REGULATORY UPDATE

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1. MACRO-ECONOMIC AND MONETARY POLICY CHALLENGES

The demise of the Bretton-Woods system explains much of our current financial vulnerabilities

Speech delivered by Jacques de Larosière during the G7 High Level Conference, Banque de France, July, 16th 2019

It is my view (a view that, I hasten to say, is not shared by the main "consensus") that the dramatic financial evolutions that have unfolded over the last four decades or so (i.e.: overleveraged global economy, excessive reliance on easy money, very low interest rates, exacerbation of financial cycles, ...) have a common origin: the demise of the Bretton Woods system.

I have lived through the breakdown, in 1971-73, of the post-war exchange rate system.

While reflecting, later, on those events, it became clear to me that the abandonment of the Bretton Woods system was bound to have profound consequences that were not understood at the time and are still largely underestimated today.

I will organize my remarks around two headings:

1. What have been the far-reaching consequences of the demise of Bretton Woods system ?
2. How can this explain the dramatic "undercurrents" and growing structural imbalances with which we are saddled today? What could be done to restore a more normal international system ?

1. The far-reaching consequences of the demise of Bretton Woods

The demise of the Bretton Woods system has entailed deep and far-reaching consequences for our societies.

Indeed, one has to understand that the International Monetary System created in 1944-45 <u>was much more than a set of technical rules on exchange rates</u>.

It was, in fact and foremost, a way of maintaining a common framework for monetary stability and a coordinated economic policy stance among the major players of the international system. If a member country decided to follow a policy at odds with the common understanding (for example by running large fiscal deficits or huge credit expansion in order to try and reach higher growth), the exchange rate of such a country came inevitably under pressure: capital flights and inflation would weaken its balance of payments as well as its exchange rate, which would be pushed against the limit of the 1% authorized fluctuation band.

At the time, the country in question could not easily devalue: it had to request from the IMF the permission to do so. And, under the Fund conditionality, its economic and monetary policies had then to be adjusted so that the country could regain the common implicit anti-inflationary stance. The system did not allow "free riders" nor the competitive and repetitive devaluations of the 30's which had contributed to the run up to the Second World War.

It was precisely to avoid that common discipline that the US, on August 15th 1971, decided to put an end to the convertibility of the dollar into gold. They wanted to finance the Vietnam war through deficit spending and recover their freedom of manoeuver that was severely constrained by the Bretton Woods system - as well as by the limits of their gold reserves. The "Triffin dilemma" had to be surmounted (at the time, dollars held by foreign Central Bank were worth twice the value of US gold reserves. So the convertibility of the $ in gold had become impossible).

At the time, the economic profession was very much in favor of getting rid of the exchange rate stability system.

The "consensus" developed the famous theme called <u>the "trilemma"</u>.

According to that view, a country could not pursue at the same time the three following objectives:

- The autonomy of its economic policy in order to maximize growth;
- The freedom of capital movements (which was supposed to be a major growth factor);
- And the fixity of the exchange rate.

One element had to give: it was the exchange rate fixity.

It was added that a floating rate system had other virtues:

- It would help – through exchange rate depreciation – debtor countries to regain their competitiveness;
- It would also encourage – through currency appreciation – creditor countries to adjust.

But, in fact, the 1976 Jamaica agreement, result of the international negotiations, was very different from the theoretical pattern of floating rates. The total freedom for countries to choose their exchange rate regime - principle

that was enshrined in the new IMF Articles of Agreement - was misused. Creditor countries were afraid to loose their competitiveness if they allowed the market to drive up the appreciation of their exchange rate. Therefore they intervened heavily by buying dollars to prevent such an appreciation.

The result was fourfold:

1. Creditor countries accumulated huge reserves in dollars, thus expanding massively international liquidity (this has been a major source of international liquidity creation);
2. The US could easily finance its structural deficits without having to suffer the impoverishment that would have been the inevitable consequence of a true floating system (imported inflation through the dollar exchange rate depreciation was thus avoided);
3. The economic policy coordination, at the heart of the Bretton Woods system, had disappeared. The expectations that had been anchored on a stable exchange rate system had been replaced by a "non-system" in which each country could intervene as it wished on the exchange rate market;
4. And most importantly, structural reforms could be postponed since it had become so easy to borrow under the new system. The name of the game, since the early 80's, became: " Borrow as much as you can and wish. You do not have to worry about your exchange rate. The market will take care of that ".

This "non-system", I should say "this anti-system", is having far reaching consequences on our so called multilateral system.

1. It is eroding confidence in money at large and in the dollar. The more accumulation of indebtedness, the more uncertainty and less confidence. We should draw our attention on the huge increase of net buying of gold by Central Banks since 2018.
2. The "non-system" allows, through Monetary Policy moves, "nationalistic" strategies for the external value of currencies, which is a root cause of trade distorsions and "beggar thy neighbour" policies.

* * *

2. The fragilities of our present financial system are largely the result of the demise of Bretton Woods

Many manifestations of overborrowing have been surging since then. A few examples:

- Official reserves in US $ jumped from:2% of world GDP in 1969 (less than 1 trillion $) to 10% in 2011 (5 trillion $); i.e. a multiplication by more than 5 in real terms in 40 years.
- Non-financial private credit more than doubled from 2000 to 2016; from 52 trillion to 105 trillion $ (outstanding).

This evolution towards more and more financial products and services was facilitated by deregulation that started in the 80's and financial innovation.

This resulted in:

- Huge leverage in the economy, accompanied by a growing fragility of the financial system (lending institutions as well as borrowers get weaker and more subject to the vagaries of the credit cycles when the amount of debt gets out of control);
- A systematic postponement of structural reforms since easy and cheap borrowed money was available after the demise of Bretton Woods.

* * *

Just a few words on the – mistaken – consensuses that have flourished since the demise of Bretton-Woods.

1. "Money creation and accommodative monetary policies are good for growth" says the consensus

I will not delve into a comprehensive analysis of the advantages and the drawbacks of an accommodative monetary policy. It would need too much time.

But let me just state one point:

Observation shows that abundance of money eventually distorts and weakens the financial system more than it simulates growth. It is now widely recognized that the cause of the 2007-2008 crisis was the result of excessive debt, encouraged by Monetary Policy. Asset bubbles are an unavoidable consequence of QE.

2. "Low interest rates (even negative) are good for investment"

An objective study shows that extremely low interest rates for long periods do not foster investment, but they encourage preference for liquidity (hoarding) which is problematic in terms of investment. Keynes shows that interest rates are basically in line with marginal return on capital and should not be too low and below what he called "a minimum acceptable rate".

In spite of very accommodative monetary policies, investment growth in the EU has been lagging over the years: 1% on average from 2010 to 2017 (3% in the US). Zero rates reduce the "risk signaling" element of interest rates.

3. "High public debt " is not a major problem"

Empirical studies show, on the contrary, that beyond certain thresholds (around 80% of GDP) public debt is accompanied by significantly less growth than in less indebted economies or in countries that have decided to reduce their public debt. I could add that the huge amount of deficit spending introduced in many countries after the 2007-2008 crisis has significantly increased their public debt. This is affecting their future economic performance as well as their fiscal sustainability.

For sure the "Keynesian" policies focusing on the need to simulate domestic demand in cases of recession have been a major breakthrough in policy making.

But one must understand that structural factors can – and do – reduce the efficiency of the multiplier effect.

I will cite just a few:

- The effectiveness of the stimulus depends very much on the state of public finance (more or less public debt) when the stimulus starts;
- Labour rigidity and too little job mobility can also jeopardize fiscal stimulus policies[1].

A stimulative policy in an open economy that has lost its competitiveness can lead to more imports than to increased local output.

Asset bubbles are an intrinsic consequence of QE (see previous paragraph).

In a recent article[2] the Nobel laureate Edmund Phelps shows that the speed of economic recovery after the crisis was faster in Germany, Switzerland, Netherlands (who used relatively little fiscal stimulus) while in Italy, France, Portugal, high stimulus was accompanied by low growth:

"Big deficits did not speed up recovery".

One of the reasons of this relative inefficiency of fiscal stimulus is lack of business confidence and of dynamic investment which are not determined by fiscal deficits.

4. "Free capital movements are good for growth"

As Mr Villeroy de Galhau has just said, capital flows can be disruptive, feed bubbles and destabilize the financial system.

Since the fall of Bretton Woods a profound change has occurred: the international world has entered the era of a "debt driven" economy.

In other words, credit expansion has outpaced potential growth. Before the demise of Bretton Woods, credit and economic growth used to move more or less at the same pace. But since the end of the 70's, credit expansion has reached two times the average rate of economic growth.

This has lead to the oversizing – and to the predominance – of financial markets ("financiarisation"). The share of the US financial industry has doubled in real terms since the end of the 70's. (from 4% to more than 8% of US GDP).

Could we go back to Bretton Woods ?

I do not think that an identical return to the Bretton Woods system is possible nor even desirable: indeed the system was too mechanistic and asymmetrical (since it penalized debtor countries and favored creditors).

This being said, it would be highly desirable to stabilize intelligently the exchange rate system. That is far from being impossible. Mechanisms exist and could be used: a basket of major national currencies should be established and an approved authority would see to it that the relationship between those currencies would be under its close surveillance. The authority should also see to it that short term disruptive capital flows should be reined in.

In a more ambitious perspective, one could think of reviving Keynes's and Triffin's ideas and move towards a truly multilateral monetary system. In such a system, the IMF would control and adjust the global supply of reserves (including private credit) and issue, for external transactions, an international currency in line with world trade needs and with low inflation. Gradually, this would bring an end to the present drawbacks of national currencies playing the exclusive role of the international reserve of the world system.

But such proposals require political vision, will and leadership.

For the time being, nothing seems to be moving in that direction.

The major players of the world economy (like the US, China, Japan) find the present "non-system" suitable. The Americans can live and grow while borrowing more and more. As for the net exporters, they accumulate dollars while taking advantage of the amount of economic growth stemming from their exports.

And, of course, financial operators are perfectly happy.

In the framework of this fragile balance of national interests, I don't see, for the moment, any will to reform things in a multilateral way.

The element of policy cooperation – and of apparent reduction of national sovereignty that is inherent to the restoration of an exchange rate stability mechanism - does not seem compatible with present nationalistic policies.

In other words, governments believed that by abandoning Bretton Woods they had, at last, recovered their freedom of choosing their policy mix. In fact they have yielded their autonomy to the markets by borrowing massively.

In the words of Edmund Phelps:

« The fundamental problem of our time is the Great Western Slowdown for the last 50 years ».

The symptoms are:

- Weak investment,
- Falling rates of return to investment,
- Poor productivity gains,
- Declining job satisfaction,
- Disappearance of "exhilarating growth".

It is clear that these issues cannot be resolved by monetary or fiscal stimulus.

The huge rise in government debt will require greatly increased taxes in the future.

The enormous rise in money creation and liquidity is inflating asset bubbles, destabilizing financial markets and hurting business confidence and, thus, entrepreneurship, which is not good for economic growth.

[1] See V. Tanzi « The limits of stabilization policies » - Acta Oeconomica, 2018.
[2] Edmund Phelps, "The fantasy of fiscal stimulus", Wall Street Journal, 29 October 2018.

Some thoughts on current account imbalances within the Euro area

Speech delivered by Jacques de Larosière during the EURO 50 Conference, Brussels, 5 June 2019

1. The present situation is characterized by large current account surpluses in some countries of the Union, and by an increasing global surplus for the Euro area as a whole.

In 2017, the Euro area had reached a current account surplus of 3,5% of its GDP (0,6% of world GDP), i.e. the equivalent of the US current deficit ***(see Chart 1)***.

From now on, the countries that used to account for very large current account surpluses – China and Japan – only represent, each, less than 50% of the combined surplus of Germany and the Netherlands (the latter countries experiencing current surplus of, respectively, 8% and 9,8% of their GDP in 2017).

Moreover, the current account surplus of the Euro area has increased over the last years, in large part because of the economic adjustment by the peripheral countries.

The following table shows that - with the exception of France and Greece - almost all the usual deficit countries of the Union have now regained a current account surplus.

Table1 Evolution of current account positions of some countries of the Euro area

Current balances as a % of GDP	2010	2017	2018
Germany	+ 5,6%	+ 8%	+ 7,4%
Netherlands	+ 3,4%	+ 10,5%	+ 9,8%
France	- 0,8%	- 0,6%	- 0,6%
Italy	- 3,4%	+ 2,8%	+ 2,6%
Spain	- 3,9%	+ 1,8%	+ 0,8%
Portugal	- 10,1%	+ 0,5%	- 0,6%
Greece	- 11,4%	- 2,4%	- 3,4%
Ireland	- 1,2%	+ 8,5%	+ 10%
Euro area	- 0,1%	+ 3,5%	+ 3%

Source: IMF – World Economic Outlook April 2019.

2. How can one explain such an evolution ?

2.1. World macro-economic factors

a) The strong propensity to consume in the US

This is a traditional feature of the international monetary system.

It has been recently boosted by the Trump Administration fiscal policy, which has added fiscal stimulus to the US domestic demand, and, therefore, contributed to increase the country's current account deficit.

b) The fact that the Euro area has gradually emerged as one of the largest sources of world savings

The *Chart 1* illustrates this major macro-economic trend.

2.2. Country specific factors

One can underline the growing specialization of manufactured exports from high current account surplus countries like Germany and the Netherlands.

In a monetary area in which levels of competitiveness are inevitably heterogeneous, the stronger countries in terms of industrial tradition, low production costs, high capital and sound macro-management, tend to become more and more efficient.

