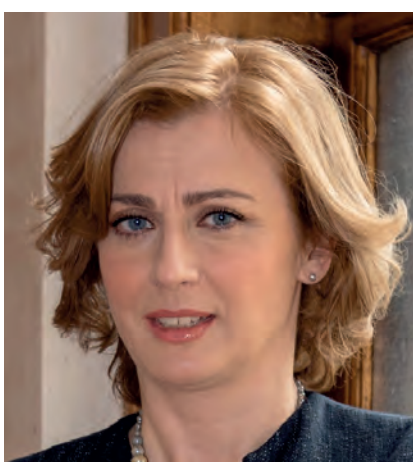
Martina Drvar

Vice Governor, Croatian National Bank

Material matters: parent institutions and home supervisors attention needed

Local materiality (for example, the largest bank in Croatia presents only 2% of its parent's balance sheet) requires parents to enforce (i) adequate compliance check of the group governance and risk management policies through adequately scoped internal audit visits and home supervisors to support (ii) sufficiently granular recovery plans and (iii) frequent on-site inspections. Home supervisors need reassurance that highly centralized banking activities at the consolidated group level will ensure stress less provision of service for local economy.

Authorization of supervised activities rather than authorization of supervised legal entities could endorse branchification, lowering the regulatory burden for banks and contributing to more efficient ▶

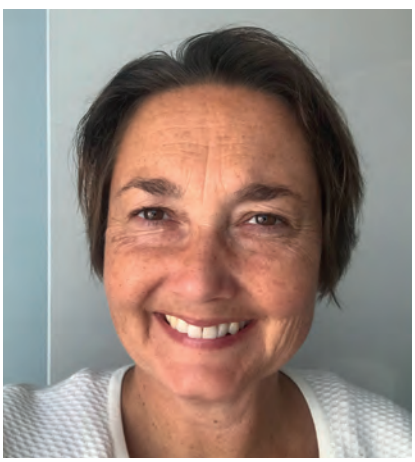


financial servicing of European citizens. High-level standards for (i) intragroup transactions and (ii) key functions insourcing activities strengthen and secure the level of group integrations. Home supervisors should run regularly recovery plans' dry runs at the solo level of locally important banks, OSIIs, to confirm credibility of recovery options, while their on-site inspections should be tailor-made to tackle also local material issues. This will increase oversight visibility of parent institution and home supervisors at the level of OSIIs.

With the confidence in high-quality organization of banking activities established at the consolidated level and appropriate level of host supervisory attention, there would be less need for ring fencing against potential liquidity and solvency problems of the European banking groups. In the banking union space, even if there will be consensus around EDIS in the near future, the other two pillars have to improve further with the help of regulatory initiatives. SSM's supervisory practice remains challenged by the absence of accounting powers and implementation of national options and discretions (NOD).

Accounting powers would provide SSM with ability to shorten the time lag in certain jurisdictions for recognition of adequate provisioning of NPLs and collateral evaluations, important for aligned resolution interventions, while NOD need to be exercised at the level of the ECB as single rule maker (the most relevant example is limiting intragroup exposures at national level). SRM on the other hand, aiming to create effective resolution plans, could increase the level of parent institutions' ability to display their preparedness and contractual readiness to support their activity regardless of different European jurisdictions and distress conditions through the high-quality and highly operational recovery plans.

This better alignment of those attention levels directed and delivered from the both parent' and home supervisors' level would definitively improve the integration of banking in the EU. ●



Maria Stolpe

Head of Group Public Affairs, Nordea

Trust in the Single Market

Nordea is the leading bank in the 10th largest economy in the World - the Nordics. We are active in four small, liberal market economies, each with its different characteristics. Finland is in the Banking Union, Denmark and Sweden are in the EU but outside of the Banking Union, and Norway is outside of the EU but a part of the EU Single Market.

Since the beginning of the creation of Nordea twenty years ago, the vision was to create one Nordic bank, One Nordea. But despite the EU efforts to create a truly single market in Europe, operating as a cross border bank was difficult with the combination of an integrated cross-border operating model and national legal entities. Nordea saw a need for structural changes to achieve One Nordea business and operating model, improve resolvability, simplify implementation of new EU regulation, and simplify governance.

Consequently, Nordea made two major changes to its legal structure: in 2017 the group merged its primary banking subsidiaries into one, creating significant branches in other Nordic countries and in 2018 the bank re-domiciled to Finland, moving into the Banking Union.

You could say that Nordea has done all in its power to structurally transform into the "perfect" cross-border EU bank. Has the regulatory side of the equation delivered at the operational level?

The simplified structure has indeed strengthened the drive for scale advantages and common processes and systems. The resolvability is improved; resolution entities now coincide with critical entities in the operating model - reducing authorities' execution risk. In principle, Nordea, including the branches in the Nordic home markets, is now subject to one set of regulation, incl. one ICAAP process, one SREP process, and the need for a unified legal structure continues to be relevant with additional regulation coming into force.

However, as the EU single rule book is still incomplete, the expected regulatory advantages has not come to fruition.

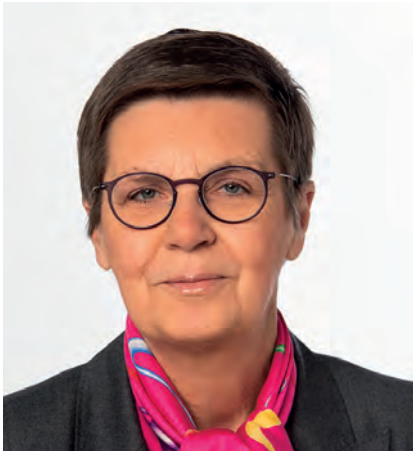
To function as a universal bank, Nordea must operate branches as well as subsidiaries across the four Nordic countries. Therefore, the operating model is susceptible to divergence in regulatory definitions, and regulatory changes to accounting definitions. Examples incl. differences in definition of default, which has implications for credit risk modelling, and differences in IFRS9 implementation. Meanwhile, macroprudential requirements are still not harmonised, distorting the level playing field in capital and operations, and regulatory guidance on structure of branch supervision is vague. This reflects issues in prudential supervision, while the less harmonized legislation relating to conduct and compliance create even further issues.

> *Nordea has done all in its power to structurally transform into the "perfect" cross-border EU bank.*

Experience shows that the many supervisory discretions distort the single market and prevents cross-border banks from being fully efficient, also in a branch structure. Even in the Nordics, where regulators have a history of mutual trust, cooperation and coordination, perhaps more so than in any other place in Europe, deviation in local practises and duplication of safeguards fundamentally hampers further integration.

This must be overcome to better enable cross-border banking in the EU. ●

EU bank resolution framework



Elke König

Chair, Single Resolution Board (SRB)

A centralized administrative liquidation tool for banks

This year marks the SRB's fifth anniversary – an appropriate time to reflect on how the crisis management framework has worked so far and consider areas for improvement.

The public interest assessment (PIA) – i.e. the evaluation of whether a bank may be wound up under national insolvency proceedings or should be resolved to maintain its critical functions and protect financial stability – has triggered a lively debate. These criteria are laid down in the SRM Regulation and the SRB has published its policy on its website[1]. In a nutshell: resolution is for the few, not the many. For smaller, less significant banks, insolvency will be the procedure at play if and when they fail.

Our experience to date has laid bare the need to find a solution for those medium-sized banks that are too "small" to meet the PIA, but possibly too "large" to be placed in insolvency. The SRB has been clear[2] that the harmonization of insolvency regimes for banks is a necessary end-goal. However, it is unlikely to be achieved in the short-term. The creation of a centralized administrative liquidation tool may be more feasible in the short-medium term, and would address many of the issues identified for medium-sized banks, with insolvency tools remaining available for smaller banks.

Such a liquidation tool could be created by amending the BRRD, SRMR and DGSD, and could provide for the powers to transfer (some) assets and liabilities in an orderly liquidation, much in line with current resolution tools. In the Banking Union, this could be entrusted to a central authority. As a first step, the SRB's toolbox could be enriched with a "pre-liquidation tool", allowing the application of resolution tools to save the good part of a bank without entering into liquidation, or without requiring a specific liquidation regime at European level.

The FDIC is a useful comparison, as it highlights the advantages of the purchase and assumption tool (P&A) for liquidation, which was used for the majority of US bank failures in the last decade. The FDIC's experience also shows the benefits of having a centralized authority with harmonized resolution and insolvency procedures, P&A tools and Deposit Guarantee competences.

By contrast, in the current patchwork of DGSs operating in the Banking Union, only some allow transfers of deposits as "alternative measures" to pay-outs, raising challenges around arbitrage, level-playing field and coordination. A centralized authority could enhance coordination across DGSs and enable a more effective management of bank failures. As the US experience shows, the use of transfer tools could reduce the cost of failure and overall impact on the DGS system.

Finally, it would help reduce moral hazard, by removing the need for Member States to provide liquidation aid, thereby better protecting taxpayers' money. This does not come free. However, based on adequate capital levels and clear rules, authorities should be able to find solutions early enough to secure functions that are critical to the franchise and minimize losses.

A centralized liquidation regime in the EU would address the current gap in the framework for medium-sized banks and improve the overall system: a further step towards the completion of the Banking Union that policymakers ought to explore further. ●

1. https://srb.europa.eu/sites/srbsite/files/2019-06-28_draft_pia_paper_v12.pdf
2. https://srb.europa.eu/en/node/622

Martin Merlin

Director, Banks, Insurance and Financial Crime, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Towards a more effective crisis management and completion of the Banking Union

In the face of the unprecedented COVID-19 pandemic, affecting all economic sectors, the European institutions and agencies intensively coordinate with Member States to ensure adequate crisis management and to prepare for the recovery of the European economy. The exact extent of the economic consequences of this crisis (and the second-round effects on the banking sector) are still unknown but the post-financial crisis framework puts us in better position to withstand the test. Yet, the need to complete Banking Union is more acute than before.

At political level, there is a broad consensus about the need to improve the bank crisis management framework to increase ▶

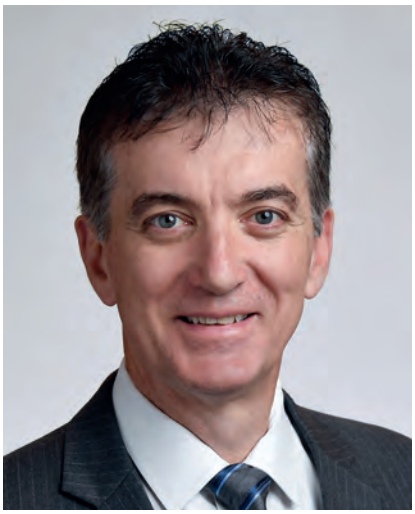
its efficiency, have appropriate common safety nets, preserve financial stability and as a result facilitate further cross-border integration.

> *A coherent approach to crisis management might facilitate progress towards completing Banking Union.*

The Commission will continue to engage with Member States to bring about a consistent framework, which can rely on effective tools and appropriate funding catering for the failures of all banks, irrespective of their size and business model and whether the failure is managed in resolution or insolvency.

To ensure a consistent treatment of banks and creditors, several issues will require careful examination. These include namely the conditions and the procedure to grant precautionary recapitalisation, the interaction between resolution and insolvency procedure, the role of deposit guarantee schemes and the application of the public interest test.