Indeed, the average rate of the common currency (given the impossible currency adjustments inherent to the existence of the monetary area) is the result of the market views on the global competitiveness of the area. Therefore, countries with low costs and high competitiveness, like Germany, take advantage from the average valuation of the Euro.

It has been calculated that the "German Euro" is undervalued by 15% to 20% (in real effective exchange rate), in relation to the peripheral countries of the Euro area[1].

This phenomenon is, by definition, boosting German exports and compounding present disparities in terms of current accounts.

2.3. Lastly, the substantial adjustment realized, since the crisis, by peripheral countries has increased the global surplus of the Euro area

The following table shows the magnitude of the adjustment: cost reduction and compression of domestic demand have changed current accounts.

	Adjustment (in points of GDP) from 2010 to 2017-18
Spain went from a current deficit of - 3,9% / GDP in 2010 to a surplus of + 1,3% in 2017-18 (average)	5,2
Portugal went from a current deficit of - 10% / GDP in 2010 to balance in 2017-18	10
Italy went from a current deficit of - 3,4% / GDP in 2010 to a surplus of + 2,7% in 2017-18	6,1
Greece went from a current deficit of - 11,4% / GDP in 2010 to a deficit of - 2,9% in 2017-18	8,5
Ireland went from a current deficit of - 1,2% / GDP in 2010 to a surplus of + 9,2% in 2017-18	10,4

[1] See CEPII letter February 2018: « The unpleasant arithmetic of Eurozone imbalances » by Guillaume Gaulier and Vincent Picard.

The considerable improvement in those peripheral current accounts can be explained by three major factors[2]:

- Firstly, the compression of domestic demand (result of fiscal discipline) and, thus, of imports;
- To a lesser degree, cost reductions have helped exports to become more competitive;
- The reduction (except in Greece), of "protected" sectors (services not subject to competition) versus manufactured exports.

3. Why is such a situation problematic?

At first glance, one could look at these imbalances within the Euro area as a rather normal situation:

- They are the manifestation of economic disparities that are not uncommon in monetary zones (in the USA one can also observe sizeable current account imbalances between different states);
- These imbalances allow "net importing countries" to take advantage of low import prices which thus improve their purchasing power;
- Deficits can be "virtuous" in so far as they allow "southern" countries to attract foreign capital in productive sectors, hence contributing to strengthen, over time, productivity, potential growth and the balance of payments;
- Such imbalances are normally financed by offsetting capital movements: surplus savings of the North moving to the South (we will see, however, that this rebalancing is thwarted in Europe).

On a more general plane, one could argue that if the financial international system is sufficiently open and integrated to allow massive transborder flows of savings, some countries could accumulate, for long periods of time, current account deficits without being compelled to adjust[3].

But that is not enough to deal adequately with the issue.

Here are a few additional thoughts.

a) <u>Even in an environment of free capital movements, the need to adjust does not disappear</u>

Empirical observation shows that the working of the principle of balance of payments financiability (cited above) depends on the solvency of countries that are net importers of capital. If a country runs for a long time an "unsustainable" current account deficit (ie a deficit that does not allow, in the future, to contain at an acceptable level its ratio: net external debt / GDP), such a country will inevitably see its "solvency" disputed by the markets, and thus will have to adjust its current account by stimulating domestic savings. It goes without saying that the more "virtuous" are the deficits (ie caused by productive investments generating future cashflows) the less the solvency constraint will manifest itself.

b) <u>In fact, the massive current account deficits of the periphery up to 2009 had not been « virtuous » in terms of their contribution to the catching up process of their productive sector</u>

These deficits were essentially caused by a very strong growth in domestic demand which intensified during the years 2000-2009 because of different factors:

- Excessive expansion of credit (especially in the real estate sector);
- Fiscal stimulus (that led to large budgetary deficits);
- And a growth in wage costs well above that of "core" European countries.

The expansion of unit labor costs has triggered a "demand shock" in the sectors that were sheltered from international competition (notably the construction bubble). This fostered current account deficits through higher imports (Ireland, Greece, Spain). The overheating was concentrated in the sheltered sectors which had grown more rapidly than the tradable ones. The result was a relative shrinking of unprotected sectors, a significant over-indebtedness of the sheltered parts of the economy as well as a massive current account deterioration. Eventually, markets reacted to those external deficits and imposed much higher spreads after 2009.

c) <u>The current surpluses of Germany, and of the whole Euro area, are the manifestation of large underlying imbalances</u>

When the IMF had still some authority in this field, and when free capital flows were less powerful than today, current imbalances exceeding 4 to 5% of GDP, were considered as "fundamental", and called for a rapid correction in a context of protracted and deep imbalances: growing distorsions between countries and solvency issues eventually threaten the survival of the system and require adjustment.

d) <u>In older days, a significant undervaluation of the currency of a country running a high current account surplus would have triggered immediate reaction from the IMF</u>

The co-existence of undervalued currencies and large current account surpluses can create, or increase, competitive advantages and thus introduce distorsions in the working of international trade. This reminds us of the "beggar thy neighbor policies" of the 30's.

No system (and even the present "non-system") can tolerate such exchange rate distorsions for a long time.

e) <u>It might be objected that the situation has completely changed and that the existence of the Euro area renders obsolete any consideration related to a national « virtual » currency of any member of the Union</u>

[2] See Joaquim Oliveira Martins and Dominique Plihon: « Déséquilibres des balances des paiements de la zone Euro. Où en est-on ? ».

[3] See Joaquim Oliveira Martins and Dominique Plihon: « L'impact des transferts internationaux sur les déséquilibres extérieurs » - Banque de France Economie et Statistiques Année 1990.

In such a perspective, the only current balance to be considered is the one of the entire Monetary area. And at 3-3,5% of GDP, the Euro area surplus is well below alarming levels.

But such an argument does not seem convincing. While there is a Monetary Union with one single currency, it is also true that the different nations remain responsible for their own balance of payments.

Indeed, the "no bail out" clause of the Maastricht Treaty calls on each member country to correct unsustainable positions. So, if some members of the Euro area were to reach extreme imbalances (surpluses or deficits), it would be up to them to adjust[4].

It is so true that those members of the Euro area that had experienced massive (and unsustainable in the long run) current account deficits during the years 2000, were forced (under the pressure of the crisis and of high market spreads), to regain equilibrium after 2009-2010, by taking strong adjustment measures ("internal devaluations").

The result of all this is that permanent surpluses, when they reach "fundamental" levels especially when they are not accompanied by "virtuous" deficits in neighboring countries, call for a "symmetric adjustment" ("internal reevaluations") which is always required by any international monetary system.

One can add that the lack of trust between member states, caused by macro-economic divergencies in the years 2000-2009, as well as by the fragmentation of the Banking Union ("ringfencing") explains that "Northern" countries are not inclined to invest their surpluses in the South and thus to facilitate the financing of external imbalances in the Union. The paradox of the Euro area is that large savings surpluses are invested outside the Union!

f) <u>The international importance of this issue is particularly significant</u>

We have stressed above that fundamental imbalances based on misaligned exchange rates are a major problem for any international monetary system.

If Germany had not been a member of the Euro area:

- The massive surplus of savings over investment in that country,
- as well as the strong world-wide demand for riskless German Treasury instruments,

would have resulted in a significant appreciation of the DM on the markets.

If that strength of the "virtual" DM does not trigger a corresponding upward movement of the Euro, it is because other countries of the area are considered by the market as rather weak (structural problems, lagging growth, poor competitiveness, high public debt ...).

This "viscosity" of the Euro can only compound the German competitiveness issue.

But this "undervaluation" of the "notional DM" raises an international issue. The USA will probably not remain passive spectators if the situation were to last. Protectionist reactions against Europe are to be feared, and are already announced.

That is another reason to start dealing with the issue.

g) <u>A surplus of savings in relation to investment can be a real problem</u>[5]

Let us consider the situation of Germany.

Chart 2 shows how this country has developed a very significant current account surplus since the early 2000's.

This surplus has obviously strengthened the financial foreign position of Germany, but it also displays problematic aspects.

Indeed, a surplus of savings can either reflect an abnormally high level of savings or a lack of investment. In fact, both factors are at play in the case of Germany.

Chart 3 shows that the level of German savings (29% of GDP) exceeds that of the majority of other countries of the Union (around 24%).

This results in a considerable reliance of the German economic growth rate on exports. Exports represent 50% of German GDP against 32% for the other members of the Union ***(see Chart 4)***.

But there is also a weakness in German investment.

Chart 5 shows that the investment rate in Germany (21% of GDP) is particularly modest when compared to other members of the Union (around 24%).

In this respect, ***Charts 6 and 7*** show that public investment is weak in Germany, which is also the case of total corporate investment (12,5% of GDP against 14% for the other European countries of the Euro area).

This is a source of difficult problems for the future potential economic growth rate of Germany while demography is declining.

We have to understand the demographic argument.

It is generally observed that a rapidly ageing country like Germany has a tendency to consume less and to save more in order to prepare for retirement. Later on, when retirement takes place, households dis-save in order to offset their lower income after retirement.

But that does not mean that the surplus of savings should necessarily be:

- Extreme (8% pf GDP);
- Almost entirely invested outside of the Euro area;
- And accompanied by a significant deficit of domestic infrastructures.

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[4] Even in an integrated financial market, the need for adjustment does not disappear. Market benevolence will eventually depend on "fiscal solvency" of defined countries (including USA). See J de Larosière: « The demise of the Bretton Woods system explains much of our current financial vulnerabilities » - London School of Economics January, 31st 2019.

[5] This paragraph draws heavily on Patrick Artus Flash Economie - NATIXIS, 18 March 2019.

h) A word on franco-german balances: structural issues do matter

We have seen above that France is continuously running a current account deficit ***(see Table 1)***.

In France - as compared to Germany – the industrial base has been disproportionally hit by the opening of trade to emerging markets.

The manufacturing sector has significantly weakened and only represents 10% of GDP, half the European average, and much less when compared to Germany.

The result is twofold:

- Vis-à-vis Germany, there has been a "conjonctural" shock: more domestic demand driven growth in France, and more export driven growth in Germany. This has led to a deterioration of the bilateral French balance with Germany;
- But there has also – and more fundamentally – been a "structural shock", because the French manufacturing base has shrunk in comparison with that of Germany, as a result of structural competitive problems (small margins, too high taxes and social contributions).

Therefore the "rebalancing" between the two countries cannot be achieved by a classical "fine tuning" of the policy mix. Any fiscal stimulus engaged by France to increase growth will, predominantly, push up imports (because of the lack of a proper industrial base) instead of French production.

The current imbalance between the two countries is bound to continue to deteriorate in terms of the French deficit with Germany, except if France were to engage in a true «supply side» set of structural reforms.

4. What to do?

One could be tempted to tell the peripheral countries something on the following lines:

« You have not yet lowered your costs sufficiently. If it is true that the "German Euro" is undervalued by 15 to 20%, it is your duty to intensify your efforts and to further reduce your costs by approximately 20% (for example, you could achieve this objective by keeping for 10years your yearly inflation at a level of 2 percentage points less than in Germany) ».

Such a recommendation was perhaps justified in the years when the costs in the South (notably wages) were increasing much faster than in the North, and when Southern current accounts were showing large deficits.

But today such a prescription does not seem warranted:

- As we have already seen, almost all countries of the South have regained balance or even surplus in their current accounts (in part because of efforts made to moderate labor costs). Thus, in terms of flux (capital movements) the situation has normalized;
- Would it be logical to impose on these countries 10 more years of austerity so that they can match exactly the German level of costs ? such a policy would only increase the surplus of the Euro area and depress the periphery. That is where we have to avoid fundamental mistakes.

I am not saying that peripheral countries should stop adjusting.

On the contrary, I believe they have to intensify their structural reforms.

And we should not forget that the outstanding amounts of their debt are the result of years of deviations[6]. Those accumulated amounts will have eventually to be reduced to more normal levels. But this can only be achieved in a long-term framework lest one would provoke too significant a slowering of domestic demand that would endanger growth, which - after all - is the key to financial normalization.

In any case, it would not seem justifiable to ask such peripheral countries to be the only ones to adjust and to suffer 10 more years of internal devaluations, just to align their costs and their indebtedness on those of countries running "fundamental surpluses"[7] who would thus be exempted – without reason – from any corrective action and whose savings model cannot (and should not) be replicated elsewhere.

The effort should be shared. If not, populism could prevail.

As a result of this reflexion, it seems that the countries that have accumulated large current account surpluses should also take their part in the rebalancing of the current account of the Euro area. A few possible avenues can be suggested:

- A commitment to increase infrastructure investments in Germany (expenditures that have been delayed for too long)[8];
- An agreement on a more equitable balance of responsibilities and financial duties regarding defense and security in Europe;
- The rapid enforcement of financial solidarity in the context of the Banking Union.

[6] One should note that imbalances in terms of outstanding debt should not be dealt with on the same scale of adjustment as for flow imbalances. Indeed, the "repair" of ongoing deficits reassures the market. But in an environment of low interest rates, one can justify a much longer time horizon for outstanding debt.

[7] See article CEPII already mentioned: « Current account imbalances in the Euro area. Where do we stand ? ". Just a quote: « Given the low inflationary environment in Europe, the fall in relative costs in the non-tradable sector could increase a deflationary risk ».

[8] The German budgetary surpluses have brought back the outstanding public debt of that country to 60% of its GDP (Maastricht norm).

Conclusion

We all know that in a Monetary Union, national economic policies have an impact on the other members as well as on the Union as a whole.

This is the reason why coordination of macro-economic policies is on the essence.

It is honest to recognize that such coordination has failed until the explosion of the sovereign debt crisis of 2009-2010.

In the wake of the crisis, the "Macroeconomic Imbalance Procedure" (MIP) was established alongside other reforms.

During the ten first years after the creation of the MIP[9], the Union has identified a large number of countries as affected by such large imbalances.

But we must also note that the Union has never suggested to trigger the corrective clauses contained in the MIP.

The objective is not to criticize surplus countries but to show that present growing imbalances are the symptom of underlying problems and that prolonged inaction can lead to an impasse or to serious tensions.

It would be a mistake to believe that such imbalances can last for ever and that capital markets will always be there to finance them ***(see Chart 8)***.

Let us not forget the solvency (and liquidity) constraint that limits access to financial markets as we always rediscover whenever a crisis breaks out.

And let us not forget either the constraint on the external acceptability of massive and durable surpluses (***see Chart 8)***.

In fact, in a monetary zone that has chosen to deal with balance of payments on a national plane, the existence of large current account imbalances within the Euro area raises a serious challenge in terms of macro-economic adjustments.

We should not remain passive while facing this situation.

In this regard, the present absence of any initiative under the excessive structural imbalance procedure seems difficult to justify.

The survival of the Eurozone calls for more symmetrical adjustments, which could, in turn, strengthen confidence and growth.

Obviously, the issue raised in these pages is all the more difficult to handle that capital flows within the Union are, in fact, blocked.

If capital emanating from surplus countries were channeled towards deficit (but adjusting) countries, the situation would be different:

- In the short term, we would see an increase in the level of investment in Europe;
- In a longer term perspective, it has been calculated that the European growth potential could increase by 0,3 percentage points a year[10].

In other words: « If the Eurozone were a true currency area, Germany's excess savings would be less of a problem, as they would finance investments in the rest of the Eurozone and would not weaken the zone's growth » (Patrick Artus).

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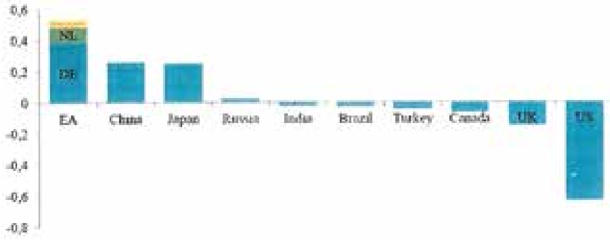
[9] This procedure now encompasses - as it should - the current account imbalances. But the decision discarding the procedure as long as current surpluses are not more than 6% of GDP during two years in a row, seems questionable.

[10] The « loss » of investments emanating from the leak outside of the Union of surplus capital amounts leads to a reduction of 1 percentage point in the accumulation of capital per year (therefore, given the 0,3 elasticity of GDP/capital), potential growth would be reduced yearly by 0,3% per year.

ANNEX

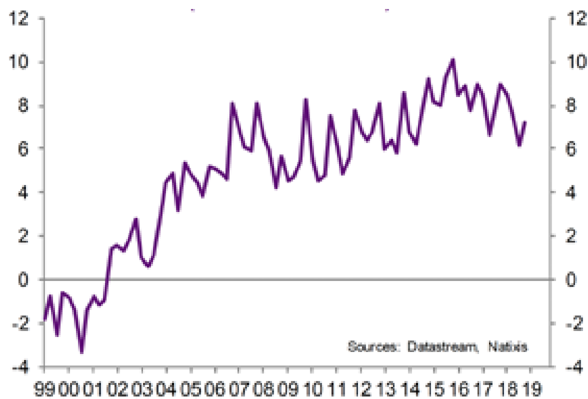
Chart 1 The current account in 2016 as percentage of global GDP



Source: Calculations based on IMF Data Mappe

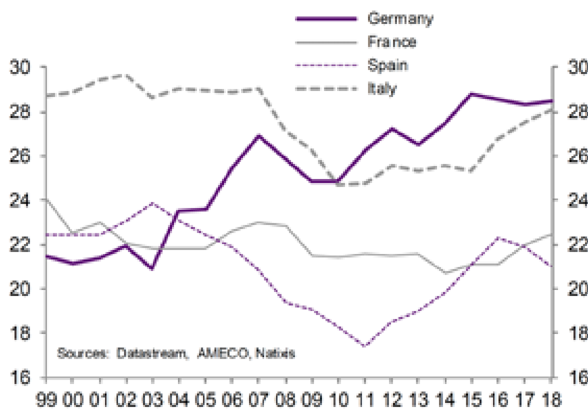
The European current surplus dominates world imbalances

Chart 2 Germany: current account (as % of GDP nominal)



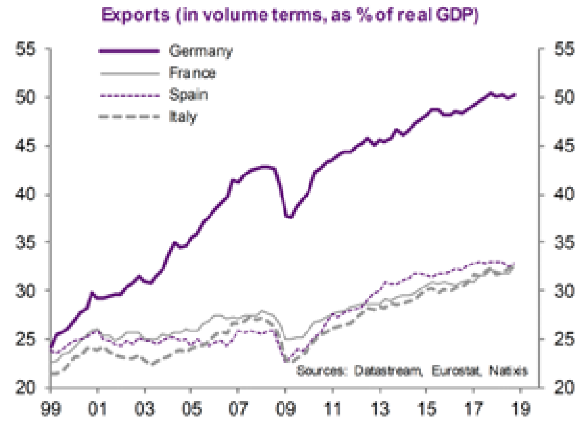
Germany: A massive surplus of savings over investment

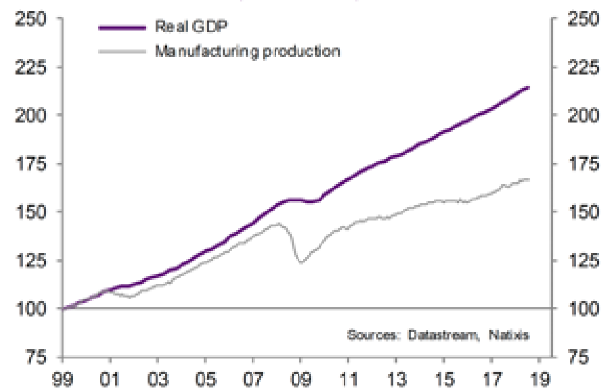
Chart 3 Savings rates (as a % of nominal GDP)



Germany: an unusually high level of savings

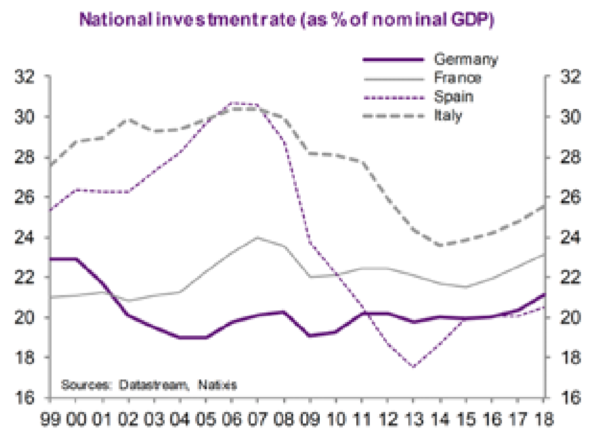
Chart 4 Exports





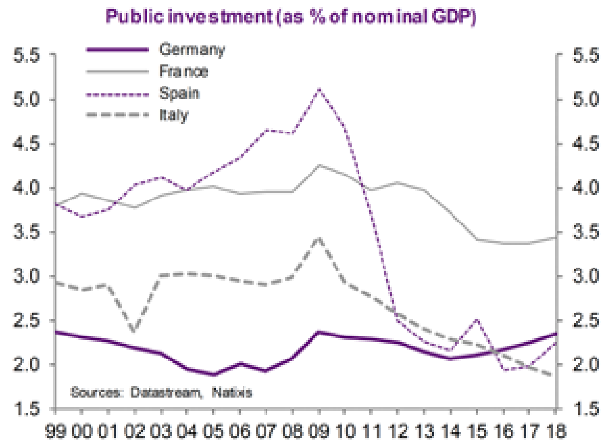
Germany: dependent on exports

Chart 5 Investment rates (as a % of nominal GDP)



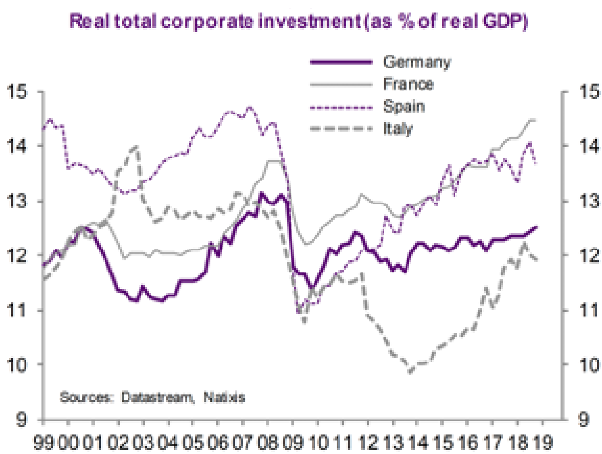
Germany: weak level of investment

Chart 6



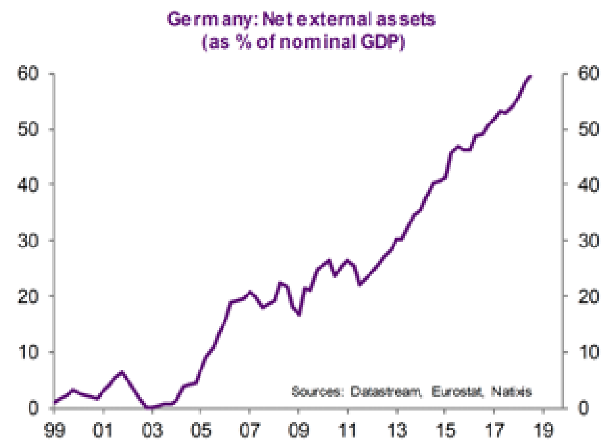
Germany: weakness of public investment

Chart 7 Corporate total investments (% of volume GDP)



Germany: weakness of total investment

Chart 8 Germany: net foreigner assets (as % of nominal GDP)



In spite of the accumulation of net foreign assets, Germany does not experience an appreciation of its exchange rate because of the Euro.

Addressing the sovereign / financial sector / Central Bank loop in the EU

The sovereign debt crisis that erupted in the euro area in 2010 highlighted again the fact that bank risk and sovereign risk are closely intertwined. Sovereigns were indeed exposed to banking risk, and banks were exposed to sovereign risk.

Therefore, a major objective of the Banking Union was to weaken the feedback loop between banks and sovereigns so that increases in banks' credit risk would no longer be reflected in sovereign risk and, conversely, banks' financing costs would no longer be driven by their sovereign's creditworthiness.

However, 7 years after its creation, the Banking Union has not succeeded in breaking this vicious circle. The quantitative easing policy of the ECB has even extended this loop to the central banks with large holdings of government bonds purchased. A solution could be a change in the regulatory treatment of sovereign exposures but there is no momentum for changing this framework. Fiscal discipline would therefore be the main component of a possible solution for reducing this sovereign-bank loop.

1. The feedback loop between banks and their sovereigns escalated the financial crisis in Europe into a sovereign debt crisis

The sovereign debt crisis that erupted in the euro area in 2010 highlighted again that bank risk and sovereign risk are closely intertwined. In some countries (Ireland, Spain), the problems arose from a major and unsustainable growth in bank lending, as well as from poor risk management. In these countries, the central government had to provide substantial financial assistance in order to prevent a collapse of the banking sector that would have shaken the whole financial system. In countries where the root cause of the problems was excessive government indebtedness (Greece, Italy, Portugal), domestic banks ultimately ensured their sovereign's access to financing. In both cases the outcome was identical: both banks and the sovereign ended up in significant distress, and external financial assistance was required to solve the problem.

In other words, domestic bank risk can weaken a country's public finances in case troubled banks require government support, while domestic sovereign risk can weaken bank balance sheets through banks' holdings of government debt. The feedbacks between bank and sovereign risks can lead to a `doom loop', as a result of which both banks and their sovereigns can end up in a crisis simultaneously.

The Banking Union was precisely designed to weaken this feedback loop between banks and their sovereigns. 7 years after its creation, it is appropriate to consider whether progress has been made in this area.

2. Banks' exposures to their sovereigns are still significant in certain high-indebted countries (Italy, Spain, Portugal)

The ESRB report on the regulatory treatment of sovereign exposure (March 2015) and the CEPR analysis of M. Lanotte and P. Tomasino[1] show that in most euro area countries, euro area sovereign debt exposures of banks (as a proportion of total assets) were considerably larger at the inception of the Economic and Monetary Union than they are now.

After a reduction in the first half of the 2000s, banks in stressed euro area countries have gradually increased their euro area sovereign debt holdings again (as a proportion of total assets) in the last eight years (***see Chart 1***). In contrast, banks from other euro area countries either continued to reduce or stabilised their euro area sovereign debt exposures[2].

In almost all euro area countries, the euro area sovereign debt exposure of banks is overwhelmingly towards their domestic issuer, and this home bias is particularly strong in the countries where banks' total euro area sovereign exposure is largest (as a proportion of total assets)[3].