A more coherent approach to crisis management might facilitate progress towards completing Banking Union and achieving a common deposit insurance scheme. A comprehensive, robust and well-functioning Banking Union should be at the core of a resilient European Monetary Union and is essential to strengthen the international role of the euro and, more generally, the European Union's economic sovereignty. It will also be necessary to ensure solidarity across the EU and to support economic recovery following the current crisis. ●



Dino Kos

Chief Regulatory Officer,
CLS Bank International

Resolution regimes: There is progress, but more needs to be done

After the 2008 global financial crisis, policymakers focused on implementing and enhancing resolution regimes governing global systemically important banks ("G-SIBs"). The objective was to prevent two untenable outcomes: a taxpayer-funded bailout; or a Lehman-style bankruptcy. Much progress has been made in various ways, including changes in legislation and the development of resolution plans. While some policymakers assert that G-SIBs can now be safely resolved, others find more work is needed. A key resolution objective is to ensure the bank in resolution can retain access to systemically important financial market infrastructures ("FMIs") such as CLS, which is the primary settlement service for the global FX market and settles a daily average of USD5.5 trillion in payments. Because of the credit and liquidity benefits CLS provides, a G-SIB in resolution losing access to CLS would likely adversely impact the resolution's success.

Fortunately, resolution of a G-SIB is designed to be a rare occurrence under these new regimes. So how can the robustness of such regimes be tested? One way is through a well-designed "war game" that tests key aspects of a resolution scenario. CLS recently conducted a war game based on the resolution of a hypothetical G-SIB. The scenario benefited from the participation of many CLS members and input from central banks and certain resolution authorities.

While the war game confirmed progress in some areas, it also revealed shortcomings and potential impediments to resolvability that merit attention, including:

- Multicurrency liquidity challenges – Nostro agents of a bank in resolution are less likely to fund on that bank's behalf in the relevant currencies without prefunding or collateral. Despite G-SIBs' extensive international activities, there continues to be an overwhelming focus on ensuring sufficient liquidity in the home currency during a bank resolution, with less consideration as to how to ensure funding in relevant foreign currencies. Per the Financial Stability Board's June 2018 Funding Strategy Elements of an Implementable Resolution Plan, resolution plans should address how funding obligations in all relevant currencies will be met, including any potential shortfalls. This may be challenging over a resolution weekend.
- Procyclicality concerns – The majority of market participants are still likely to have procyclical responses (e.g., significantly reducing or effectively eliminating credit limits) to a bank's entry into resolution, which may jeopardize the resolution's success. In addition, authorities' use of "moral suasion" on market participants in order to bolster confidence in the resolution may not be as effective as expected.

> *Testing exercise reveals shortcomings and potential impediments to resolvability that merit attention.*

- Enhancing communications – Timely and effective communication is critical to fostering market confidence in a resolution, especially from the resolution authority and central banks. For example, the hypothetical G-SIB's nostro agents indicated their desire for information from their own regulators regarding the resolution. Communication plans and information-sharing arrangements (e.g., crisis management groups) should consider how to address these needs.

Successfully addressing these issues will require coordinated, proactive efforts across a variety of stakeholders. ●

Mark Venus

Head of Recovery and Resolution Planning, BNP Paribas

Liquidity in Resolution: the case for constructive certainty

For centuries, the doctrine of 'constructive ambiguity' played a key role in central banks' approach to failing banks. Uncertainty as to whether the liquidity lifeboat would arrive was felt to discourage reckless skippers at the helm of banks from sailing too close to the wind, or indeed to the rocks.

But the rules of navigation have now changed.

Banks are now equipped with double hulls, in the form of enhanced capital requirements and behind that an additional protective sheet of MREL or TLAC to give them the ability to recapitalise. They are like self-righting boats. To assist, we have built repair dockyards, in the form of resolution authorities, with all the necessary tools : bail-in, transfer strategies, asset separation vehicles, restructuring plans.

However, we have a problem in the Eurozone. We have built a dry dock, and banks, like any other vessel after repair, need liquid(ity) in order to float properly and go back to sea.

The absence of a liquidity provider for banks in resolution is the missing piece in the Eurozone resolution framework. Banks in resolution are the archetype of the banks that Walter Bagehot (in Lombard Street: A Description of the Money Market) saw as being deserving of support by a 'lender of last resort'. They are solvent, because their losses have been absorbed and they have been recapitalised, but they may be illiquid. They are stuck in dry dock.

Why can banks in resolution be solvent but illiquid? The essential reason is information mismatch. The dockyard, or resolution authority, knows perfectly the state of the hull and that they have carried out the necessary repairs. The bank is solvent once again. But prospective passengers, or private sector liquidity providers, will have an obvious desire to see for themselves that the bank can float before they venture aboard with their cash.

This is where we need to import into the Eurozone the concept of 'constructive certainty'. The markets needs to know that there is a dependable liquidity provider to enable banks to successfully emerge from resolution. If this is the case, the probability that private sector liquidity will become available is all the higher.

Liquidity provision in resolution is not the same as liquidity provision in the run-up to resolution. That function is a far more risky proposition, from which central banks understandably shy away. The debate as to who should provide the liquidity in resolution in the Eurozone has been going on for too long, and appears to have reached deadlock. This debate was resolved in the US and UK long ago.

> *They may be illiquid, they are stuck in dry dock.*

Some confuse the provision of liquidity with the provision of capital and claim it constitutes State Aid. Others say that the ECB cannot provide liquidity because it would be incompatible with the monetary financing prohibition, and that the provision of liquidity in resolution is a government task and should be carried out by Treasury. But there is no Treasury for the Eurozone. The ESM may be the nearest thing to that, but any ESM schemes proposed to date have proved to be too cumbersome to be of practical use.

The current COVID crisis has shown that the ECB can act decisively in crisis conditions to provide liquidity to the entire banking sector. Surely it should be able to do so in response to the need to enable single banks in resolution to successfully leave dry dock, and it should say so. ●

Giles Edwards

Sector Lead, European Financial Institutions, S&P Global Ratings

Continued bank bail-outs stretch the credibility of Europe's resolution intent

Following the financial crisis, European authorities introduced resolution legislation and tightened state aid rules to ensure creditors, not taxpayers, incur most of the costs of bank failures. The handful of banks that failed since the start of 2015 do not provide a comprehensive examination of how the rules will be applied. However, while resolution tools have on occasion been used to good effect, in other cases we see that some EU governments have continued to support failing and failed banks, sometimes resorting to creative methods to adhere to the letter of the law.

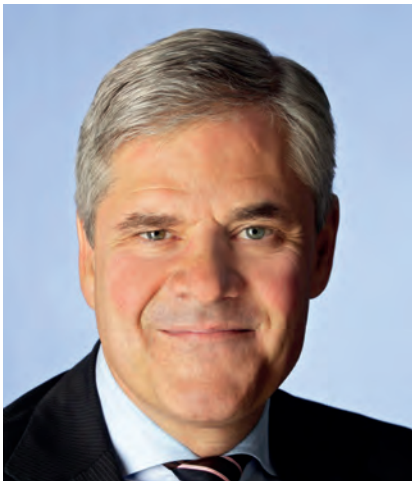
Given also that these bail-outs occurred even outside a system-wide stress scenario, it is little surprise that bank investors see considerable doubt over some European governments' commitment to this reform program. In S&P Global Ratings' view, these effective bail-outs have stretched ▶

the credibility of the EU's resolution agenda, though not yet to breaking point. While governmental and regulatory decisions remain unpredictable, the market will inevitably lack confidence in the effectiveness of the resolution process, and the scope and timing of any government support. We see four main, interconnected factors behind persistent government bail-outs:

1. There is still limited appetite to impose losses on certain senior and retail creditors.
2. Most banks are not yet resolvable. Resolvability is a multi-faceted concept, but options are heavily constrained without adequate resources to recapitalize banks and bolster liquidity while market access remains difficult.
3. The fragmented mix of regional and national decision-making within the Eurozone.
4. Some governments may see bank bail-outs as lower risk than the largely-untested resolution and orderly liquidation tools. Predictability in the use of resolution powers will increase as more banks build a sufficient layer of bail-inable debt that is subordinated to operating liabilities and deposits.

However, this step alone will be insufficient. We see also a need for:

1. Removal of some of the guesswork: expanding resolution authorities' ex-ante communications that try to guide market expectations, whether on their concept of resolution, on bail-in buffer requirements (including any unsubordinated element), and on resolution strategy for individual banks or types of banks, particularly the middle tier that would targeted neither for open bank resolution nor for liquidation.
2. Consistent rules, including a harmonized insolvency framework as this appears to be a key cause of inconsistency today.
3. Consistent actions, or at least logically inconsistent ones (since the fact-set will differ from case to case). This might be enhanced by reducing the number of decision-makers in the banking union.
4. Strong ex-post explanation of decisions around the use (or non-use) of resolution powers, subject of course to constraints arising from the inevitable legal proceedings.
5. Time. Whatever the quality of preparation, whatever the consistency of actions on smaller banks, parts of the market will still doubt regulatory intent until resolution is used for a major bank. ●



Andreas Dombret

Global Senior Advisor, Oliver Wyman

Much still needs be done!

At the time of writing, Europe is entering a Corona lockdown. The impact on our economies and the subsequent challenges for the banking system in the Eurozone are yet to emerge.

Gladly, important progress has been made since the last financial crisis. Banks, urged by the international regulators, have successfully built up absorbing capacity. A statutory resolution framework, run by dedicated authorities, is now firmly in place, and banks are progressing towards resolvability.

However, much still needs be done. Policy priorities in the Eurozone include liquidity in resolution, resolution decision-making, harmonization of insolvency regimes and a European Deposit Insurance Scheme.

Starting with liquidity in resolution: By 2023, the Single Resolution Fund is expected to have accumulated €60bn of contributions from the European banking system. This represents a big step forward but potentially will not be sufficient to fund multiple failures of significant banks. In addition the Eurogroup has designated the European Stability Mechanism, or ESM for short, as a backstop.

Until then and beyond the capacity of both schemes, temporary central bank funding remains paramount. The instrument currently in place is Emergency Liquidity Assistance, or ELA for short, where the main responsibility and risks continue to ly with the national central banks.

As a result, the ESM and the national central banks will need some involvement in resolution planning when it comes to projecting potential funding needs. A common standard on collateral eligibility for ELA would help ex-ante preparation by banks and could come with a requirement for a positive Governing Council approval of ELA instead of the current objection rule.

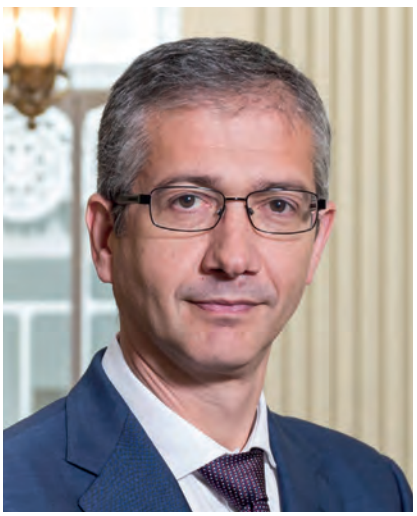
Now to decision-making for resolution. This is already a complex undertaking, involving the Council, the Commission, the Single Resolution Board, national resolution authorities as well as the European Central Bank - and it will become even more complex with the ESM Board of Directors and several national central banks. I find it worthwhile and quite important to reflect on this complexity and consider simplifications in the decision-making. In my opinion the provision of ELA needs to be with the ECB, and speedy decision making may well be a priority.

Failing banks not passing the „public interest test" and that therefore are not resolved are to be wound down under insolvency rules. The fact that the applicable rules are national and not yet harmonized can create rather different outcomes for investors and are likely to create improper pressure on governments to bail-out debt holders. This is important as no creditor can be worse off in resolution than in insolvency. A European bank insolvency law would of course reduce the complexity of the resolution of banks and increase transparency for investors.

The final piece remains a European Deposit Insurance Scheme operating on a "least cost basis". This would allow for optimal use of resources when losses in insolvency would be higher than a solvent wind-down of the bank. These initiatives will require joint efforts by law-makers, regulators and industry experts, and some will take longer to reach political consensus.

Europe cannot afford to be complacent and needs to get all of the above done. I remain optimistic but joint efforts are of the essence. ●

EDIS: is a political agreement nearer?



Pablo Hernández de Cos

Governor, Banco de España

Common policies against common shocks

History tells us that crises happen. Some of them can be more easily anticipated. The Coronavirus outbreak, which is spreading around the globe, has little to do with economic fundamentals or the quality of economic governance. In addition to the huge stress it is placing on healthcare systems, it combines elements of supply and demand shocks which require measures to prevent the closure of firms and to support firms' and households' expenditure. It has also caused a confidence shock in financial markets, unleashing fire sales, a hurried search for liquidity and flows towards safe havens. This situation is likely to be transitory, but the speed and the scale of our response to the crisis and our ability as policymakers to work together will determine the strength of the recovery.

These events underline the need to strengthen EMU with a comprehensive package of common safety nets, robust joint policy tools, and a reinforced and effective coordination of national policies. Notable among common actions are those aimed at effectively materialising the capacity to share budgetary risks within EMU, and more broadly the EU. Joint fiscal actions in the face of this common shock would not only ensure maximum efficiency in our response, but also embody the solidarity values underpinning the European project. A common safe asset would be ideal, providing a neutral source of funding and simultaneously sending a strong signal of unity and goodwill. The world is watching. If not now, when?

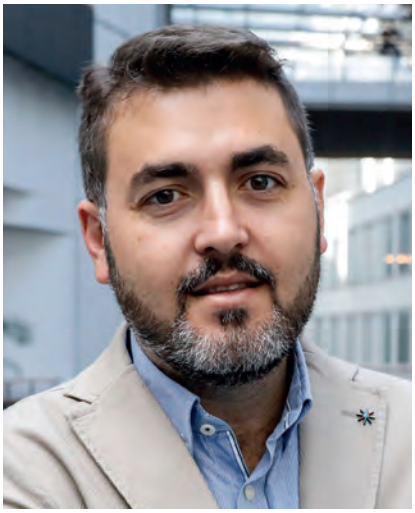
We also need to conclude the Banking Union. The sizeable monetary policy and liquidity provisioning measures already taken will surely mitigate the risks in the banking sector. But we should not be complacent when it comes to raising a firewall against further deterioration of the crisis.

Regarding the current resolution framework, we need to accelerate the entry into force of its final stage. A fully centralised resolution mechanism will weaken the doom loop because it alleviates the burden of bank resolutions for national sovereigns. Given the observed progress in risk reduction, Member States should summon up the political resolve to bring forward the full mutualisation of the SRF, duly reinforced by the ESM as the common backstop. This is an essential step that would ensure that the SRM/SRF is fully operational.

A stable banking system also requires a credible safety net for depositors, especially during confidence crises. It is what prevents liquidity shocks such as the current one from morphing into banking crises and, eventually, bank runs. More generally, it allows for higher private risk-sharing, by increasing confidence in the European banking framework.

The current institutional arrangements of the Banking Union do not provide the required level of credibility. Banking activity transcends national frontiers, but the guarantee on deposits is still borne by Member States. The two pillars already in place have reduced moral hazard concerns by transferring supervisory and resolution power to common institutions. On the one hand, the Single Supervisory Mechanism provides a strong and neutral institutional framework for bank supervision across Member States. On the other, the Single Resolution Mechanism covers the uniform enforcement of resolution frameworks when a bank is failing or likely to fail. But, by retaining responsibility for deposit protection at the national level, an additional and important problem may arise, namely one of discredit of the banking framework. The alignment of power, responsibility and accountability is what provides the necessary legitimacy of any institutional arrangement.

Current circumstances are highlighting even more the need to strengthen our Union. Completion of the Banking Union and the deployment of mutualised fiscal instruments will contribute to the stability of the European Union, enhancing the necessary private risk-sharing channels and helping European citizens to overcome current and future crisis. ●



Jonás Fernández

MEP, Committee on Economic and Monetary Affairs, European Parliament

EDIS: completing the Banking Union

The banking union project began in the summer of 2012, after a first semester in which the capital outflows of some countries – only balanced out by the Target2 program – had nearly led to a rupture of the monetary union. Thus, it can be stated that the banking union was launched at a critical moment for the Eurozone, during which the general banking risks were absorbed by sovereign governments. This triggered a surge in public deficit and hence the debt in some countries.

These increments in public liability fed an uncertainty in the markets concerning their ability to repay, and, therefore, the sustainability of pegged interest rates and the integrity of the monetary union. In order to minimize the risks of rupture, countries had to adopt pro-cyclical fiscal policies, in the short-term, and these policies narrowed the possibilities of recovery due to the absence of a common budgetary instrument that would be able to counter public national deficit reductions in a supplementary way. Precisely for this reason, the "banking union" was commenced, with the aim to avoid similar spiraling in each member state and to prevent the transfer of general banking risks to national sovereignty.

The journey began with the creation of the single-rule book, a European supervisor (SSM) and the design of a shared mechanism in order to manage the banking crises (SRM and SRF). However, this boundary between sovereign and banking risks has not been completely due to the maintenance of national deposit insurances, which continue to be managed by national authorities. It is not consistent that the national tax-payers would assume the risk of a banking crisis whose regulation is not the competency of the national legislature, as not even the supervisory organisms are controlled by their respective parliaments.

The European Commission presented its regulatory proposal for the creation of a European deposit insurance scheme in 2015 – nearly 5 years ago. While progress on the negotiations in the Parliament and the Council has been scarce, the excuses have been abundant.

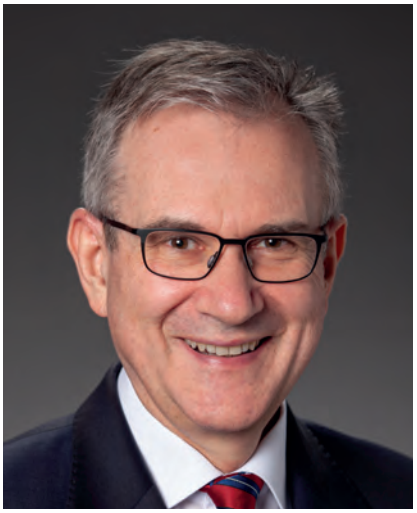
Within this period, I have identified at least two types of obstacles to the negotiation. The first argument is based on the necessity of reducing the general banking risks in all national systems before merging the assurance at the European level. The second argument centers on the heterogeneousness of the current deposit insurance models, including various systems within a certain countries.

To tackle the former of these two problems, the Union has continued legislating to raise capital and liquidity requirements and clarifying resolution payment models. A massive task certainly lies ahead as there cannot possibly be a new requirement at each juncture of the process before beginning the negotiation of the EDIS. Naturally, this would seriously erode the levels of confidence among negotiatiors. In order to resolve the latter of the problems, and to provide a reasonable amount of time to achieve larger amounts of risk mutualisation, the S&D Group in the European Parliament has proposed an alternative model to the European Commission text, referred to as the "bi-insurance model".

> *S&D has unveild a new EDIS proposal to solve some political disputes: «bi-insurence model».*

The proposal of the S&D Group entails the maintenance of current national insurance schemes alongside a European scheme. The banking entities must contribute to both funds, subject to a limit of 0.8% of covered funds. In the case of "accident", the national insurance would cover the liquidity requirements until their exhaustion before being supplied directly to the entity or depositors by the European insurance. As such, it is not a model of the reinsurance of national systems, but rather a 'double insurance' of the entities themselves.

Under this system, the level of mutualisation would depend on redistributing the contributions of each entity to each insurance scheme and, naturally, must be an open issue in the negotiations. In such a system, with a previously agreed level of mutualisation, the framework of security deposits would cease to depend – whether explicitly or implicitly – on the respective national treasuries. And this, in turn, would allow us to achieve the original objective of the banking union. ●



Georg Huber

Head of the Representation to the EU,
Deutscher Sparkassen- und Giroverband (DSGV)

Banking Union already established

The European Commission argues that the Banking Union is incomplete without a European Deposit Insurance Scheme (EDIS) as its third pillar and that EDIS would contribute to the financial stability in the EU. However, the Banking Union is already complete with the introduction of the Deposit Guarantee Scheme Directive (DGSD). The DGSD ensures that all depositors in the EU enjoy the same level of protection by introducing a common set of rules. The DGSD requires that all Member States progressively fill up their guarantee schemes to the required target level. Consequently, the DGSD makes EDIS redundant.

Many alternatives to the Commission's original proposal have been discussed since its publication in 2015. The Commission itself presented a two-phased insurance scheme in its Communication on Completing the Banking Union in 2017. However, the communication only is a variation of the original proposal, since the objective of centralization and full mutualisation remains.

> *EDIS conceals hazards to the financial stability in the European Union.*

The DGSD takes account of the diverse banking sector in the EU Member States allowing options of national discretion. Hence, this enables Deposit Guarantee Schemes (DGS) to use their funds for alternative and preventive measures. In sharp contrast, EDIS would prohibit such measures. This is especially detrimental to Institutional Protection Schemes (IPSs) that are recognized as DGSs in accordance with the DGSD.

Small and locally active credit institutions, such as the German Savings Banks, have been using IPSs for decades. IPSs protect member institutions and avert emerging or existing financial difficulties for these institutions by deploying alternative measures. In order to be able to use funds for that type of measures, it is indispensable that decision-making powers remain with national DGSs. Contrary to that, EDIS would deprive national DGSs and IPSs of these powers, since it would not only centralize and mutualize funds, but also centralize decision-making powers on the EU level. There are inherent differences between IPSs and EDIS. While the latter is merely a paybox that is triggered in an event of a bank's insolvency, IPSs prevent such a situation by ensuring their members' solvency and liquidity. This allows the continuation of business relationships at all times.

EDIS would abolish national DGSs. This would have severe negative effects on small and regional credit institutions, their clients and ultimately on the EU`s financial stability.

Especially in times where we see a fundamental shock to the whole European economy, it is important to understand the risks that are attached to EDIS. Firstly, EDIS would decouple risks and responsibility. Credit institutions with a high-risk affinity would be encouraged to continue to do so knowing that they would be supported by EDIS. This would be at the expense of banks having less risky business models. Another issue to be adressed is the sovereign-bank nexus, which may prove to be a significant burden in the difficult economic situation to be faced. In the same vein, it is almost inevitable that the ratio of Non-Performing Loans (NPLs) will increase as a consequence of the Corona pandemic, which will probably exacerbate - despite recent efforts - the very significant differences from one member state's banking system to another.

In light of the above, three conclusions have to be drawn:

- EDIS conceals more hazards to the financial stability in the European Union than it does provide appropriate tools to prevent a bank crisis.
- the diversification of funds in the different DGSs in the EU member states is an important feature to avoid the spreading of a potential loss of confidence in the banking sector within all of the EU.
- Looking at the third pillar of the banking union alone is not the right way. More elements have to be analysed in order to set up the banking union appropriately.