In general, banks in stressed euro area countries increased their exposure to domestic sovereign debt in response to increases in its yield. This response may have been motivated by different factors, including banks' search for yield by engaging in carry trades that take into account redenomination risk, the desire to increase holdings of liquid assets etc. For a more limited range of countries, there is also some evidence that banks in stressed countries increased their sovereign exposures in response to worsening domestic macroeconomic conditions.

According to the IMF[4], almost 60 percent of French, German, Italian, and Spanish banking groups' exposure to euro area sovereigns, for instance, is concentrated in securities issued by the home sovereign. Similarly,

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[1] M. Lanotte and P. Tomasino, "Recent developments in the regulatory treatment of sovereign exposures", VOX, February 2018.

[2] According to the ESRB study, there is no significant difference between sovereign exposures held by systemically important financial institutions (SIFI) and non-SIFI.

[3] Italian banks are the most exposed in Europe, holding €387bn of domestic sovereign debt, equivalent tp about 10% of their total assets, according to data from the ECB.

[4] IMF, Euro area policies, article IV, July 2018.

60–80 percent of French, Italian, and Spanish Insurance companies' investments in sovereign debt are in home-country bonds.

Whatever the motive, the exposure of banks in stressed euro area countries to domestic sovereign debt has increased concurrently with an increase in the risk of such debt, therefore increasing risk in these banks' balance sheets and reinforcing the banks-sovereign link, which is itself a source of systemic risk.

Chart 1 Banks' holdings of domestic sovereign bonds

Note: Percentage of banks' assets; based on Eurosystem data.

Source: M. Lanotte & P. Tommasino analysis

According to the Risk Assessment of the European Banking System issued by the EBA in December 2018, exposures to general governments have declined in particular since June 2016. Total sovereign exposure of the EU banking sector stood at EUR 3.0 tn as of June 2018, a 2% decrease compared with June 2017 and a 10% decrease compared with 2 years ago. On EU average, nearly 50% of these exposures were towards domestic counterparties (June 2018), with significant dispersion across countries. For the vast majority of these countries, foreign sovereign exposures are mostly concentrated in EEA countries, with the exceptions of Norway and the UK, where banks have at least 50% of their total exposures towards non-EEA countries (***Chart 2***).

Chart 2 Country distribution of exposures to general governments by their domicile – June 2018 (domestic, other EEA and non-EEA)

Source: EBA supervisory reporting data

According to EBA, on average, 65% of a medium sized bank's Tier 1 capital is on the domestic sovereign, but in the whole distribution there are banks which have up to eight or nine times their Tier 1 capital on domestic sovereign.

3. The sovereign doom loop also affects central banks with large holdings of government bonds purchased as part of QE programs

The quantitative easing policy of the ECB has led to a doubling of the Eurosystem's balance sheet from €2,150 billion at the end of 2014 to €4,620 billion in September 2018. As a result of the Public Sector Purchase Programme of the ECB, the share of government bonds held by NCBs surged in the last three years from around 5% to 15-20% of total outstanding government bonds, as illustrated in ***Table 1***.

But this policy has not reduced the vicious circle between Sovereign and banks in euro area highly indebted countries, as explained above. On the contrary, quantitative easing programs encouraged institutions to borrow cheaply from central banks and invest in government bonds with higher returns. In addition, in Italy, the end of the European Central Bank's QE program and domestic political instability — have increased the problems of financial institutions already laden with significant nonperforming loans.

The linkages between governments and banks are now extended to central banks and this casts a special light on the independence of the central banks.

Table 1 General Government debt held by the Eurosystem (as % of government debt)

	BE	DE	SP	FR	IT	PT	EA19
mi-2019	15.8	20.1	22.4	18.8	19.3	18.9	19.6
2018	16.1	19.9	22.9	19.1	19.3	19.4	19.7
2017	15.5	17.4	21.4	18.5	19.3	19.0	18.7
2016	11.8	12.1	16.3	14.8	15.5	17.4	14.4
2015	7.5	6.0	10.6	9.7	11.3	14.0	9.3

Source: ECB monetary statistics, Eurostat

In any case, the normalization of the monetary policy of the ECB should be very challenging in the absence of structural reforms in these highly indebted Member States and could still reinforce the sovereign- domestic bank nexus.

4. At the global and EU levels, there is no momentum for changing the regulatory treatment of sovereign exposures

For decades, the regulatory treatment of sovereign debt has significantly discounted and, in many cases, ignored the possibility of default on exposures that are denominated and funded in the country's own currency

In most cases, the existing treatment of sovereign exposures is more favourable than other asset classes. Most notably, the risk-weighted framework includes a

national discretion that allows jurisdictions to apply a 0% risk weight for sovereign exposures denominated and funded in domestic currency, regardless of their inherent risk. This discretion is currently exercised by all members of the Basel Committee on Banking Supervision. Sovereign exposures are also currently exempted from the large exposures framework. Moreover, no limits or haircuts are applied to domestic sovereign exposures that are eligible as high-quality liquid assets in meeting the liquidity standards. In contrast, sovereign exposures are included as part of the leverage ratio framework.

EU policy makers urged regulatory actions on EU sovereign doom loop

The SSM said last year that it was vital that banks' capital regimes should reflect the risks they were taking when they held the sovereign bonds of less secure countries. The EU Commission also stressed that the eurozone should think about the concentration charges above a certain level of retention of the home sovereign. The Bundesbank has repeatedly urged regulators to impose limits on the amount of their own government's bonds that banks can hold on their balance sheets. The German Central Bank views the weakening of the sovereign bank nexus as vital for a more solid Banking Union and is reluctant to back measures such as a Europe-wide insurance scheme for deposits (EDIS) without such limits.

The Basel Committee published a discussion paper on the regulatory treatment of sovereign exposures in December 2017, but it did not reach a consensus on making any changes to the regulatory treatment of sovereign exposures

In a discussion paper issued for comments in December 2017, the Banking Committee on Banking Supervision set out some ideas regarding the regulatory treatment of sovereign exposures. It started by reviewing the existing perimeter and segmentation of sovereign exposures and presented the Committee's discussions on possible revisions to the definition of sovereign entities to ensure greater consistency across jurisdictions. It then outlined ideas related to revising the regulatory treatment of sovereign exposures. These can be grouped into three broad categories.

The first set of ideas relates to: (i) the removal of the internal ratings-based (IRB) approach framework for sovereign exposures; (ii) revised standardised risk weights for sovereign exposures held in both the banking and trading book, including the removal of the national discretion to apply a preferential risk weight for certain sovereign exposures; and (iii) adjustments to the existing credit risk mitigation framework, including the removal of the national discretion to set a zero haircut for certain sovereign repo-style transactions.

The second set of ideas relate to mitigating the potential risks of excessive holdings of sovereign exposures, which, for instance, could take the form of marginal risk weight add-ons that would vary based on the degree of a bank's concentration to a sovereign (defined as the proportion of sovereign exposures relative to Tier 1 capital).

The third set of ideas is related to the Pillar 2 (supervisory review process) and Pillar 3 (disclosure) treatment of sovereign exposures. Regarding the former, these include ideas related to guidance on: (i) monitoring sovereign risk; (ii) stress testing for sovereign risk; and (iii) supervisory responses to mitigating sovereign risk. Regarding the Pillar 3 framework, this paper includes ideas related to disclosure requirements related to banks' exposures and risk-weighted assets of different sovereign entities by jurisdictional breakdown, currency breakdown and accounting classification.

However, the Committee has not reached a consensus on making any changes to the regulatory treatment of sovereign exposures at this stage and has therefore decided not to consult on the ideas presented in the discussion paper. This has of course weakened the momentum for change in the EU because it would be contrary to maintaining an international level playing field issues.

In any case, proposals to reduce the bias, ranging from concentration charges to sovereign risk weights to risk-based premia for common deposit issuance, warrant careful consideration, with due attention to serious transitional risks in a context where the international banking regulatory framework (Basel III) creates further incentives for banking institutions to purchase sovereign debt (Liquidity Coverage Ratio...).

5. Fiscal discipline should be the essential feature of the required solution

When States are sanctioned by the market because of their excessive indebtedness, and when commercial banks are saddled with huge amounts of sovereign instruments issued by their country, the weakening of State ratings is automatically reflected in banking balance sheets. Fundamentally, the problem comes from lack of fiscal discipline, excess liquidity created by lasting loose monetary policy as well as from the lack of macroeconomic coordination, more than from banking weaknesses. Therefore, fiscal discipline in all parts of the euro area and in particular in high indebted countries would effectively improve sovereign debt sustainability and reduce the risk of sovereign-related distress.

The enforcement of the Stability and Growth Pact has been too lenient since 2003 EU. Despite the different reforms which took place after the sovereign debt crisis[5], the public debt ratio in significant European Union countries continues to increase and is approaching 100% of GDP or even more in certain Member States. Looking ahead, it should be ensured that compliance with the requirements of the debt reduction benchmark (60% of GDP) is not unduly delayed. Indeed, a monetary union is

[5] A reform (part of the 'Six-Pack') amending the Stability and Growth Pact entered into force at the end of 2011. Another one, the intergovernmental Treaty on Stability, Coordination and Governance, including the Fiscal Compact, entered into force in early 2013. A regulation on assessing national draft budgetary plans (part of the 'Two-Pack') entered into force in May 2013.

not workable without economic convergence and fiscal discipline. Fiscal rules need to be enforced more rigorously. By converging towards lower levels of government debt and regaining fiscal buffers, the euro area will increase its resilience and fiscal space to cope with potentially adverse economic shocks in the future.

Lastly, there is also an international dimension in the sovereign- bank nexus. Indeed, this nexus would weaken if banks were diversified across countries of the Eurozone. This is the reason why addressing the regulatory impediments related to cross-border banking in the euro area would significantly contribute to address the sovereign bank loop in the European Union. In this perspective, cleaning up rapidly the Non - Performing Loan issue and addressing the asymmetry between supervision and resolution at the EU level and, on the other hand, liquidation which is still handled at the national level remain essential EU regulatory priorities.

Strengthening the international role of the euro: how?

With 340 million inhabitants, Europe is the second largest developed world market for trade, after China and before the US. Providing this economic and commercial power with this common currency brings substantial advantages both for the international system and for European countries:

- While exchange rate disorder had reigned since the fall of the Bretton Woods system in 1971-73, a major economic area was the first to acquire a mechanism for the stability of internal exchange rates (the European Monetary System of 1979) and then a single currency (1999). As a result, Europe has made a significant contribution to stabilising the international monetary system;
- As for the countries of the Euro zone, they avoided the uncertainties and economic disorders associated with fluctuating exchange rates. They have therefore been able to benefit from stable benchmarks. Europeans identify the euro as one of the main symbols of the European Union. It has brought visible and very practical benefits to European households, businesses and governments alike: stable prices, lower transaction costs, more transparent and competitive markets, and increased trade. It makes travelling and living abroad easier, interest rates low and savings protected.

The euro is 20 years young and the EU Commission launched an initiative to strengthen the international role of the euro (Communication on 5 December 2018). The decision to use a currency is ultimately made by market participants. The objective of the Commission is not to interfere in commercial freedom or limit choice, but rather to expand the choice for market participants by ensuring that the euro represents a strong and reliable currency of choice.

This note is organised around four headings: The euro is today the second most important international currency (i). The increasing use of the dollar for American political purposes can only obscure its weakening (ii). However, several weaknesses hamper the global use of the euro (iii) and have to be addressed to insure its international development (iiii).

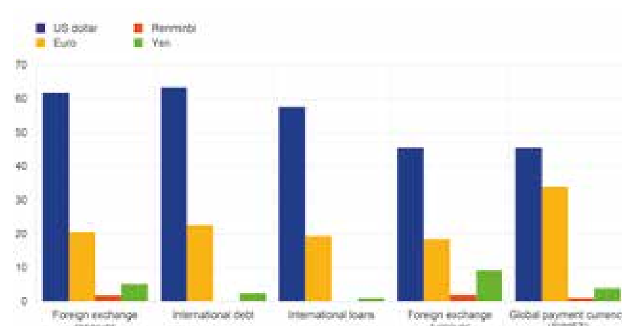
1. The European currency remains the second most important currency in the international monetary system

Since its introduction 20 years ago, the euro has remained unchallenged as the second most used currency after the dollar (***see chart 1***). Some 340 million European citizens use euro banknotes and coins every day across the euro area's 19 Member States. Public support for the euro has been significantly reinforced in the euro area according to the surveys and the «populist» parties no longer militate for the exit of the Euro.

Around 60 countries in the world use, will use or link their currency to the euro. It is a widely accepted currency for international payments, and a significant share of international reserves of foreign central banks and debt issuance on international markets are in euros.

Chart 1 The euro remains the second most important currency in the international monetary system

Snapshot of the international monetary system (percentages)



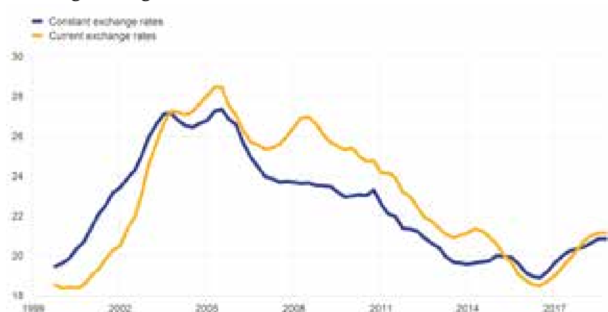
Sources: BIS, CLS Bank International, IMF, SWIFT and ECB calculations.

Note: The latest data are for the fourth quarter of 2018 or the latest available.