Looking ahead, there is no doubt that with the DGSD a well-functioning deposit protection framework already exists in the European Union. Not only it ensures the EU's financial stability, but also takes account of unique national features. ●

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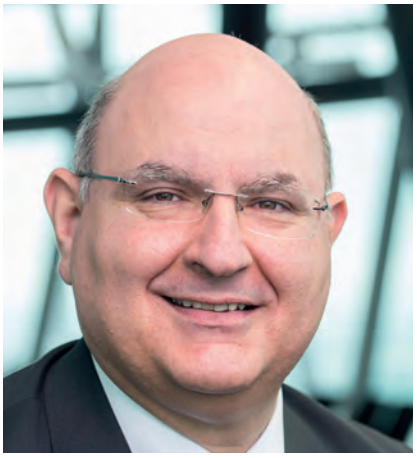
Solvency II revision: long-term investment challenges



Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

The role of insurers in building a stronger and sustainable Europe post COVID-19

The insurance sector plays a fundamental role managing risks from citizens and businesses and mobilising savings and investing them, thus developing the European economy and stimulating growth. The sector represents some of Europe's largest institutional investors and, in line with the nature of its liabilities, acts as a long-term investor.

In this sense, the insurance sector is key to achieving the objectives of the Capital Markets Union (CMU). As Europe's largest institutional investors, insurers have the financial strength to provide widespread benefits for the economy, acting in a counter-cyclical manner and investing with a sustainable, longer term perspective.

This role of insurers will be crucial for the European economic recovery post COVID-19.

Insurers are currently facing a 'low for long' interest rate scenario and Solvency II needs to reflect this new market reality. In this environment, the risk of adverse returns is gradually being transferred from the insurer to the policyholder by shifting the supply of insurance products from those with guaranteed returns to so-called unit linked products.

In this context, the 2020 Solvency II review should seek to strike a better balance by fully exploring the scope for differential treatment of liabilities according to their liquidity, and for the capital requirements of assets also to better consider the liabilities which they back. The assets backing illiquid liabilities are less vulnerable to short term fluctuations in market values. Recognising that feature will improve the risk-sensitivity of the framework and facilitate long-term guarantees and long-term productive investments.

EIOPA is currently testing a more favourable, yet prudent, treatment of long-term and illiquid liabilities compared with those of shorter duration, and the assets that back them, in particular long term equity.

On the volatility adjustment, an area for review is the recalibration of application ratios with the aim that insurers are rewarded for holding illiquid liabilities rather than being penalised for holding liquid liabilities.

On the risk margin, EIOPA is exploring ways to reduce its size and volatility, especially for the long term liabilities, based on the fact that the future capital requirements are not fully independent.

With regard to equity risk, EIOPA is testing the criteria for the ability to hold equity long-term, by making a link with long-term illiquid liabilities and taking into account that equity investments are managed on a portfolio basis rather than on an individual asset basis.

These adjustments are intended to improve risk-sensitivity, facilitate the design of truly long-term illiquid liabilities and incentivise long-term investments. In this way, the insurance sector will be better placed to invest with a sustainable, longer-term perspective which, in turn, will boost growth for Europe's economy and provide better perspectives for Europe's long-term savers.

In a post-COVID-19 world, long term investment is more important than never. Insurers can and will play an important role in the building up of a stronger and sustainable Europe. ●

Clément Michaud

Chief Financial Officer, Crédit Agricole Assurances

Choices to make for the European Commission

At the end of the year, when the Commission will draft its review of the Solvency II directive, it should ask itself the right questions.

Over the past quarters, the Solvency II framework has shown its structural weaknesses. Indeed, the directive acts as a pro-cyclical tool, with volatile solvency ratios, which forces companies to immediately sell long-term assets to preserve their equity ratio. Insurance is intrinsically a long-term business. Solvency 2 is short sighted by assessing a long-term financial environment with a mark-to-market approach. Moreover, the consequences of the accounting standards IFRS 9 and IFRS17 might negatively impact the long-term positioning of the sector. ▶

The Commission, especially in a negative rate environment that requires major changes for the profession, should use a framework that encourages the insurers who commit to long-term financing and reduces volatility, by introducing tools such as dynamic VA for standard formula, or market assumptions based on historical average values instead of spot values. The Commission should resist to any change that increases capital needs by more strident prudential rules, which are encouraged by EIOPA.

To pursue the ambitious roadmap for the years and decades to come, drafted by Mrs. von der Leyen, in which the transition towards a carbon-neutral economy and digitalization are emblematic objectives, all stakeholders should act along the same lines. With the right Solvency II framework, we are convinced that insurers could play a key role in this transformation.

For a stronger Europe, we should also be more realistic regarding the international markets. Regulators in other countries sometimes seem to prioritise the functioning of their economy over the implementation of international accounting or prudential norms. As an example, IFRS17 will not be applied everywhere, which will be detrimental to the EU companies in the global market place. Therefore, we should use our time to consolidate our current standards through a qualitative rather than a quantitative exercise.

Therefore, our recommendations to the Commission are three-fold:

- Preserve the stability of the European prudential framework. The directive review is crucial in this respect. There is no need to put in question the entirety of Solvency II but to correct shortcomings towards a less volatile system. For example, the dynamic VA should be extended to the standard formula. Likewise, implementing other new norms in parallel such as IFRS17 that aggregates the same inconveniences should be avoided.
- Evaluating the anticipated benefits of the proposed regulatory changes for the long-term funding of our economy and proposing easy-to-implement measures in this realm.
- Consider that additional capital charges is not the most appropriate solution to solve problems. The Coronavirus pandemic causes dire economic challenges and demonstrates that the EU economy requires stabilisers and the insurance sector is definitely one of them.

The shock absorption will require time, yet the success of European programmes and projects passes by a robust insurance market which is able to overcome and foresee beyond the current turbulence.

Cyril Roux

Chief Financial Officer, Groupama

Who's to decide how to invest insurers assets?

Much has been written about the way insurers should invest the funds they receive from their policyholders. Viewpoints differ, based in particular on the stakeholders most prominent in the mind of the respondent. For insurance regulators, the primary stakeholders of insurance undertakings are the policyholders: monies should be invested by insurers in order to safeguard policyholders' interests. This is akin to the view of asset managers and their regulators. In their minds, fiduciary duty trumps other considerations and investors' interests should come first.

In this worldview insurers are financial intermediaries managing policyholders' money and are answerable to them. On the other end of the spectrum, fractions of national and European political forces view insurers' balance sheets as too large not to try and commandeer for macroeconomic purposes. Insurers should thus be incentivized or brought to invest in the asset classes deemed most useful for European or national policy-making – if not taxed altogether.

In European circles, these asset classes include infrastructure and Green deal investments. The French government focuses on equity financing of local start-ups and equity stakes of French listed companies, so as to avoid foreign takeovers, neuter American activists, and ultimately maintain the State's ability to weigh on business decision making, including the number of staff employed domestically. Left unsaid but weighing prominently on insurers' balance sheets is the financial repression leading to the large overweight of sovereign credit thanks to its nil capital charge under solvency II. This plays out very differently by country: the Italian life insurance industry would be crippled by the eventual restructuring of the BTP, whereas the solvency of the German one depends on the eventual "return of the return" (on its sovereign holdings).

The bank-sovereign loop hasn't been much defused, but the less commented insurance-sovereign loop is also severe. To escape the heavy, shifting and sometimes contradictory regulatory and political interventions, and to steer their clients towards products with positive expected real returns, while alleviating solvency requirements, life insurers have touted unit-linked products in lieu of with-profit funds or "gestione separata". In so doing they give their clients a financial education similar to that given by asset managers, adding the insurance cover (such as annuities in the decumulation period) and the associated costs.

While the costs are mingled and opaque in traditional life insurance, they are separate and visible in unit-linked products. While decried, costs associated with intermediation and advice, asset-liability management, data, research, portfolio management, execution, servicing, risk management, compliance, reporting and disbursements have to be borne by the client.

This reality must also form part of the education of the clients who entrust their funds to financial intermediaries.

Mireille Aubry

Head of Prudential Regulation Standards & Foresight, COVEA

Making a clear distinction between liquidity and solvency in the Solvency II 2020 Review

The overweighting of liquidity needs is a major bias that is a source of dysfunction in the Solvency II regime. It is the result of a failure to adequately take into account the going concern perspective of the insurance undertaking as well as a lack of recognition of the key role own funds play in the management of liquidity risk itself.

A good liquidity ratio does not guarantee good solvency. Conversely, there is a positive impact of the solvency ratio on liquidity. These two observations alert us to the importance of distinguishing between liquidity and solvency and the non-reciprocal influence of one on the other. It should be remembered that the need for liquidity is not a major risk for an insurer (unlike a bank), which benefits from stable and long-term resources that are also based on a reverse production cycle. The insurer collects insurance premiums before any commitment to pay guarantees, and payments are positioned at maturities that can be very distant. In this respect, it should be noted that the risk of massive surrenders is particularly over-estimated in Solvency 2, in disconnection with the historical series of surrenderable contracts and statistics including during the last financial crisis. Finally, it should be noted that the surrender risk, where it exists, may be greatly reduced by the presence of discretionary profit sharing released in case of lapses.

Besides, an overweighting of liquidity can be a source of under-optimisation of overall financial performance. This under-optimization constitutes a risk that negatively impacts the insurer's future profitability and solvency as well as the performance of the guarantees offered to policyholders and is potentially very significant in the long term.
Insurance undertakings' own funds constitute a provision of liquidity in the event of unexpected adverse events that could potentially increase cash outflows, particularly in relation to policyholder liabilities. In the context of a general asset, in addition to directly absorbing losses and thus providing liquidity by absorbing losses, own funds are represented by assets whose regular inflows (coupons, dividends, rents, redemptions, etc.) also provide liquidity to avoid forced sales of assets representing best-estimate provisions in the event of contingencies on the outflow date of payment flows related to insurance liabilities. In a total balance sheet approach, where the assets representing own funds are themselves subject to a risk and capital requirement calculation (recursive loop), it is extremely important to include own funds in all their dimensions and to recognise their contribution to the management of the liquidity risk of commitments.

> *A good liquidity ratio does not guarantee good solvency. Conversely, there is a positive impact of the solvency ratio on liquidity.*

Own funds also change the "volume of technical provisions" by taking on a role of provisioning for "unexpected" losses. It should be noted that, even if the calculations of required capital are based on "instantaneous" shocks, this set of losses in no way corresponds to an immediate cash outflow, but has a run-off period close to that of best-estimate provisions, or even longer in the case of non-life companies, where the run-off period of best-estimate provisions is itself truncated and does not reflect their much longer actual duration as a going concern. ●

Martin Merlin

Director, Banks, Insurance and Financial Crime, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Removing regulatory obstacles to insurers' contribution to a sustainable growth

The European Commission is committed to lead the global effort to fight against climate change. Our European Green Deal aims to make the EU the world's first climate-neutral continent by 2050. To achieve our ambitions of a sustainable economic growth, Europe needs more stable capital in order to finance energy infrastructure, environmental-friendly facilities, eco-innovation technologies, but also research and development, which can boost growth, innovation and competitiveness.

With trillions of assets under management, the insurance sector is a mainstay of the European financial industry. Due to the long-term nature of their liabilities, insurers can contribute to the European Green Deal and the Capital Markets Union. ▶

The new Commission is committed to identifying the barriers that are keeping insurers' allocations to long-term investments low, and to determining which policy levers can help overcome these barriers. In this regard, some stakeholders claim that the prudential framework has fostered insurers' short-termism in investment decisions.

On the other hand, the downward trend of investments in long-term assets dates back to the late 1990s, and therefore cannot be only driven by prudential rules, as confirmed by recent studies on insurers' investment behaviour.

In fact, the prudential regulation should neither unduly favour nor hinder long-term investment, but provide the right incentives for robust risk-management while avoiding excessive risk-taking. Last year, the European Commission amended Solvency II to lower capital requirement for long-term investments in equity, including in small and medium sized enterprises, provided that insurers have implemented appropriate asset-liability management.

In the context of the forthcoming broader review of the Solvency II Directive, the Commission will further explore whether the prudential framework appropriately reflects the long-term nature of the insurance business, and whether it influences insurers' long-term and sustainable investment behaviour.

> *The European Commission will have to "green" all European legislation, by leveraging on the EU taxonomy.*

This assessment should not be limited to a mere discussion as to whether capital charges on investments – be they green or long-term – should be reduced, although this is of course part of the debate. In fact, under the current uncertain financial conditions, insurers' ability to contribute to our political objectives may depend more heavily on whether the prudential framework is efficient in mitigating the impact of short-term market volatility on insurers' solvency position. The review of the so-called "long-term guarantee measures" should therefore play a pivotal role in future debates.

In any case, in view of the high volatility of equity investments, as currently observed with the Covid-19 crisis, European regulators should carefully consider financial stability implications of any further capital relief on long-term investments, which would not be supported by quantitative evidence.

Reviewing the prudential framework will not be sufficient to achieve our climate objectives. The European Commission will have to "green" all European legislation, by leveraging on the EU taxonomy currently under development, in order to support insurer's effective contribution to the financing of the shift to a low-carbon economy and a sustainable growth. ●

Ilijana Jeleč

Member of the Board,
Croatian Financial Services Supervisory Agency (HANFA-CFSSA)

Financial sector as a key driving force in achieving EU sustainability goals

The financial sector has a key role in achieving the EU's overall sustainability goals through its demand-side investment potential on one hand, and creation of supply in the form of product development based on environmental and social factors on the other hand. The European Commission has adopted the Action Plan: Financing Sustainable Growth as a preparation for the future that ensures stability, a healthy planet, fair, inclusive and resilient societies and prosperous economies.

As early as 2014, European regulators set a milestone through the Non-Financial Reporting Directive, which requires the largest, as well as public-interest entities, to publish non-financial data related to environment and social responsibility. This seeks to achieve transparency in managing sustainability risks, given the growing demand for financial products that take into account social and environmental aspects of the investment. An additional boost for investing in sustainable projects will be the introduction of an EU taxonomy, as well as an agreement on green and brown taxonomies that will facilitate investor evaluation of projects in terms of sustainability.

> *We need a broad base of interaction oriented towards innovation to achieve long-term sustainable solutions.*

The insurance industry helps the community understand, prevent and mitigate risks, including those associated with natural disasters and climate change, by taking on and managing them. On the other hand, the demand of insurance and pension funds as a reflection of the desire

to achieve long-term and stable returns with significant capital potential is at the same time a considerable challenge. Therefore, it is not surprising that Solvency II, as the basis of the regulatory and supervisory framework for the insurance industry, directs a significant part of it towards sustainability issues.

Supervisors have already started directing the industry towards anticipating, in particular, climate change ▶

risk, through guidelines and recommendations on the use of scenario analyses in the underwriting system and risk management system through the ORSA process. What lies ahead is a detailed exploration and analysis of ways to better assess and integrate environmental risks into supervisory processes and practices, while the future supervisory efforts should focus on improving the quantity and quality of disclosed information, which may in part encourage the changes in investor practices. At the same time, the establishment and operation of green financial markets should continue to be promoted and facilitated as they do not retain their focus solely on creating value for shareholders, but extend it to all stakeholders by promoting the economic, environmental and social aspects of investments.

Government policies aimed at promoting sustainability, establishing a tax relief system and removing barriers to investment in sustainable projects and innovative and new technologies are also indispensable. In the perspective of complexity and breadth of sustainability dimensions, we need a broad base of interaction oriented towards innovation to long-term sustainable solutions, in which each member of the financial sector plays a role in the transition to a sustainable and prosperous economy, environment and society.

Alberto Corinti

Member of the Board of Directors, Italian Insurance Supervisory Authority (IVASS)

EU insurance firms and their expected role to channel premiums into long-term savings

In line with its traditional objectives, insurance is a process providing efficient protection against risks. In this context, insurance firms can certainly represent a driver for long-term savings and a mechanism for a stable and sustainable funding of the economy. However, we can neither expect that insurance plays a role in transforming short-term savings into long- term investments, nor in supporting the economy without a proper assessment of the associated investment risks.

Any financial mediation role of insurance should always be the product of a sound insurance process and should not become an objective per se. We have to acknowledge, however, that regulations might not always strike the right balance between prudential objectives and social and economic ones. Solvency II is a good prudential framework, but some consider it an obstacle to the release of financial guarantees and to the investment in long-term assets, particularly in the current scenario of low interest rates.

My view is that the Solvency II framework relies on features, such as the market consistent valuation, that we should not abandon, as they ensure proper and early risk identification and assessment. At the same time, however, the framework needs adjustments to avoid unduly penalizing long-term business. The first adjustment relates to the need to reduce balance sheet volatility, which could produce solvency indicators that do not reflect the long-term nature of the business.

The review of LTG Solvency II measures should allow increased stability of the balance sheet without jeopardizing the predictive characteristics of its indicators. Elements like the Volatility Adjustment, for example, should be better designed to reflect the capacity of firms to protect themselves from short-term spread volatility and to earn a risk premium on longer durations, avoiding unjustified capital relief.

Another area for improvement is the elimination of any undue capital charge penalization. Much has already been done in this field, but proper calibration needs an on-going monitoring and regulators should regularly review their conclusions in line with market developments. At the same time, a proper risk measurement should always inform the definition of financial requirements. Also proper capitalization is key for long-term business. The revision of interest rate capital charge is necessary in this regard.

Besides prudential regulation, insurance product design too is relevant in order to foster long-term guarantees and investments. For example, increased flexibility in the allocation of profits in certain life contracts or the increase of the illiquidity features of certain contractual liabilities could represent important factors to sustain long-term business.

> *Any financial mediation role of insurance should always be the product of a sound insurance process.*

Finally, we should not forget that a number of other factors not related to the regulation are also necessary. For example, the availability of well-structured long-term financial instruments in transparent markets is a precondition for incentivizing insurers to invest in long-term assets. Prudential regulations can only be part of the solution.

It is certain, however, that the focus should be centered on solutions that could soften, within prudential limits, the impact of the current low interest rate scenario on insurers and allow them to continue to play their role as providers of protection and long-term investors. A regulatory approach that simply provides disincentives to the release of long-term financial guarantees is not, I think, a desirable solution.

Petra Hielkema

Director Insurance Supervision,
De Nederlandsche Bank

Finding the right balance: market valuation versus long-termism

There is a broad agreement that insurance companies play an important role in facilitating the real economy. With assets under management equal to EUR 11.5 trillion, or around two-third of the European GDP, their investment base is large. Given that insurers can invest over the life cycle these parties are regarded as important providers of long-term financing to governments, companies and financial institutions. However, we must be aware of the key role of insurance companies: to help policyholders manage their risks efficiently through the provision of a variety of insurance products. In a discussion on enabling insurance companies' long-term and equity role one should not ignore this. This brings me to the regulatory framework Solvency II and its main role: policyholder protection.

One big achievement of Solvency II is mark-to-market balance sheet valuation. While this forces institutions to be more concerned with short-term market movements, it is an important condition for proper risk management. Without mark-to-market valuation, the economic position of insurance companies is not fully reflected in their regulatory ratios and this becomes especially worrisome in a gone concern situation. Therefore, the alternative of having no mark-to-market valuation could be worse. This, however, clearly shows the trade-off. On the one hand, market valuation is an important condition for proper risk management and policyholder protection. On the other hand, the long-term investment horizon of insurers is not fully supported by mark-to-market valuation. In that sense, it is about finding the right balance.

There are some considerations that I would like to share in this regard. Firstly, the achievements of Solvency II so far. As mentioned previously, one big achievement is the introduction of mark-to-market valuation. A limitation is the potential short-termism that is inherent to market valuation. The Long-Term Guarantee package that was introduced with Solvency II provides a counteracting force by reducing the volatility in the Solvency II ratios, thereby acknowledging the role of insurers as long-term investors. Second, the aim of Solvency II. Its aim is not to steer the investments by setting capital requirements. The current discussion on supporting financial institutions' lending to green finance provides a nice example.

While I am fully supportive of the goal to create incentives for green finance, this should not happen at the cost of policyholder protection. Relieving capital requirements for insurers' green exposures may indeed provide a good stimulus in greening the system. However, as there is currently no evidence that green assets are less risky, this undermines the concept of a risk-based framework and potentially increases risk at the cost of policyholder protection. And as concluded by EIOPA in their recent Opinion on Sustainability within Solvency II, EIOPA did not receive any evidence that the Solvency II framework provides a disincentive that hinders investments in sustainable assets. That brings me to my last point.

Third, a broader perspective on investment opportunities. Insurers are indeed important providers of funding to the economy. The discussion is often focused on enabling insurers' role as equity investors, while it should be seen in a broader perspective. There are more opportunities, e.g. the provision of direct loans, for example mortgages, that will fit the characteristics of their liabilities and are less prone to price fluctuations. To conclude, in finding the right balance, Solvency II has been a big step in the right direction. Of course, we are still in its early years and Solvency II is not yet perfect. But we know also that Solvency II gives us opportunities in finding this balance. ●

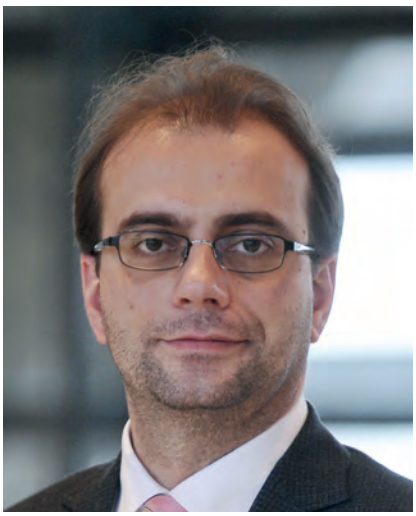
Sébastien Raspiller

Head of Department, French Treasury,
Ministry of Economy and Finance, France

Lifting the barriers to investments to achieve our common goals for Europe

Over the past years, we have reached a global consensus on the importance of long-term investment for our economy. Indeed, long-term financing in equity is necessary to innovate and develop technologies that will ensure the future growth of Europe. The European Central Bank recently concluded in this regard that equity funding is more appropriate than bank lending to support new technologies, and underlined that this is all the more the case for innovation related to green technologies, since these kind of development are intangible and firm specific, several characteristics which could discourage banks to intervene. Moreover, the current economic context calls for a breakthrough regarding the financing of our economy, which will be key for the recovery in the aftermath of the Covid-19 crisis.

On this basis, the European Commission and the co-legislators decided to launch the Capital Market Union and the Green ▶



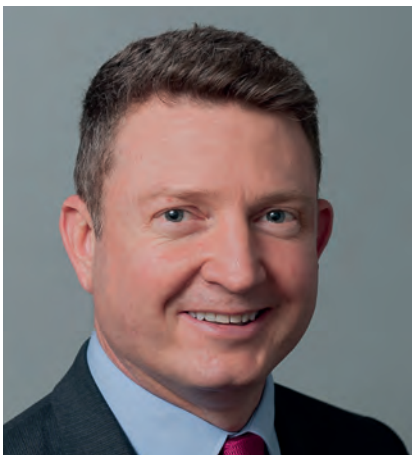
Deal, which encompass the long-term investment issues through the deepening and efficiency of European markets and the financing of the transition to a sustainable economy. However, these initiatives alone will not succeed if we do not lift the existing barriers to long-term investments. In this regard, the shortening of the time horizon of our European prudential and regulatory framework over the last years is preventing our financial undertakings from playing their natural role in the economy.