However, its usage declined after the global financial crisis (***see chart 2***). After bottoming out in 2016, the international use if the euro has recently slightly strengthened.

Chart 2 The international role of the euro rose from historic lows in the review period

Composite index of the international role of the euro (percentages; at current and Q4 2018 exchange rates; four-quarter moving averages)



Sources: BIS, IMF, CLS Bank International, Ilzetzki, Reinhart and Rogoff (2017) and ECB calculations.

Notes: Arithmetic average of the shares of the euro at constant (current) exchange rates in stocks of international bonds, loans by banks outside the euro area to borrowers outside the euro area, deposits with banks outside the euro area from creditors outside the euro area, foreign exchange settlements, global foreign exchange reserves and share of the euro in exchange rate regimes globally. Data at constant exchange rates were not available for foreign exchange settlements. Data for 2016 are used for 2017 and 2018 observations for the share of the euro in exchange rate regimes globally. The latest observations are for the fourth quarter of 2018.

1.1. The euro is a stable currency widely accepted for international payments but supplanted by the dollar as regards its function as a reserve currency

Stable currency

The euro does fluctuate on the foreign exchange market, because that is the system in which we operate. But, in fact, the variations between the euro and the dollar have been relatively small in the twenty years of the European currency's existence, fluctuating around parity (0. 86 November 2000/1, 12 May 2019).

Moreover, the euro has maintained its «internal stability»; and inflation has remained around 1.7% per year for the past twenty years.

The euro, as a currency of transactions, is at the level of the dollar

The euro has become a widely accepted currency for international payments. About 36% of the value of international transactions were invoiced or settled in euros in 2017, compared to about 40% for the US dollar.

As a reserve currency, the euro is far behind the dollar

The euro represents around 21% of international reserves of foreign central banks while the US dollar remains the leading global reserve currency and accounts for 62% of international reserves of foreign central banks. No other currency exceeds 5%.

1.2. The use of the euro as an invoicing currency is limited notably when transactions do not involve the euro area

The share of the euro as an invoicing currency has been stable in the past decade. Unlike other dimensions of the international use of the euro, the share of the euro in the invoicing of euro area international trade transactions in goods has hovered around 50-60% over the past decade. However, trade invoicing practices vary across euro area trading partners. For instance, the vast majority of euro area trade with the United States is invoiced and settled in US dollars, while the bulk of euro area trade with non-euro area EU countries is invoiced in euro.

Unlike the US dollar, use of the euro for the invoicing of international transactions between third countries is limited. The euro is used as an invoicing currency in more than 30% of global trade transactions in goods. However, unlike the US dollar, there is limited evidence that the euro is used for invoicing when transactions do not involve the euro area. The dominant role of the US dollar is particularly noteworthy in the global trade of oil and other commodity products.

1.3. The role of the US dollar in international debt markets and in international loan and deposits markets is dominant

Since the mid-2000, the share of the euro in the stock of international debt securities has declined by about 8 percentage points (at 23% at the end of 2017) while that of the US dollar has increased by close to 20 percentage points (to over 63%.) The share of the euro in stocks of international debt remains limited outside European countries.

Aside from developed Europe and Canada, the share of the euro in outstanding debt remains below 16%. The dominance of the US dollar in global debt markets is most pronounced in the Middle east and in offshore financial centres, where its share is typically close to 90%, in line with the US dollar's pre-eminence as an invoicing currency of energy products and in global financial transactions. The preference of emerging market borrowers for the US dollar as a funding currency is one persistent factor behind the decline in the share of the euro in international debt markets.

Between 2006 et 2014, the share of the euro international loans declined continuously, reflecting among other things deleveraging by euro area banks, as well as regulatory efforts to reduce exposures to foreign loans denominated in euro. This trend has partially been reversed in the past few years. The share of the euro in the stock of international loans stood at 19,3% at the end of 2018, an increase of 1% relative to the end of 2017, while the US dollar stood at around 60%.

1.4. The ECB's asset purchase programme (APP) has had significant impacts on global bond and deposit flows[1]

At the cessation of net purchases at end-December 2018, Eurosystem holdings of debt securities under the APP had reached €2.6 trillion, with holdings of public sector securities at €2.1 trillion, or 82% of the total. The ECB's massive interventions have changed the distribution

[1] All the statistics and charts presented below are taken from the study, S. Avdjiev, M. Everett and H. Song Shin, "Following the imprint of the ECB's asset purchase programme on global bond and deposit flows, BIS Quarterly Review, March 2019.

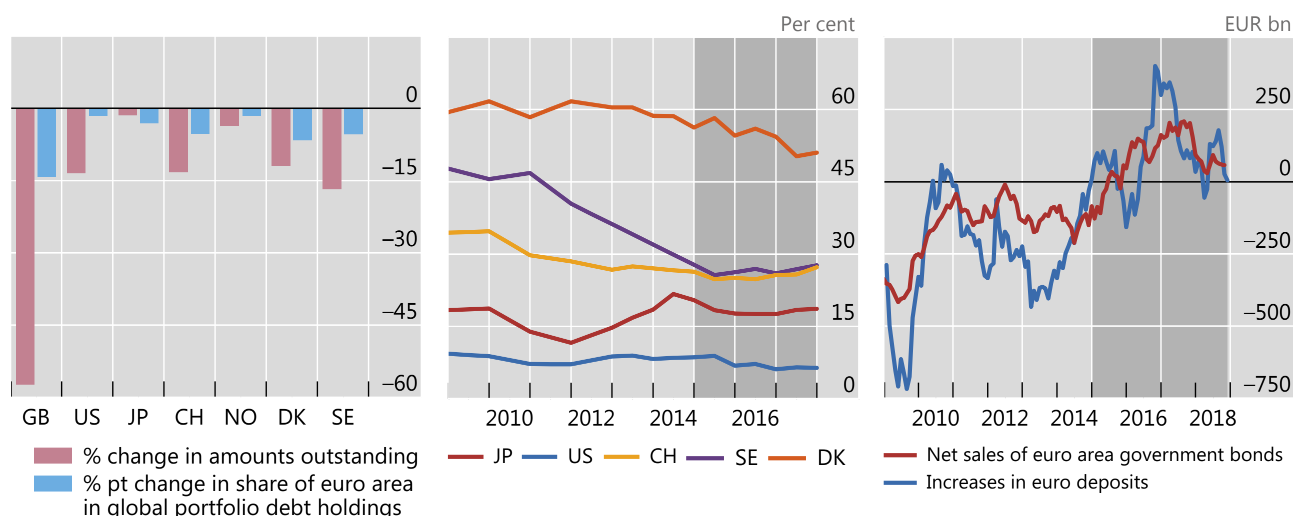
between euro area and non-euro area investors holding government bonds of euro area countries.

Non-euro area investors sold large amounts of euro area government bonds into the Eurosystem bid. In fact, these investors accounted for approximately half of net sales during this period. This represented a sharp reversal of the trend from the pre-APP period, when non-euro area investors were net purchasers. Investors located in the United Kingdom were the most active sellers located outside the euro area (***Chart 3, left-hand panel, red bars***). Their portfolio holdings of euro area debt contracted by more than 50% between end-2014 and end 2017.

Among individual sectors, non-bank financial institutions (NBFIs) sold the most euro area bonds during the period of the ECB's APP. NBFIs resident in the United Kingdom cut their holdings of euro area debt securities by approximately €300 billion between end-2014 and end-2017. NBFIs resident in Denmark and Sweden also reduced their holdings of euro area bonds considerably.

In contrast to the share of bonds issued by euro area residents, the share of euro-denominated bonds remained relatively stable for most major investor countries outside the euro area during the APP period (***Chart 3, centre panel***). This finding suggests that those investors purchased euro-denominated bonds issued by non-euro area residents.

Chart 3 Non-euro area investors' holdings of euro area bonds, euro-denominated bonds and euro-denominated deposits



[1] Euro area government bond holdings for the countries that report a borrowing sector breakdown (US); euro area total (all sectors) bond holdings for the countries that do not report a borrowing sector breakdown (CH, DK, GB, JP, NO and SE). [2] The shaded area refers to the period of the ECB's expanded asset purchase programme. [3] The currency breakdowns for the portfolio debt holdings of NO and UK residents are not available. Missing observations have been filled using linear interpolation. [4] Net sales of euro area bonds by investors located outside the euro area. Increases in euro-denominated deposits by non-euro area residents in banks located in the euro area. Positive figures indicate net sales (red line) or net increases in deposits (blue line).

Sources: ECB, euro area balance of payments statistics; ECB, money, credit and banking statistics; IMF, CPIS.

The net sales of euro area securities by non-euro area investors during the APP have gone hand in hand with a significant rise in non-euro area-sourced euro-denominated deposits in euro area-resident banks (***Chart 3, right-hand panel***).

The increase in euro-denominated deposits outside the euro area between end 2014 and end-2017 was substantial. At approximately €190 billion, it amounted to almost 20% of the total volume of APP public sector securities sold by non-euro area investors. NBFIs accounted for the majority of the expansion in euro-denominated deposits. Most of those were placed in UK-resident banks.

2. Towards a reduction in the international use of the dollar?[2]

Despite the uncertainties of American policy, despite the considerable amount of US debt, and the existence of persistent current account deficits, despite the relative weakening of the US economy against China, the dollar is still the international currency par excellence as we have just seen in the previous chapter of this note.

This supremacy of the dollar does not reflect a «superiority»; it reflects the fact that only the United States, with a permanent balance of payments deficit, can offer the rest of the world a huge amount of debt securities issued in the world's largest market.

[2] This section below is based on a recent speech delivered by Jacques de Larosière, "Tendances de l'économie mondiale", Swiss Life AM, 19 June 2019.

These securities, considered risk-free, are not only accepted but sought after: the strength of the American economy - flexible and competitive - as well as the military strength and political stability of the United States explain this preference.

At the moment, it is not clear what other currency could replace the dollar as an international currency.

The euro is the currency of a continent divided into 19 states, some of which are problematic. As for the renminbi, it is the currency of a major economic power whose financial market remains largely domestic and inconvertible.

Nevertheless, we must ask ourselves a question of the future in a new light, dictated by current events: «Can a key currency such as the dollar retain its status on a long-term basis if the issuing State deliberately engages in protectionist policies? ».

Until recently, the dollar had resisted the relative weakening of the US economy because the country had, on the whole, been able to preserve for non-resident dollar holders the rights that are normally attached to the use of an international currency.

Admittedly, the United States has long practiced a policy of sanctions (Cuba, Sudan, Iran...) against non-residents using the dollar for transactions prohibited by American law. This was already a strong incursion into extraterritoriality and the very negation of multilateralism.

But the current US Administration goes further: it threatens sanctions against foreign (and allied) states that use their own currencies (the Euro for example) to pay for purchases from countries on the list of US boycotted countries (such as Iran), but not subject to boycott outside the US.

This situation is far from anecdotal. A key currency is not a commodity. It must allow transactions to be settled through a clearing system open to all participants. It is a public good. But the fact that the US administration uses the dollar - or threatens to close the US market - as a means of diplomatic pressure for unilateral purposes changes the very nature of the international currency whose «privilege» has been recognized in the USA for so long.

As a result, some EU Member States are seeking to develop a financial mechanism that would allow Iran, for example, to export oil for Euros. But the attractiveness of the American market is so strong that large European companies (those that are highly dependent on their ability to sell in the USA) are reluctant to engage in such a mechanism.

Today, the «dollar system» is still holding up well. But its increasing use for American political purposes can only hasten its weakening. It is still too early to judge. But it is a fact that countries such as China and Russia are in the process of using non-dollar-centric settlement systems. In this respect, we can mention the following:

- China's growing presence in Africa and the Middle East, which is increasingly accompanied by commercial transactions in renminbi;
- The oil market for renminbi futures is expanding rapidly;
- The implementation of CIPS (Chinese cross-border interbank payment system) in 2015 has rapidly become internationalised (CIPS was connected to SWIFT in 2017). Since then, the network of international banks participating in CIPS has grown considerably (including Europe and North America).

It is therefore likely that the rise of the Chinese economy will eventually lead to an increasing internationalisation of the renminbi. The American abuse of extraterritoriality will only accelerate this process.

History shows, moreover, that economic power always ends up extending to finance (the case of the British pound, the world's leading currency, which gave way to the dollar less than a hundred years ago).

3. The weaknesses of the euro which hamper its international use

The expected benefits of a wider use of the euro are significant but the strengthening of the international role of the euro faces multiple obstacles.

3.1. The benefits of a wider use of the euro are well known

A wider international use of the euro would benefit both European citizens and European companies. The latter would benefit from lower cost and risk in international trade, more reliable access to finance through more integrated and liquid financial markets. A greater role of the euro is also desirable because it would provide a greater degree of financial autonomy in the euro area reduce exposure to third country legal actions (through extraterritorial sanctions). It would notably shield the euro area from the increasing use of the dollar by the US administration as a foreign policy tool, possibly conflicting with European interests.

Strengthening the international role of the euro would increase Europe's ability to shape major world events. A currency with a global standing would not just be a symbol of European unity on the world stage, it would also be a tool to project global finance. Indeed, it would allow us to take advantage of the sovereignty of the euro zone in the international monetary system and also improve the resilience of the international financial system by expanding the choices available to market operators around the world.

3.2. The barriers to the euro's global role are in Europe

The euro zone is still facing structural challenges which are obstacles to the international use of the euro: there is a growing heterogeneity in productive specialisation between Member States[3], cross-border capital flows are

[3] Jacques de Larosière and Didier Cahen, Ensuring a viable EMU: are we on the right track, Eurofi note, September 2018.

almost inexistent, and the rebalancing with the Eurozone remains essentially asymmetric. In addition, European capital markets are currently too small and too fragmented, and the Banking Union is far from being completed.

- **The Euro zone is far from functioning as a true integrated monetary zone**

Indeed, in an integrated currency area (as in the case of the USA, for example), regions with a savings surplus transfer capital to deficit regions and thus contribute to investment and growth throughout the Union.

But in Europe, this is not the case. The divergences in economic policies between «core and periphery» during the first ten years of the euro's existence (2000-2010) have deteriorated confidence between states. Some of them, despite their recovery efforts and the fact that they have returned to balance in their external accounts, are still suffering from an accumulation of «non-performing»; bank loans and are subject to obvious structural weaknesses. As a result, savings surpluses from countries like Germany are channelled to the rest of the world (especially Asia), but not to Europe in search of investment.

- **European capital markets are currently too small and too fragmented**

Achieving developed, integrated EU markets that are open and attractive to international investors would reinforce the role of the euro on the international stage. But various legal and institutional barriers (disparate insolvency, securities laws and tax regimes) hinder the creation of a single pool of liquidity. European savings are over-invested in monetary assets (bank accounts, regulated savings accounts, bonds) and insufficiently invested in equities. The capital markets in Europe also suffer from the absence of pension funds.

The underfunding of innovative SMEs all along the financing chain is also a significant EU weakness: the number of IPO on SME dedicated markets have halved to what it used to be before the financial crisis; venture capital funds in Europe have an average size of around €56 million. This is too small to allow Eu start-ups to become bid companies. In the US, venture capital funds are 3x bigger than in the EU. The European private investment/venture capital market is not as well developed as in the US. The amount of money (venture capital) invested in the EU startup companies is 6x less than in the US.

- **The persistent non-conventional monetary policy weakens the EU financial industry, discourages the development of savings products and therefore complicates the relaunch of the CMU project**

Lasting zero and event negative interest rates are an obstacle to the relaunch of the CMU project. Indeed, they encourage retail savers to keep their savings in standard deposit accounts as much as possible, such as checking accounts instead of other investment options (to avoid the tax» levied on securities invested in risk-free assets). In other words, persistent zero interest rates discourage savers from investing in financial investments and encourage preference for liquidity (hoarding). One can observe that retail investors in the EU indeed prefer cash savings over bond purchasing, which do not generate enough return and higher safety. At the same time, the gloomy economic outlook and high levels of equity markets do not encourage equity investment in Europe.

Persistent zero interest rates are « de facto » insufficient for taking risks. Moreover, they weaken the profitability of the financial industry (in particular retail banks and life insurance companies), eventually blur risk premiums and discourage investment.

- **Let us not forget either that the Banking Union is far from being completed**

- Despite the implementation of the SSM and the SRM, ring fencing policies still apply to capital, liquidity and bailinable liabilities of subsidiaries of EU transnational banking groups. This clearly distort banking markets, fragments them and impedes the restructuring of the banking sector in Europe, which cannot benefit from the economies of scale of the single market compared to US banks for instance, which rely on a large unified domestic market.
- The amount of NPLs, although decreasing since the peak of 1. 2 trillion in 2013, remains a major source of vulnerabilities in some member states (Greece, Cyprus, Italy, Portugal...).
- The treatment of bank failures is not sufficiently harmonised, consistent and predictable.

4. Ways to further strengthen the euro's global role

The EU has the means to erode at least some of the dollar's privilege, but strength abroad reflects unity at home. The EU needs to make the eurozone a properly managed currency area and to implement serious reforms. Then the implementation of the initiatives listed in the Communication of the EU Commission issued on December 2018 would certainly boost the international role of the euro.

4.1. Sound domestic economic policies in all parts of the euro area would boost the global role of the euro

Implementing structural reforms within each Member State with a view to achieving a steady convergence towards resilient economies is fundamental for improving the functioning of the EMU and the international use of the euro. Reducing vulnerabilities whilst enhancing the capacity to absorb shocks and reallocate resources will require comprehensive structural reforms.

A monetary Union cannot work without fiscal discipline and the enforcement of the Stability and Growth Pact has been too lenient since 2003[4]. It is difficult to make

[4] The weak implementation and lax enforcement of the rules have undermined the credibility of the fiscal framework. This, in turn, has weakened countries' incentives to respect the rules, as well as the European institution's ability to enforce them.

progress to deepen the EMU and the use of the euro as long as existing rules have not been met by all Member States. Eurozone fiscal rules should be more effective and binding. This would help to rebuild buffers and ensure debt sustainability.

4.2. Correcting in a symmetric way the current disequilibrium in the Monetary union in order to ensure the long-term viability of the euro and facilitate its international development

The current economic situation is problematic in the euro area. Germany, the Netherlands and others now have major current account surpluses, while other countries have great difficulty in balancing their external accounts.

And the effects of specialisation go in this direction: countries like Germany with a strong industrial tradition, low costs and exemplary economic governance benefit from the existence of the Euro zone, in which devaluations are impossible.

Without the Euro, the markets would have strongly revalued the currencies of these creditor countries (the virtual DM would be undervalued by 15 to 20% compared to the peripheral countries). But since the euro exchange rate is the result of an average of countries (strong and weak), it follows that highly competitive economies benefit from an additional export strength, due to the relatively low appreciation of the euro. And this can only maintain the «dynamic of heterogeneity».

It is time to correct these imbalances in a symmetric way:

This implies:

- That countries in deficit and whose debts are not «sustainable», gradually take credible measures to put their public accounts in order; sound economic and fiscal policies and structural measures[5] in all parts of the euro area would ensure mutual trust among member states, strengthen and upgrade the credit quality of outstanding debt, and would contribute to increasing the supply of safe euro area debt[6] and raising the euro's global role.
- But that structurally surplus countries such as Germany and the Netherlands also take measures to reduce their savings surplus relative to their investments (by stimulating their infrastructure investments, a more equitable share of European defence and security spending, the implementation of planned intra-European financial solidarity mechanisms, etc.). The aim is to put more symmetry into the adjustment process, and to make the whole area contribute to a more harmonious policy.

We are at the moment of the «last chance». If nothing is done towards greater cohesion, imbalances will accumulate and some parts of the Union will sink even deeper into under-productivity and deindustrialisation. Let us not forget that, over the last ten years, the per capita income of the poorest European countries has been falling relative to that of the richest countries.

Without wishing to create a supranational arsenal of too great an ambition, and without falling into the unrealistic trap of a complete pooling of risks, existing cooperation mechanisms should be applied more seriously (Macroeconomic Imbalance Procedure...) than we do today, and the necessary economic adjustments should be implemented in a more symmetrical and mutually supportive manner between debtors and creditors.

4.3. Implementing the initiatives of the EU Commission presented in its Communication (December 2018)

to the extent that Europe is implementing the reforms mentioned above, the initiatives mentioned in this Communication would effectively boost the international use of the euro

It is about:

- Completing Europe's Economic and Monetary Union, Banking Union and Capital Markets Union.
- Additional measures to foster a deep European financial sector, including more efficient European financial market infrastructures; solid interest rate benchmarks and an integrated instant payment system in the EU.
- Initiatives linked to the international financial sector: ongoing cooperation between central banks to safeguard financial stability; increasing the share of euro denominated debt issued by European entities; fostering economic diplomacy to promote the use of the euro and providing technical assistance to improve access to the euro payment system by foreign entities, notably in the context of the European External Investment Plan.
- Promoting the wider use of the euro in strategic sectors and notably in international energy agreements and transactions.

[5] Structural reforms to foster entrepreneurship, support SMEs and advance digitalization would encourage domestic investment and improve potential growth.

[6] In the longer term, the creation of a common euro area safe asset, in a way that does not undermine incentives for sound national fiscal policies, could also contribute to this objective.

Initiatives to strengthen the international role of the euro include:

1	Completing the Economic and Monetary Union, Banking Union, Capital Markets Union	
2	Measures to foster a deep European financial sector	• Strengthening the liquidity and resilience of European market infrastructure • Ensuring a reliable framework for a trustworthy interest rate benchmark • Supporting a fully integrated instant payment system in the EU • Consultation about euro liquidity in foreign exchange markets
3	Initiatives linked to the international financial sector	• Supporting Central Banks' collaboration to safeguard global financial stability • Increasing the share of euro denominated debt by European bodies • Fostering economic diplomacy to promote the use of the euro in payments and as a reserve currency • Technical support to improve access of developing countries to the euro payment system

4	Promoting the use of the euro in key strategic sectors	• Energy:
		  • Recommendation to promote a wider use of the euro in international energy agreements and transactions
		  • Consultation on expanding use of euro-denominated transactions in oil, refined products and gas
		• Consultation on increasing use of the euro in raw materials and food commodity trading
		• Consultation on expanding use of the euro by transport sector manufacturers (aircraft, maritime and railways)

Source: European Commission, Factsheet "Further strengthening the euro's role in the world", December 2018

Promoting the euro internationally attempts to counter the US-led retreat from globalisation and free markets. The European Commission has argued for a more global role for the euro amid concerns that elements of US foreign policy, such as "America first" and sanctions on Iran, cannot be bypassed in a world order where most global trade and financial transactions are priced in dollars.

The euro is a natural candidate for a diversification of the US dollar as the euro Is the second largest global reserve currency. But the US dollar is used in reserves, in payment systems and for funding banks because it has a massive pool of safe assets in the form of US Treasuries and stable and tested monetary and political governance.

Europeans should not ignore the fact that a currency cannot be given reserve status by administrative fiat. Strength abroad reflects unity at home. To erode some of the dollar privilege, the member states should implement structural reforms and make the euro zone a properly managed currency area. Only steadfast and balanced efforts both in deficit and surplus countries reinforced by actions to deepen EMU and to develop private risk sharing will galvanise growth and stability in the euro area and assure that Europe becomes a beacon of hope and a place of prosperity in a troubled world. The problem with the euro is that it does not lack assets but unity…

How to sustainably improve capital allocation across the EU?

Priorities for improving investment financing into the sectors of the future across the EU

Long-term and sustainable investment is essential for economic growth. An appropriate allocation of capital in the EU is crucial to ensure that investment supports productivity and growth through Foreign Direct Investment and technology for Europe's future and to promote exports.

The EU has a long-term growth and productivity weakness and is falling behind the US and China in a number of technologies that are essential not only from an economic viewpoint but also from a geopolitical perspective. Europe is home to only 16 unicorns[1], versus 91 in the US and 44 in Asia. Of the world's 15 largest digital firms, all are American or Chinese.

Furthermore, the financing gaps in European risk capital markets – caused by the lack of funding, the regulatory fragmentation across the EU and the risk averse nature of the European investor - are driving both early-stage and growth-stage companies to turn to non-European - for example US and Chinese - investors to meet their financing needs. Europeans can no longer afford to be the incubator for other industrialised countries.

In such a context, the success of the European states will necessarily entail a shared strategy. Technological challenges require a European industrial policy and strategy for technology funding.

In this perspective, member states need to accelerate their homework and implement strong and credible domestic reforms in order to improve the business environment, the competitiveness of SMEs, promote digital services, education and skills and attract private investors. But Europe has also to do more. In order to compete with large economies, the EU must focus its efforts and boost its firepower beyond the full use of InvestEU and a strong implementation of Horizon Europe[2].

The EU should restore cross border capital flows between EU countries, encourage the development of equity instruments and support more actively disruptive technologies that are key in maintaining Europe's leading role in innovation and global competition.

This note is divided into three parts: it focuses on the long-term growth and productivity weakness the EU is facing (i), the causes of this situation (ii) and propose different initiatives in order to contribute to a better allocation of capital across the EU and restore EU industrial leadership in the sectors of the future (digital, artificial-intelligence, innovation...).

1. The EU has a long-term growth and productivity weakness and faces challenges in terms of investment band innovation

Productivity gains in the euro area have failed to catch up with the U.S. over the past two decades, and productivity gaps across member countries remain significant. Corporate investment is much higher in China and Japan than in the EU and the US. and there is considerable variation across EU countries.

In terms of research spending, the EU is also lagging behind the US, China and Japan. Furthermore, Europe is adding an Artificial Intelligence (AI) gap to its digital gap. The next decade may well see a revolution in manufacturing service provision, through shared platforms built on control over data flows. Countries are increasingly engaging in active competition to secure leadership in many of these sectors. But none of the world's 15 largest digital firms are currently European.

Creating an environment where businesses thrive should be at the heart of the European project. A healthy business environment allows winners to grow organically, requiring limited direct state support or protection. However, according to the World Bank's Ease of Doing Business ranking, the EU is steadily losing its competitiveness with respect to other economies in its ability to foster a dynamic firm environment. Only two of 28 Member States saw improvements in their ranking in the 2019 report, three retained their positions, while all the rest saw a decline, compared to 2018.

1.1. The EU and in particular the euro area have not recovered from the deep economic crisis compared to global competitors

Euro-area average annual GDP growth since 2014 has been 1,9%, while that of the United-States has been 2,3%. The bulk of the lagging euro-area performance is attributable to Italy, Spain and France. Meanwhile central and eastern European countries 'growth rates have exceeded the EU average.

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[1] Private companies with a value of at least $1 billion.