This is especially the case for the insurance sector's prudential framework, Solvency II. By focusing on short term risks, neglecting the capacity of undertakings to hold their assets in a long-term perspective, it hinders the investment capacity of these entities, although they are long-term investors by nature. Indeed, their business model relies on the inversion of the production cycle – they collect premium first and pay potential claims later – which allow them to invest for the long run, in front of life and non-life contracts. Besides the financing of the economy, long-term investors are stabilizers for the financial system as a whole: they act as a counter-cyclical force, with the ability not to sell in times of crisis. This key role in the economy, which is also the very purpose of our prudential regulations at the EU level, also has to be recognized and the current crisis illustrates this need for our economy.

Against this backdrop, following the recommendation stemming from the Next CMU report, the 2020 review of Solvency II should be the opportunity to better take into account the very nature of long-term investment. This means that the specificities of equities which are not to be sold, or at least which could be kept in difficult times, need to be recognized in the prudential framework. The long term equity investments module introduced in the 2018 review of the delegated acts is a step in the right direction in this regards.

Beyond, we also need to encourage the use of long-term products by consumers which intend to invest for the long-run. This is for instance what France did last year with the creation of a single and simple pension product for both insurers and asset managers. Such products could also, in combination with the necessary adaptation of our European regulations, foster long-term investments in our economy.

Insurance comprehensive systemic risk framework



Jonathan Dixon

Secretary General, International Association of Insurance Supervisors (IAIS)

Global framework for the supervision of insurance groups and systemic risks

The supervision of cross-border insurance groups is now facilitated by the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), adopted by the IAIS last year. ComFrame is a comprehensive framework for effective group-wide supervision of Internationally Active Insurance Groups (IAIGs), to help supervisors address group-wide risks and avoid supervisory gaps. ComFrame will provide supervisors with a common language for the supervision of IAIGs. By coordinating supervisory activities and exchange of information about IAIGs, the practical implementation of ComFrame should result in more efficient supervisory processes, for the benefit of both supervisors and IAIGs.

ComFrame builds on, and expands upon, the high-level standards and guidance set out in the Insurance Core Principles (ICPs), which generally apply to the supervision of all insurers and insurance groups.

As part of ComFrame, the IAIS is developing the Insurance Capital Standard (ICS), which aims to provide a globally comparable risk-based measure of capital adequacy of IAIGs. In November 2019, the IAIS agreed on ICS Version 2.0 to be used during a five-year monitoring period for confidential reporting to group-wide supervisors (GWSs) and discussion in supervisory colleges. The purpose of the five-year monitoring period is to monitor the performance of the ICS over a period of time, and not the capital adequacy of IAIGs. Earlier this year, GWSs identified IAIGs based on the international activity and size criteria as provided in ComFrame. GWSs committed to publicly disclose the identification of IAIGs at the earliest possible opportunity, noting that in some cases this disclosure may require legislative changes or regulatory action.

The IAIS is currently focused on supporting Members' efforts in the implementation of ComFrame. In future years, the IAIS will shift its focus to the robust assessment of the timely and globally-consistent implementation of ComFrame.

In delivering its commitment to contribute to global financial stability, last year the IAIS also adopted the Holistic Framework for the assessment and mitigation of systemic risk in the insurance sector. This framework recognises that systemic risk can arise both from sector-wide trends with regard to specific activities and exposures, as well as from a concentration of these activities and exposures in individual insurers. The Holistic Framework consists of: 1) an enhanced set of supervisory policy measures and powers of intervention for macroprudential purposes, incorporated into the ICPs and ComFrame; 2) an annual IAIS global monitoring exercise and collective discussion on the assessment of the potential build-up of systemic risk and appropriate supervisory responses; and 3) a robust assessment of the globally consistent implementation of the enhanced supervisory measures.

ComFrame and the Holistic Framework help provide the tools insurance supervisors need to assess and respond to the impact of COVID-19 on the global insurance sector, including on IAIGs. ComFrame provides a globally consistent framework for both assessing (through, for instance, supervisory review and stress testing) and coordinating (through supervisory colleges) a cross-border supervisory response at the level of the insurance group.

The Holistic Framework will be employed by the IAIS to undertake a targeted assessment of the impact of COVID-19 at the global level and to facilitate a collective discussion among insurance supervisors from around the globe on a coordinated supervisory response. ●

Dimitris Zafeiris

Head of Risks and Financial Stability Department, European Insurance and Occupational Pensions Authority (EIOPA)

ICS 2.0: a big opportunity for European insurers

The Insurance Capital Standard (ICS) has been developed since 2014 by the International Association of Insurance Supervisors (IAIS) with the purpose of creating a common language for supervisory discussions of group solvency of internationally active insurance groups (IAIGs) to enhance global convergence among group capital standards. A major milestone in the development of the ICS was achieved on 13 November 2019 with the agreement of the so-called ICS version 2.0. Indeed, since then, the ICS has entered a 'monitoring period' and, for the next five years, it will be used for confidential reporting to the group-wide supervisor, for discussion in supervisory colleges, and for further analysis by the IAIS.

The agreed ICS fulfilled all the major objectives specified by European supervisors and insurers. This success results from the continuous and intense engagement of all European supervisory authorities and numerous European IAIGs, for more than 5 years. Key elements of Solvency II, such as the market-adjusted valuation of the prudential balance ▶

sheet, are already fully acknowledged within the reference ICS. In addition, internal models have been allowed as additional reporting methodologies for them to be further discussed. Solvency II will be a practical implementation of the ICS in most of its areas, which prevents parallel layers of regulation in the future or any degradation of the strong and successful European prudential framework currently in place.

The United States is currently developing an Aggregation Method (AM) to a group capital calculation that is not part of ICS Version 2.0. The IAIS aims to be in a position by the end of the monitoring period to assess whether the AM provides comparable outcomes to the ICS. If so, it will be considered an outcome-equivalent approach for implementation of ICS as a prescribed capital requirement. The IAIS has already agreed that the comparability assessment will take into account the prudence of the AM in relation to the ICS, recognising that the latter will be a minimum standard. Therefore, the AM will have to be more prudent than the ICS throughout all economic and financial market conditions over the usual business cycle.

The purpose of the monitoring period is to monitor the performance of the ICS over a significant period. The active participation of IAIGs in the monitoring period is of the utmost importance to provide effective feedback on the ICS (covering both the reference ICS and additional reporting - on internal models for instance). EIOPA therefore strongly encourages European IAIGs to participate in the monitoring period, including the use of internal models, to ensure their specificities will be as well taken into account as possible in the next steps of the ICS development. ●

Joseph Engelhard

Senior Vice President, Head Regulatory Policy Group, MetLife

Carpe Diem and give thought to the future

On April 2, 2019, U.S. Federal Reserve Board Vice Chair Randall Quarles outlined his vision of how best to build on post 2008 reforms to strengthen the financial system and address the so-called "too-big-to-fail" issue. Cautioning that "the causes of financial crises rarely announce themselves ahead of time", he called for a focus on emerging risks through the broader perspectives and range of views of "search parties" organized with the intention of sharing and discussing concerns to determine if and how they should be addressed in advance.[1]

Today we live the situation Vice Chairman Quarles urged us to be prepared to meet and we call on our standard setters to seize this unannounced opportunity to integrate learnings from the impact of COVID-19 into standards under development.

This will ensure that global standards, necessarily developed on the basis of historical evidence and theoretical constructs, reflect real-time issues and offer more effective models of how to manage solvency and systemic risk in the insurance sector. One example is the IAIS Holistic Framework due to be implemented this year.

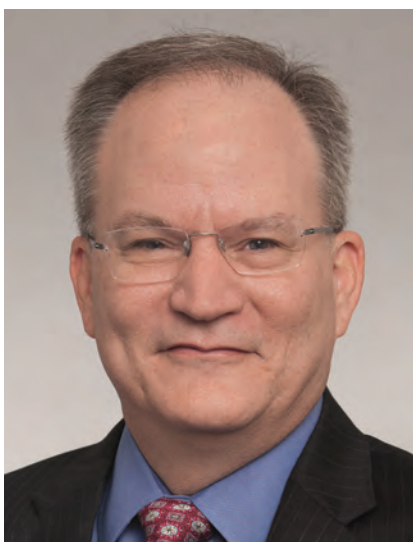
Its sector-wide monitoring exercise (SME) would be a strong foundation for the creation of the kind of search party Vice Chair Quarles describes.

Most importantly, the IAIS intention to hold regular public/private discussions of current trends and potential concerns arising from the SME, would encourage early identification and correction of emerging threats to the financial system and broader economy. We applaud the IAIS for taking this step.

Another example is the IAIS global Insurance Capital Standard (ICS) that enters its five-year monitoring phase this year.

> *Today we live the situation Vice Chairman Quarles urged us to be prepared to meet.*

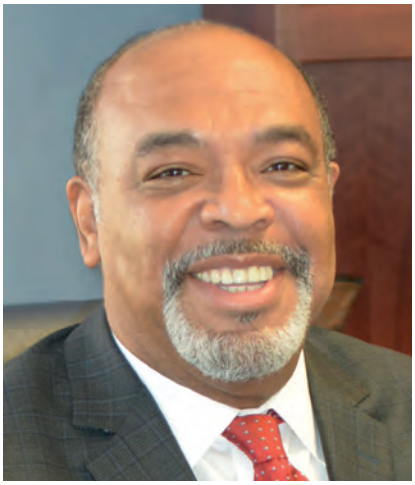
What better opportunity than the current situation for the IAIS to understand the impact of the ICS, particularly its market-adjusted valuation approach, on insurers' ability to manage through short-term volatility in capital markets and the potential unintended consequences it could have on availability of product and markets worldwide?



There are likely to be many detailed and valuable insights afforded by the sector's experience of this evolving and uncertain situation that we continue to live through and learn from.

Once the air begins to clear, we urge the IAIS to engage with industry to leverage the great potential for the current unprecedented and unfortunate situation to provide insights and understandings that could improve standards that will impact the industry for many years to come. ●

1. April 2, 2019 remarks to European Bank Executive Committee Forum, "The Future of Banking: The Human Factor", Brussels, Belgium



Andrew Mais

Insurance Commissioner,
Connecticut Insurance Department

The Aggregation Method: an outcome-equivalent approach to implementing the ICS

As a founding member of the International Association of Insurance Supervisors (IAIS), and by virtue of the size and diversity of the U.S.'s highly competitive insurance market, the NAIC and U.S. state regulators actively participate in and have been a critical and leading voice in international standard setting activities. As we work with our international counterparts, it is important that the elements of an effective international insurance supervisory framework are adaptable to the U.S. insurance market in particular and respect jurisdictional imperatives in general.

Last November, the IAIS reached agreement on a way forward on the Insurance Capital Standard (ICS), which is to be used during a five-year monitoring period. At the same time, the IAIS agreed on a definition of comparable outcomes and an overarching approach and timeline for the development of criteria to assess whether the Aggregation Method (AM), being developed by the U.S. and other interested jurisdictions, provides comparable outcomes to the ICS.

While U.S. state insurance regulators will not be implementing the ICS, we remain committed to an approach to group capital analysis which can and should be viewed as comparable to the outcomes achieved by the ICS, namely the AM. The AM builds on existing proven capital regimes to provide a measure of group capital adequacy. The starting point is existing legal entity regulatory capital requirements and scaling to a common level.