[2] Invest EU is the follower of the Junker plan that allows the building of bridges with the use of structural funds. Invest EU provides an EU guarantee to mobilise public and private financing in the form of loans, guarantees, equity or other market-based instruments, to strategic investments in the support of Research and Development through a dedicated investment window. Regarding Horizon Europe, the European Parliament has requested from the next multi-annual financial framework a budget of 120 billion euros over the 2021/2027 period.

1.2. Productivity gains are much higher in the US, China and Japan than in the EU

On productivity growth, Germany has been performing strongly over the past years, whereas productivity growth in other euro area countries such as France and Italy is well below that in China, Japan and the US (***see charts 1 and 2 in the annex***).

Looking at the past decades, there is a slowdown in productivity growth in Europe compared to previous decades, especially in France and Italy. This has led to higher potential growth in the United States than in the EU. it also explains the gap in the modernisation and innovation of companies. Indeed, productivity growth ultimately depends on the capacity to innovate and to improve business processes.

The example of Italy shows the major problems a country finds itself with labour productivity is stagnant over a long period; stagnant purchasing power (i.e. stagnant per capita incomes), declining competitiveness, declining profitability and corporate investment, stagnant tax revenues and a reduction in efficient public spending[3]. All economic policies in the EU should have the explicit objective of lifting productivity (education, training, development of tech companies, efficient public investment).

Moreover, digitalisation, artificial intelligence and the data and platform economy are all key drivers of European productivity, growth and employment. In the long term, maintaining economic growth and employment will depend on the ability of business and industry to make full use of the potential offered by digital technologies. According to McKinsey[4], if Europe on average develops and diffuses AI according to its current assets and digital position relative to the world, could add some €2,7 trillion or 20 percent, to its combined economy output, resulting in 1,4% compound annual growth through 2030.

1.3. Corporate investments and R&D are higher in large economies than in Europe

Corporate investment is much higher in China, Korea, and Japan than in the EU and the US. And there is considerable variation across EU countries (***see chart 3***).

On R&D, the European innovation scoreboard for 2019 is quite positive since it shows that the EU's average innovation performance has increased by 8,8 % between 2011 and 2018, one point above the US. However, in terms of research spending, the EU spent 1.93% of GDP in 2016, compared to 2.11% in China, 2.74% in the US and 3.14% in Japan[5]. China is catching up to EU levels (in percent of GDP), but still below US levels (***see chart 4***).

1.4. Europe is adding an Artificial Intelligence (AI) gap to its digital gap

Europe may risk falling further behind the US and China, the leaders on the adoption and supply of artificial intelligence (AI). Both are investing aggressively in these technologies.

According to a recent study issued by McKinsey Global Institute[6], although Europe's GDP is comparable with that of the United States and just ahead of China's, the digital portion of Europe's Information and Communication Technologies (ICT) sector today accounts for around 1.7 percent of GDP, lower than the share in China at 2.1 percent and only half the 3.3 percent share in the United States.

There is a large spread of artificial-intelligence (AI) readiness in Europe, but even the most ready countries are behind the United States on the AI frontier. AI initiatives remain fragmented in Europe, and investment in AI is nothing like the size of that in the United States or China. According to another note issues by Mc Kinsey[7]:

- As of the end of 2017, Europe was not home to any of the world's 10 largest internet companies and only two European companies were in the worldwide digital top 30;
- In February 2017, Europe had only 10% of the world's 185 unicorns – private companies with a value of at least $1 billion – compared with 54% for the US. China had 23% of unicorns (McKinsey Global Institute 2019). Only four European companies were in the top 100 global AI start-ups: Onfido and Tractable in the UK, Shift Technology in France, and Sherpa from Spain (CB Insights 2017);
- Despite the fact that Europe has been a pioneer in testing and developing AI technologies, capital invested for digital startups has been subscale compared with the US and China. As of the end of 2017, the US has invested around €220 per capita. In Europe, Sweden invested €123 per capita (the highest in the region) and Finland €58, but per capita investment was only €3 in Italy. In the provision of AI, Europe attracted only 11% of global venture capital and corporate funding in 2016. At this time, 50% went to US companies, with the balance going to Asia – mostly China (MGI 2017);
- In 2018, Europe had still not caught up (CB Insights 2017). In that year, China attracted almost half of global investment in AI start-ups, ahead of the US with 38%.

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[3] P. Artus, Zero productivity gains: is the euro zone heading in the direction of Italy?, Flash Economics, Natixis 15 February 2019.

[4] J. Bughin, J. Seeing, J. Manyika, L. Hämäläinen, E. Windhagen and E. Hazan, AI in Europe, MCKinsey, February 2019

[5] M. Demertzis, A. Sapir, G. Wolff, Promoting sustainable and inclusive growth and convergence in eh European Union, Policy Contribution, Bruegel, April 2019.

[6] Tackling Europe's gap in digital and AI, Discussion paper, McKinsey Global Institute, February 2019.

[7] Jacques Bughin, How to develop enough European AI startups?, VOX, CEPR Policy Portail, 26 February 2019.

2. Why is it so?

2.1. Enterprises are freer to work and make profits in the US than in Europe

The role of the State in economic life is less important in the United States than in Europe: Total public expenditure is 38% of GDP in the USA compared to an average of 49% in Europe. Consequently, fiscal and social contributions are higher in Europe.

Markets are also more flexible in the US. Europe imposes administrative burdens on creating new firms or on growing beyond arbitrary thresholds that trigger an increase in compliance costs. This is not observed in the US. Furthermore, the number of EU tax jurisdictions make for a complex business environment, especially for start-ups and SMEs. As a result, firms operating in the EU face a higher tax compliance burden than firms in the US, Japan, Australia or Canada, effectively reducing EU firm competitiveness in global markets.

In addition, Europe has been comparatively slow to adapt to technological changes (e.g. integrating digital into existing industrial processes, understanding the transformative nature of digital technologies). And yet digitalisation has dramatically augmented the reach, flexibility and agility of companies, big and small. Today's most successful businesses are those that use digital technology not just to boost productivity and improve internal processes, but as a means of reinventing themselves: their operational models, their value chains and their customer relationships.

Late 2017, only 24% of enterprises had adopted big data analytics, 16% had integrated robotics and automated machinery, and only 5% were working with Artificial Intelligence or 3D printing[8]. This also reflects a general shortage of highly-skilled tech professionals in these areas – hardly surprising when one considers that in 2017, 43% of the EU population had an insufficient (less than basic) level of digital skills, while those with low overall digital skills had actually increased from 23% in 2015 to 26% in 2017[9]. These numbers speak for themselves, and the repercussions down the road could be severe: Europe can hardly expect to become a global leader in Artificial Intelligence if its companies fail to master its most basic feature, namely big data analytics.

2.2. In spite of more buoyant savings in Europe, financial markets are three times more important in the US than in the EU in financing the economy

Cross-border capital flows are underdeveloped in Europe. Since the financial and sovereign debt crisis, financial flows between Eurozone countries have declined and fragmentation in the single banking market has increased despite the implementation of the Banking Union five years ago. Although the euro zone has a large surplus of savings over investment (while the USA has a deficit), European companies do not benefit from it. German, Dutch, etc. investments do not irrigate the countries of southern Europe, but are placed outside the euro zone, particularly in the United States and Asia. It is therefore a real paradox: the euro zone's savings surpluses do not contribute to investment in Europe.

Banks in Europe, which are a key component of financial markets, are in a relatively weaker position compared to their American competitors, and the Capital Markets Union is far from having kept its promises.

The underfunding of innovative SMEs all along the financing chain is notably a significant EU weakness: the number of IPO on SME dedicated markets have halved to what it used to be before the financial crisis; venture capital funds in Europe have an average size of around €56 million. This is too small to allow EU start-ups to become bid companies. In the US, venture capital funds are 3x bigger than in the EU. The amount of money (venture capital) invested in the EU startup companies is 6x less than in the US. This is why successful start-ups in Europe are more likely to exit European markets in a context where they are unable to access sufficient scale-up funding. European unicorns like Spotify, for example, had turn to foreign investors to gain access to the capital they needed to scale up and become globally competitive.

In 2017, growth capital still represented less than 7.5% of overall funding in Europe – at 6.7 billion euro, against 92 billion euro of total private equity raised. This is one of the key reasons why Europe's most successful companies often end up in the hands of third country firms or investment funds (***see following chart***).

Chart 1 Funding gap between the US and Europe is widening in later stages...

Investments in Europe and US by stage focus in 2017, in billion US dollars

Source: Dow Jones VentureSource, EU industrial policy after Siemens-Alstom - Finding a new balance between openness and protection, EU Commission 2019

3. What can be done?

Monetary policy cannot do everything and cannot replace the domestic reforms needed for long-term growth and reduce unemployment. Productivity growth ultimately depends on the capacity to innovate and to improve business processes.

[8] European Commission, Digital Transformation Scoreboard, 2018.

[9] EPSC estimate based on Belt and Road initiative data.

Member States need to accelerate the implementation of structural reforms in order to improve the competitiveness of firms and increase trust between member states; reducing the administrative burden will help crowd-in more private capital. Transforming education and training[11] and improving labor market dynamics and enabling more diverse forms of work are also required. But structural reforms will not be sufficient to restore robust growth in Europe and encourage technological change.

Europe has to do more. Restoring cross-border capital flows between EU countries in order to allow excess savings from northern countries with a high marginal productivity of capital (Germany, Netherlands…) to flow to finance sustainable investment in countries with low labour productivity (South Europe, CEE countries) and developing equity markets in Europe would actively support sustainable growth in Europe.

Furthermore, in order to compete with large, uniform economies like the US or economies where the state plays a strong role, the EU must support disruptive and critical technologies that are key in maintaining Europe's leading role in innovation and global competition.

But as stated by Roger Havenith in the Eurofi Helsinki Magazine," In this perspective, EU public decision makers need in particular to reinforce financial instruments so that they can offer effective, proven fields, market-based solutions that can attract private capital and boost the European innovation ecosystem…. We also need to offer continuity in our proposal of support, throughout a company's lifetime, focusing as much on early-stage innovative ventures as on companies in the growth and expansion stages. We need to offer the kind of support that will allow the next global industrial champions to not only be born in Europe, but grow and flourish in Europe, without having to relocate to access the finance they need. Today, of the world's 15 largest digital firms, not one is European. We can no longer afford to be the incubator for other industrialised countries".

Lastly, a European industrial policy and strategy for technology funding is required if Member States wants to sustain their economic sovereignty and independence.

3.1. European countries need to accelerate their homework and implement strong and credible domestic reforms in order to improve the business environment, the competitiveness of SMEs and attract private investors

Monetary policy cannot be the engine of growth. High sustainable growth in Europe can only be achieved by reducing reliance on debt and reinvigorating productive strength. Only domestic structural reforms - e.g. reducing public spending in relation to GDP, reducing the regulatory burden on firms, taking steps to encourage innovation and technology diffusion, shifting taxes away from labour, encouraging apprenticeship programmes, modernizing social safety nets to reduce disincentives to work, enhancing public administrative capacity and procurement frameworks… - can solve structural weaknesses in Member States, raise output and productivity growth, contribute to a healthy business environment, and reduce competitiveness problems and recourse to debt.

A comparison between Germany and other EU countries such as France shows major economic and fiscal discrepancies that need to be addressed for achieving stronger growth in these countries and restoring trust between Member States. Reducing public expenditures specially when they represent too large a proportion of GDP (France 56,5%, Italy 48,8% versus 43,9% in Germany and 41% in Spain) is essential[12]. Furthermore, improving the quality of public expenditure (increasing funding for future technologies and R&D and reducing non-productive expenditures) is of the essence.

3.2. Restoring cross border capital flows between EU countries

Europe competes against the US and China, which benefit from large and relatively homogeneous markets. Even the largest European economies lack scale to compete on a global scale. However, cross-border capital flows declined in Europe after the financial and sovereign debt crisis. Data on cross-border capital flows shows that despite recent improvements, financial integration in the EU remains below pre-crisis levels. Retail credit markets are fragmented, cross-border private risk sharing is subdued, and a persistent home bias remains in portfolio allocations.

Accelerating the integration of European capital markets, making effective the Banking Union and more flexible the EU legislative process to respond efficiently to technological change are important policy priorities in this respect (see Eurofi papers produced on those topics for the Eurofi Helsinki events).

Regarding the CMU project, the Commission is always focused on the laudable objective of reducing regulatory barriers. As suggested by Jacques de Larosière[13], "there should be a little less focus on reducing barriers and a little more on Europe's attractiveness for foreign investors. How far can we open the windows and how can we attract more capital? Even if we don't have the answer, how to properly pose the problems is more important than the immediate answers. We should also focus on openness, because by focusing solely on the elimination of intra-European barriers, we are not looking at the essential issue, which is to attract the world's capital to Europe".

[11] This will require coordination between parents, educators, governments, employers and employees with a focus on enabling lifelong learning, especially for individuals with skills that can be easily automated, as explained in the studies issued by MC Kinsey.

[12] The main issue in France is the level of public expenditure which amounts to 56,5% of GDP in 2017 compared to the average level of the euro zone (49% in 2016). This too high level of expenditure must be accompanied by an excessively high level of taxes, particularly on businesses. This is why France urgently needs to rebalance its public accounts in order to reduce the excessive level of tax and contributions which are detrimental to the competitiveness of French companies.