Nevertheless, we remain interested in ICS Version 2.0 as part of IAIS activities and join other jurisdictions in wishing to avoid a "one-size-fits-all" approach to group capital adequacy. During the monitoring period, other approaches within the ICS construct are being actively considered, such as a GAAP Plus approach to valuation and an internal model approach to capital requirements. The impact of such approaches on providing comparability will need to be considered as part of the process.

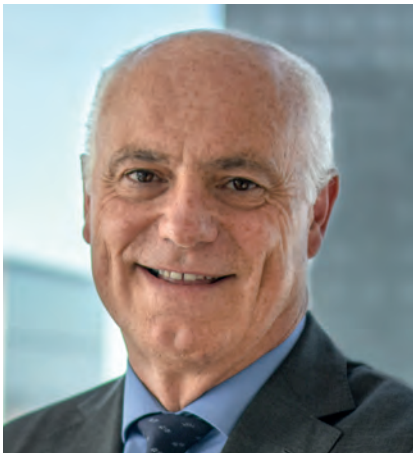
The AM embodies principles underlying the ICS - indifference to corporate structure, minimization of procyclical behavior, promotion of sound risk management and transparency – while being grounded in existing legal entity requirements. We have long questioned whether the "market adjusted valuation" (MAV) approach in the ICS Reference Method is consistent with these principles. The environment created by COVID-19 will provide a test of whether MAV provides the appropriate risk management incentives during periods of market volatility. In our view, the AM is not only comparable, but superior to the current ICS as it provides more transparency into the capital structure and local risks within a group and uses less volatile accounting methods.

> *Committed to an approach to group capital analysis which can and should be viewed as comparable to the outcomes achieved by the ICS, namely the AM.*

The IAIS began collecting data on the AM in 2018 and will continue to do so through the ICS Monitoring Period. The next milestone for the AM will be the IAIS' assessment regarding comparable outcomes. If comparable, the AM will be considered an "outcome-equivalent" approach for implementation of the ICS.

The IAIS has made clear that the AM will not be precluded at the outset from being comparable nor given a free pass. The question is not whether aggregation can produce comparable outcomes but what form a comparable AM will take. As this work continues forward, we are committed to working with our colleagues at the IAIS and in other jurisdictions in reaching this determination. ●

Improving AML / CFT



José Manuel Campa

Chairperson, European Banking Authority

Strengthening AML/CFT supervision in the EU

Money laundering and terrorist financing (ML/TF) need to be stopped. They undermine the trust of citizens in financial institutions, negatively affect market integrity and threaten the stability of the financial system. ML/TF cannot be fought in isolation. Governments, public authorities and the private sector all have a role to play. This is why, since its inception, the EBA has been working to foster a consistent and effective approach to anti-money laundering and countering the financing of terrorism (AML/CFT) by authorities and financial institutions. Financial crime respects no borders and a weakness in one area of the single market opens up the entire single market to abuse.

The high-profile scandals of the last few years have shown that Europe's AML/CFT defences must be strengthened. As a first step, the European legislature gave the EBA an enhanced objective to prevent the use of the financial system for the purposes of ML/TF. It also gave the EBA new powers to lead, coordinate and monitor EU supervisors' fight against ML/TF, which we are rolling out in 2020.

Leading the way in effective supervision

The EBA will continue to lead EU AML/CFT policy work in the financial services sector, and support effective implementation through training and assistance to competent authorities. In 2019, we introduced staff led reviews of competent authorities' approaches to the AML/CFT supervision of banks. Each review concludes with feedback on which aspects of a competent authority's approach work well, and which aspects could be improved.

We published our aggregate first round findings in February. They suggest that change is underway, but that many competent authorities continue to find AML/CFT supervision difficult. As a result, the EBA is carrying out targeted revisions of its core AML/CFT guidelines whilst maintaining the cycle of implementation reviews.

Coordinating cooperation

We will be coordinating information flows and working to strengthen supervisory cooperation, which is key to effective AML/CFT supervision, especially across borders. This is why, in 2019, we created a framework to foster cooperation and information exchange including the establishment of AML/CFT colleges, which we will support in 2020.

We are also setting up a central database that brings together information currently held by individual competent authorities. As part of this we will be working to ensure all relevant information is shared effectively, whether it be on emerging geographical or product risk or the impact of new technologies.

Monitoring

The EBA's database will also allow us to obtain a clear view of the ML/TF risks in the EU, and take action where warranted to strengthen EU supervisors' response to those risks. For example, the EBA can ask a competent authority to investigate or consider taking corrective measures should there be indications that a financial institution might be in breach of its AML/CFT obligations.

The EBA is uniquely placed to work with, strengthen and coordinate the work of AML/CFT authorities across the EU. We are committed to using our resources and powers to contribute to making the EU's financial system a truly hostile place for financial crime, as well as ensuring the EBA is well placed to contribute to the establishment of any new EU AML authority in the future. ●

Martin Merlin

Director, Banks, Insurance and Financial Crime, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Shaping up a comprehensive AML policy

The current unprecedented global crisis has certainly shifted attention to the need to use all the adequate tools to bring back stability and growth. Anti-money laundering is certainly not the first field that springs to mind among the many issues that we need to tackle in the very near future. Still, our commitment to have in place a truly comprehensive and coordinated EU approach to preventing and fighting money laundering is unfaltering. Over the last year or so, we have clearly identified the missing pieces of the puzzle needed for this approach.

The Commission remains dedicated to delivering the backbone of an effective AML policy, including harmonisation, enforcement and supervision, confident that the values that underpin an effective anti-money laundering framework go hand in hand with solid growth.

There is increasing realisation that more efforts are needed to improve the current minimum harmonisation in the EU anti-money laundering regime. Today, we are faced with different compliance and supervisory cultures and inadequate cross-border collaboration. A reinforced and more effective EU regime will need to deliver on transparency, traceability, and accountability. It should capture new ▶

business models and emerging risks in a fast-changing financial environment and be sufficiently flexible to fit the cross-border dimension of financial activities.

Delivering on these aims means building on the existing rules, with precise objectives in mind and with the ambition to have in place a truly integrated action. They will be spelled out in a soon-to-be adopted strategic document, inviting experts to contribute their views to the process.

Improving the EU's anti-money laundering policy will have to tackle the need to have in place common rules, directly applicable in all corners of the Union. This implies having in place a Regulation. A framework combining a full and targeted harmonisation of issues such as obliged entities, customer due diligence and maybe sanctions, with more flexibility allowed to distinct Member States in other areas may be the most effective way forward. This would constitute a single anti-money laundering rule-book setting out the full spectrum of requirements.

Dedicated action in the areas of supervision, enforcement, inter-agency cooperation and global outreach will complete the picture. An EU-wide supervisory system would also need to take shape. Given the many recent case studies that proved the current supervisory system to be flawed, an integrated, effective and truly deterrent institutional architecture would be required. At the heart of the new system, it is essential to have a central, independent supervisory Union body. In close cooperation with the national supervisors, the Commission is seeking to clarify how the Union can bring added value where risks are most felt, so that we are able to collectively map out risks and direct supervisory efforts and resources.

> *Dedicated to delivering the backbone of an effective AML policy.*

International influence and representation of the Union, including in the FATF, the dedicated forum, needs to also be strengthened. This way, we ensure that we are able to export our high standards in areas such as beneficial ownership transparency, bank account registers or smooth onboarding processes and turn them into the global standard. ●

Jesper Berg

Director General, Danish Financial Supervisory Authority (Finanstilsynet)

The potential of technology – a common front in fighting ML and TF

In recent years, much has been done to combat money laundering (ML) and terrorist financing (TF), by strengthening our toolbox and regulatory framework and increasing our supervisory intensity. But more can and must be done, not least to strengthen the first line of defence.

In December last year, the Council adopted conclusions on strategic AML-priorities, highlighting many important aspects and possible measures. Some elements have attracted much attention, such as the possible creation of an EU AML supervisor, others less – and I would like to focus on one of those less prominent but nonetheless vital and necessary steps forward – the exploration of opportunities and challenges in using technological innovation to combat ML.

This does not mean that we should stop focusing on strengthened supervision and coordination. Supervisory colleges add clear value as for a for information sharing – and they should be mandatory to create for all financial institutions with cross-border entities. Other initiatives to strengthen supervisory cooperation could also be envisaged. For instance, we have established a common Nordic-Baltic working group to intensify and formalize regional supervisory cooperation. It is key that new initiatives add value to our supervisory tasks. But increased supervisory cooperation cannot stand alone.

> *Current CDD processes are vital, but also cumbersome for both customers and banks. The use of technology should be a key priority.*

We also need to strengthen the first line of defence in financial institutions, not least the customer due diligence (CDD) processes they carry out to know their

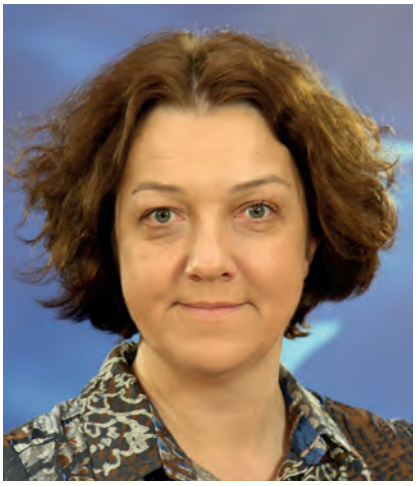
customers – a crucial prerequisite for them in assessing whether customers' transactions are unusual and suspicious. Current CDD processes are vital, but also cumbersome for both customers and banks. Vital because it is the first step in the value chain on which subsequent actions are taken, and cumbersome due to friction in getting access to information and lack of automated processes. The use of technology and better access to and use of existing infrastructure and databases or the creation of a new, shared European

platform can improve financial institution's AML/CTF efforts and should be a key priority.

It could deliver higher quality CDD, allowing suspicious behaviour and patterns to be identified earlier and resources to be allocated more efficiently. One step would be to support the financial sector in building such a common infrastructure, where information can be safely shared and assessed, ideally at a European level. This is easier said than done. The creation of such a platform, and the extent and consequences of the underlying elements, such as what information it should contain, needs to be thoroughly assessed. And the legal complexity and possible regulatory obstacles must also be carefully considered, such as the sharing of personal data. It is a difficult but necessary agenda.

Giving financial institutions further access to databases or establishing a shared European platform would simplify and increase the quality of CDD-processes and add value to the efforts in the first line of defence.

The Commission will soon publish an EU AML action plan. It is a window of opportunity for us to launch new initiatives to help build a common infrastructure, which enables data sharing across the EU. This could be a true game changer and make a real difference. ●



Līga Kļaviņa

Deputy State Secretary on Financial Policy Issues, Ministry of Finance of Republic of Latvia

Main challenges in the field of AML supervision and operational implementation

At the time of writing the world is experiencing spread of COVID-19. Besides the tragic human consequences all around the globe, slowdown of economy will affect all the sectors and financial sector might be exposed to the new challenges. Governments across the EU are announcing financial stimulus and economic response packages and institutions – EC, ECB and ESM are massively launching financial stimulus in hundreds of billions EUR to retain confidence of the markets and euro currency, as well as to protect economy and jobs.

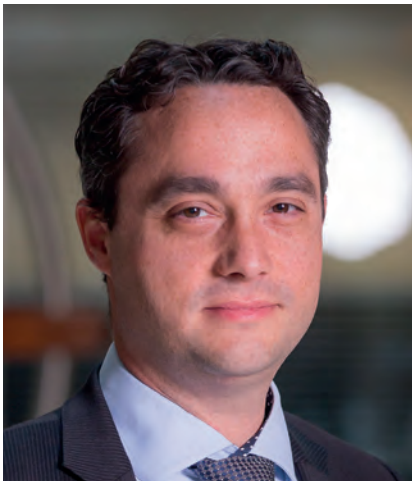
Financial sector actors will be vested with the tasks to transmit the financial means and support the economies and ease the liquidity shortage while maintaining the sound banking principles. EBA has already announced the postponement of the EU-wide stress tests and invited national competent authorities make full use of flexibility embedded in existing regulation thus supporting bank focus on performing their core activities in extraordinary circumstances.

One should admit that last two years banking sector, especially in the geographies with misused financial system, has gone through substantial de-risking process when it comes to AML/TF issues. These questions are high at the agenda of new European Commission agenda who adopted "zero tolerance" approach and have to launch infringement procedures against several MS that have not transposed AMLD5 as of beginning of year 2020, which already encompasses many safeguards and enhanced practices to combat illicit financing. Still persistent divergence in interpretation, implementation and application of AML/CFT legislation, among others future looking proposals, leads to the need of Regulation provisions. This would result in more precise and less prone to interpretation legislation.

Apart from anticipated global shift in the behavioral patterns of consumers and businesses, inevitable outcome of the COVID-19 situation is the removal of still existing artificial barriers to online and digital services. It will facilitate the demand for an alternative, fast and cheap payment system to the ones provided by the banks and at the same time, there will emerge the need to acknowledge the new services, products and discuss the possible use of them; while protecting customer and financial system. Probably one of the technical solution that could eliminate the risks of anonymous users and subsequent AML/CFT implication could be the facilitation of digital identification or any other means of trustworthy electronic verification systems. Though Latvia is one of few pioneer countries using handy digital app (Smart-ID) which grants access to digitalized financial and state provided services, system might serve its purpose if it is compatible and used in the EU. When it comes the digitalization and harmonization of systems, much depend on the countries digital culture, IT literacy and financial resources to launch such projects.

> *New "post-COVID" environment might challenge many aspects, but safety and security is a result of collective consensus and effort.*

Numerous studies and post mortem analysis proved that EU-level AML/CFT supervisory authority could be of value added for the overall EU financial services architecture thus facilitating the implementation of possible single AML/CTF rulebook across the sectors. Integrated system of central and local level supervisors could use the utmost of common best practices, expertise and resources. Moreover, possible expansion of its scope to non-financial sector would provide more broad coverage since AML/TF neither stops by the border nor it attributed to the specific sector of financial services. New, "post-COVID" environment might challenge many aspects of our lifestyle, but safety and security of the individuals is a result of collective consensus and effort. ●



Tristan Van Der Vijver

Head of Compliance, Payments and WUIB, Western Union

Two sides of the same coin: fighting crime in a single market

Over the many Eurofi seminars we attended Western Union has consistently called for harmonised anti-money laundering and anti-terrorism financing rules. Therefore, I am absolutely delighted that these proposals today find the political attention they deserve.

Western Union has always been at the forefront of developing new AML solutions at a global level. The remittance industry in general and Western Union in particular is committed to delivering fast, secure and convenient cash and electronic transfers to every corner of the globe. Today we operate in across more than 200 countries and territories.

Our single largest cost of doing business is compliance with AML rules: identifying customers correctly, monitoring the purpose of transactions and reporting suspicious transactions. These tasks are fundamental to all our safety and security. Western Union will not compromise on that.

Nonetheless, we question the efficiency of today's regulatory and supervisory AML framework which unintentionally contributes to fragmentation, duplication and is not always as efficient as it could be. Why is that?

Looking only at the European Single Market, each Member State imposes slightly different requirements on companies. Reporting templates are not harmonised and cooperation between national authorities or across borders within the EU remains sub-optimal. This prevents the financial services industry from adopting a single EU-wide approach to AML and to deploy and scale new technologies effectively and efficiently across Europe

At Western Union, we welcome plans by the European Commission to move towards more harmonisation of the AML rules, as well as to a clearer supervisory and reporting framework.

Ideally, we would like at a minimum to see four measures in this new legislation:

- A common suspicious transaction filing system;
- Harmonised customer due diligences requirements;
- The introduction of EU-wide electronic identification; and
- Better information sharing between public and private sectors.

Tony Blanco

Secretary General and Member of the Executive Board, La Banque Postale

Improving cooperation, information-sharing and use of new technologies

Banks have been involved alongside member states in the anti-money laundering (AML) fight for almost 30 years. They have continually invested huge amounts in IT and compliance tools and adapted their internal processes to regulatory requirements provided for in the 5 subsequent directives. By setting up dedicated services for investigations, they are the main providers of information to FIU (financial intelligence unit).The strengthening of both banks obligations (KYC, beneficial owner, PEP) and resources allocated to this fight went together with greater intensity of supervision and sanction by the supervisory authorities (€ 16 billion in fines paid by European banks between 2012 and 2018).

> *Capture the opportunity for a more effective and efficient AML approach at European level.*

Thus, given the amount of sanctions, AML-CFT fight has become one of the major concerns for bank executive managers. However the current situation is clearly sub-optimal: financial institutions have to monitor billions of transactions to identify those that would be problematic, with a disappointingly low conversion rate: a bank could get tens or hundreds of thousands "hits" / year, that would translate into only a few thousand SAR (suspicious activity reports) to the supervisors, which themselves would typically lead to only a few tens of legal investigations. Not only

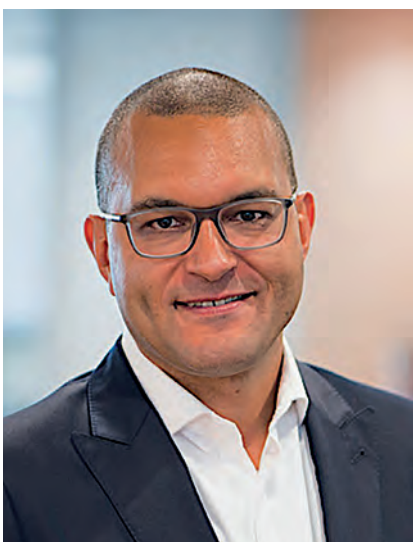
that, but the current quest for "zero failure", without a shared framework to think about relevant trade-offs between cost and impact, leads to ever more requirements and controls, with diminishing returns.

Furthermore, the current AML rules, methods and supervision remain fragmented. Current gaps in directive

transpositions are particularly detrimental as the strength of the whole AML system depends on its weakest part. And, last but not least, data sharing is limited, and the power of AI is not yet widely leveraged.

So what are the possible actions that could lead to a more effective and efficient system?

- Cooperation and information sharing: not only between authorities, as provided for in the 5th directive, but also to all the actors involved in this fight, especially banks. For example, shared resources and common platforms implementation, gathering suspicious activity reports or aggregating customer knowledge information could be considered.
- Prioritization and trade-offs: public authorities could identify the main threats on which institutions should focus on. Implementing performance indicators with regard to specific goals would make it possible to ensure the commitment of financial players and help develop and share best practices.
- Fully leveraging new technologies: notably by exploiting the full potential of data science in processing and sharing KYC information, or by using IA and machine learning to sort critical transactions and identify patterns in AML activity. Authorities should support a wider use of such future-proof tools and monitor initiatives to identify best practices or potential regulatory barriers.
- Harmonization of European regulation and supervision: to ensure greater alignment between countries, some aspects of the AML legislation should probably take the form of a regulation rather than a directive as the former is directly applicable. And a greater standardization of supervision rules and practices could also be explored to reinforce the harmonization of supervision.



Che Sidanius

Global Head of Financial Crime and Industry Affairs, Refinitiv

Europe's Anti-Money Laundering Framework needs further reforming

Following the spate of money-laundering breaches by European banks and further digital developments in the last two years, it has become apparent that the current EU framework needs to be profoundly reformed if the fight against financial crime is to yield meaningful successes in the future. The EU has gone some way to improve the current situation in its last mandate by revising the Anti-Money Laundering Directive (AMLD), where supervisory powers are now more anchored in the European Banking Authority (EBA), and by developing an AML action plan; however, there remains five key areas where more could be done to strengthen the effectiveness of the current regime - with little or no added costs for supervisors or businesses.

The money laundering scandals in Europe involving credit institutions have demonstrated that more needs to be done in terms of risk assessments and customer due diligence. However, it is also important to note that financial crime is not simply an issue of compliance, it also has significant consequences from a financial stability perspective. Whilst Europe has formed very significant and important initiatives to create a prudential and market regulatory framework to prevent the next financial crisis, the possibility of a large financial institution becoming insolvent due to money-laundering is a real possibility. Money laundering has become one of the most important potential sources of financial instability.

This new legislative mandate offers EU leaders a unique opportunity to reform its AML framework and become a global leader in the fight against financial crime which, as we explain further below, also links to Europe's ambitions on leading the climate change and digital revolutions.

Money laundering and other types of financial crime do not happen in isolation. More often than not, they are global in nature and part of a much wider criminal operation – with real societal impact, ranging from the funding of terrorism, to modern slavery and child-related crime and even environmental degradation. As such, Europe needs to be a global leader also on the fight against financial crime if it aspires to be a global leader on the fight for a greener and more sustainable future. As often the first line of defense against financial crime, the private sector has a key role to play in helping reduce current financial crime figures, if utilized properly – i.e. if there is more collaboration between both the public and private sector.

> *Making the fight against financial crime more effective*

Obligated and non-obligated firms, such as third-party vendors, hold valuable information for law enforcement authorities. However, communication flows are often a one-way street between the private sector and Financial Intelligence Units (FIUs).

Building on the work of, for example, Europol's Financial Intelligence Public-Private Partnership or the UK's Joint Money Laundering Intelligence Taskforce (JMLIT), the EU could be at the vanguard of fighting financial crime if it established some form of similar public-private information sharing arrangement at EU level. This has been called for by the European Parliament in recommendations from its special committees on tax and terrorism (e.g. TERR and TAX3).

EUROFI PRESIDENT // David Wright
SECRETARY GENERAL & PUBLISHER // Didier Cahen
ASSOCIATE PUBLISHERS // Jean-Marie Andrès and Marc Truchet

EDITORIAL COORDINATORS // Virginie Denis and Daniela Craciun
GRAPHIC STUDIO // Initial Production - www.initialproduction.be

INDEX OF CONTRIBUTORS

About EUROFI

The European think tank dedicated to financial services

- **A platform for exchanges between industry players operating in the financial services sector and the public authorities**
- **Topics addressed include the latest developments in financial regulation and supervision and the macroeconomic and industry trends affecting the financial sector**
- **A process organised around 2 major international yearly events, supported by extensive research and consultation among the public and private sectors**

Our objectives

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

Our approach

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user or consumer standpoint.

We organise our work mainly around two yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow us to structure effective debates and offer extensive input. The result of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proven over time to be an effective way of moving the regulatory debate forward in an objective and open manner.

Our organisation and membership

Eurofi works on a membership basis and comprises a diverse range of more than 70 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, different service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

Our events and meetings

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends.

These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society. More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (USA, Japan, China...) and international organisations (IMF, BIS, FSB, IOSCO, IAIS…). The logistics of these events are handled by Virginie Denis and her team.

These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings. In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

Our research activities and publications

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments impacting the financial sector and significant industry trends (technology, sustainable finance…).

Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance....These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net:

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 150 contributions on current regulatory topics and industry trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of each conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

NEXT EUROFI EVENTS

The Eurofi Financial Forum
9, 10 & 11 September 2020
Berlin - **Germany**

The Eurofi High Level Seminar
April 2021
Lisbon - **Portugal**

The Eurofi Financial Forum
September 2021
Slovenia

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