3.3. Deeper equity markets would bring economies closer to the technological frontier supporting growth and encouraging "greener innovations"

3.3.1. Equity financing in Europe needs to be significantly improved

Europe is lagging behind in this area. The funding of European companies is indeed characterised by a bias towards debt and against equity. The equity share of corporate financing is half as large as in the US-only 52% of GDP in the euro area, versus 120% in the US. European savings mainly consist of monetary assets (bank accounts, passbooks, bonds), but not shares. As long as powerful equity investors (e. g. pension funds) do not appear in the euro zone, we will continue to see the jewels of European industry passing into foreign hands that have the firepower to buy shares.

If we really want an equity market in Europe, it is essential to have a favourable ecosystem, and we need to change the regulations which create disincentives to long term investment and equity in particular (Solvency II, Accounting rules etc.). Correcting the current bias in favour of debt that exists in EU tax systems at issuer level is an important issue that needs to be addressed. Indeed, the tax deductibility of interest payments in most corporate income tax systems coupled with no such measure for equity financing creates economic distortions, impedes efficient capital market financing and exacerbates leverage. Another challenge is to develop more cross-border issuance and the holding of securities. This requires launching harmonization efforts at the EU level with regard to the legal regimes applying to securities (e.g. ownership rules) and insolvency laws. These actions may seem ambitious but launching them is essential for further developing EU capital markets.

3.3.2. Proposal for a European Savings-Investment Fund

Such a Fund was proposed in 2014 by Messrs Edmond Alphandéry, Jacques de Larosière, Daniel Gros and Thomas Meyer. This proposal[14] is still valid notably in the environment of persistent negative interest rates and should be taken up by the new Commission. It would notably overcome the current financial fragmentation of capital markets. This proposal can be summarized as follow:

At present, the euro area suffers from a savings surplus and an investment deficit at the same time. Savings surpluses and investment deficits are distributed unequally over regions. The key problem of the savings-imbalance in the euro area is that savers primarily demand debt instruments. The demand for debt is especially pronounced in Germany, which is also the largest contributor to the savings surplus. German savers traditionally are averse to equity investments and put their money into bank accounts, government bonds or life insurance.

The European Savings-Investment Fund would use euro area excess savings to fund the euro area investment deficit. This Fund would issue debt instruments and invest the funds raised into equity instruments. It offers savers what they demand and invests the funds companies cannot obtain otherwise. The sole purpose of the Fund is to achieve an attractive return (which is easier in an environment of persistent very low interest rates) with low risk. To raise capital the authors of this proposal envisaged to offer long-maturity savings bonds to euro area households and potentially life insurance companies with a guaranteed minimum real rate of return.

Funds should be invested in a broadly diversified international equity portfolio, with country allocation reflecting global GDP weights, market capitalization and a discretionary home bias factor. Investable instruments would include traded equity, private equity and mezzanine capital. It was envisaged that funds would be collected by National Public Development Banks, such as KFW in Germany, Caisse des Depôts in France, Cassa Depositi in Italy and ICO in Spain. These public institutions would guarantee the minimum interest and redemption of the savings bonds (and hedge this guarantee with their governments) ...

3.4. Innovation and funding: fast tracking investment into the sectors of the future

Europe boasts a wealth of talent, world class researchers and skilled entrepreneurs. Europe should do better at turning that excellence into success stories. European champions need to be able to find all the support they need in Europe. We cannot afford to be the incubators for the US and China. This is why the EU needs to define a strategy for technology funding which supports breakthrough innovation, ensures the protection and diffusion of knowledge and seamless funding throughout the innovation cycle. We need in particular a quantum leap for private equity and venture capital in Europe; in addition, the EU must design market-oriented financial instruments that target gaps in terms of sectors, geographies and SME segments that stand to benefit most, so that we can ensure long-run growth.

Supporting breakthrough innovation

The EU innovation policy framework has for too long lacked instruments to support disruptive or breakthrough innovation, aimed at creating new markets. The new vehicle to address this gap, the European Innovation Council, is currently in the pilot phase but already has a budget of some 2.2 billion euro for 2019-2020, including combined grant and equity investments to fill market gaps for fast-growing, technology-based companies, and for targeted support to next-generation technologies (digital twins, human-centric AI, etc.).

The European Commission has proposed to scale this up to 10 billion euro under the next budgetary cycle. It is important to strengthen this proposal to encourage breakthrough innovation projects in Europe.

[13] Jacques de Larosière, Union des marchés de capitaux et supervision: quel système financier européen voulons nous ? Confrontation, 27 June 2019.

[14] Edmond Alphandéry, Jacques de Larosière, Daniel Gros and Thomas Meyer, « Proposal for European Savings- Investment Fund", Euro50 Group, 28 March 2014.

Ensuring the protection and diffusion of knowledge

Although Europe boasts the largest publicly funded research programme in the world (Horizon 2020), only about 1% of this funding is dedicated to knowledge and tech transfer. What is more, where R&D funding results in successful innovations, there are too few guarantees that these will be industrially deployed in Europe. A more holistic approach is needed, which acknowledges the interlinkages between the different stages from research to innovation, and from lab to company.

Seamless funding throughout the innovation cycle: a quantum leap for private equity and venture capital is urgently needed in Europe

The EU needs to offer continuity in the financial support throughout the lifetime of a company, from its early days to commercialisation, growth, straight through internationalisation and eventually even IPO.

A particular effort for public actors is needed to incentivise private venture capital investments – in particular from large institutional funds (pension funds, insurance companies, sovereign wealth funds) which are currently chronically underrepresented in venture capital, and by crowding in trusted foreign investors. Risk capital lacks critical mass. While Europe has made real advances in narrowing the gap to the US with regard to seed and early-stage funding for start-ups, it lags behind on the later-stage funding of companies. Indeed, investments in venture capital are approximately 10 times smaller than in the US for the early stage. For the late stage the ratio is 1 to 20.

In 2017, growth capital still represented less than 7.5% of overall funding in Europe – at 6.7 billion euro, against 92 billion euro of total private equity raised[15]. This is one of the key reasons why Europe's most successful companies often end up in the hands of third country firms or investment funds (***Chart 1***). There is therefore an important role for public actors in developing the private equity and venture capital markets in Europe. This should be one of the key priorities of the relaunch of the Capital Markets Union project.

The success achieved with the European Fund for Strategic Investments must be continued, reinforced and broadened. It would be appropriate to create a European strategy for technology financing within the framework of Invest EU and with the participation of competent and experienced European institutions (such as the European Investment Fund) capable of raising private capital in order to contribute to the financing of equity capital for start-ups and innovative technology companies.

3.6. Technological and climate challenges require a European industrial policy

At a time of increasingly fast technological and climate changes, Europe must pool its strengths and be more united than ever. The industrial sector of the 20th century is changing to digitalization. Brand new industrial sectors are appearing such as those linked to artificial intelligence, others are changing at great speed such as the car or railways sectors, and other traditional sectors will continue to be essential such as steel or aluminium.

As stated in the Franco German Manifesto "If Europe still wants to be a manufacturing powerhouse in 2030, we need a genuine European industrial policy. The investments required to enable Europe to compete on the global stage and the development of long-term industrial strategies aiming inter alia at a carbon-neutral economy are so important that we can only succeed if we pool our funding, our skills, and our expertise. The choice is simple when it comes to industrial policy: unite our forces or allow our industrial base and capacity to gradually disappear. A strong industry is at the heart of sustainable and inclusive growth. And above all, it's what will give Europe its economic sovereignty and independence".

Benjamin Angel outlines in his article for the Eurofi Helsinki Magazine that "a strategic focus on growing future innovation leaders is important here, as is attracting and retaining skilled labour in Europe. A possible investment arm of a European industrial strategy should keep in mind the objective of developing innovation in key industries of the future, fixing financial market inefficiencies and fostering technological adoption and diffusion. It could, for example, focus on strategic long-term investments, tailor-made to support European champions of the future".

A clear view of which sectors will drive future innovation should guide the industrial policy measures of government and the EU. Clarity is needed about the nature of support for European industry. The political level needs to make strategic choices about support for broad technologies or industries. Particular attention needs to be paid to areas: a) where Europe possesses or is developing a competitive advantage, b) chooses to prioritise and invest public resources, given their importance in addressing societal challenges, c) sees as vital to its strategic autonomy. Many of these areas have already been identified in the EU's 2017 Industrial Policy Strategy, such as automotive (including batteries), energy systems, the Internet of Things, robotics, Artificial Intelligence, defence, space and the bio economy.

However, action in these areas needs to be stepped up and accelerated if Europe is to stay in the global race. Focus should also be placed on key enabling technologies such as 5G or quantum technologies that will be central to Europe's future cybersecurity.

3.7. For a European Sovereign Wealth Fund or a European Industrial Renaissance Fund (EIRF) as an investment arm of a European industrial strategy

Countries like China systematically use sovereign wealth funds (SWFs) – state-owned or supported investment vehicles – as strategic tools to acquire competitive advantages and strategic inroads abroad. These funds not only offer a return on investment but also an opportunity to inform and shape economic developments elsewhere.

[15] Invest Europe, 2017 European private equity activity Report, May 2018.

The EU has no real SWF, which limits the set of tools it can use to support and diversify its economy and puts it at a comparative disadvantage. A European SWF could provide an optimal and future-oriented way of developing strategic sectors with a strong focus on innovation. Of course, this would require a properly designed governance and accountability framework, as these types of tools often suffer from lack of transparency in their structure, investment strategy and returns. Naturally, the ability of a European SWF to deliver an impact would depend on the resources it can mobilise...

Another proposal could be to set up a European Industrial Renaissance Fund (EIRF) able to be a long-term cornerstone investor which could complement and amplify national initiatives. Such a Fund could invest across the spectrum both in private and public markets and in particular in innovation leaders, contribute to building European champions in EU strategic sectors, take strategic equity holdings in EU companies, to ensure EU anchoring. This vehicle would maximise crowding-in of resources on specific thematics/ sectors and in specific geographies and would provide a European scale.

Lastly, as stated by Pervenche Berès in her article for the Eurofi Helsinki Magazine, “Europe should rethink the competition policy and the way it should support an EU industrial policy. Up to now this policy was first targeted to oppose monopoly but in a more complex world trade environment the debate has finally emerged on how should the EU competition policy favour EU stakeholders vis-à-vis their global competitors. In this spirit, it will be very interesting to follow the next step after the adoption of the copy right directive with which the EU could be taking the lead to boost its cultural and creative industry”.

Despite domestic and EU efforts to strengthen Europe’s industrial base and innovation potential, the results in Member States have been disappointing particularly in light of the pace of rapid change that the world is now undergoing. The onus is now clearly on member states to come together around a coherent set of actions that they truly embrace and endorse.

ANNEX

Chart 1

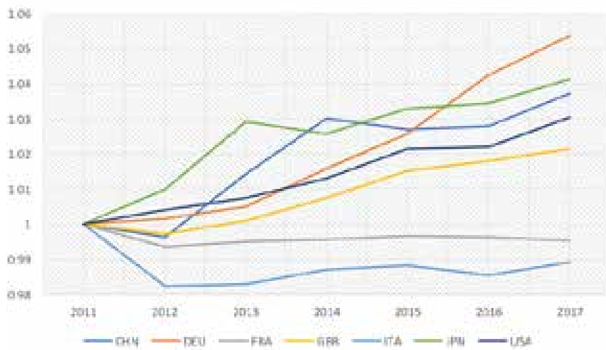


Chart 2

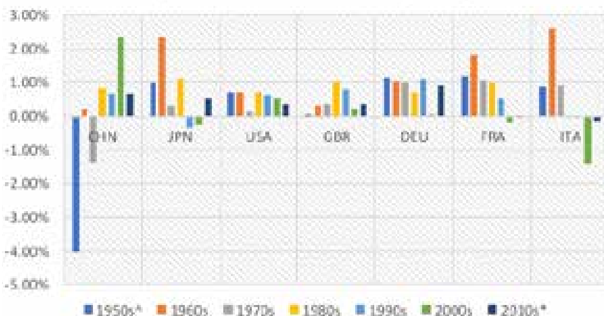


Chart 3

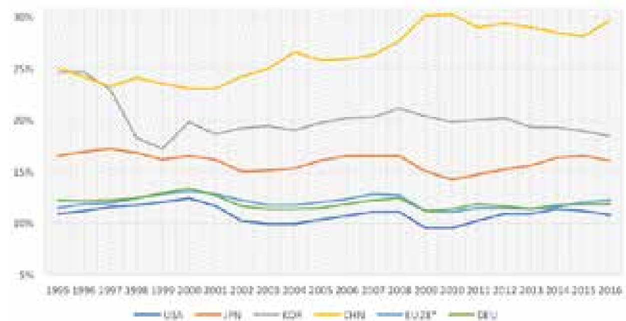
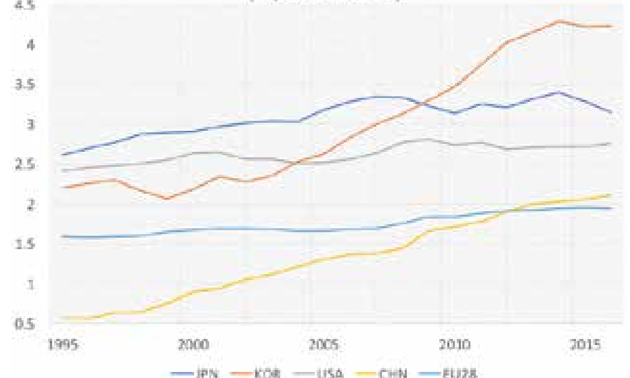


Chart 4



2. POLICY PRIORITIES

Key priority for the incoming Commission: deepening integration, boosting growth or strengthening financial stability?

Despite the strengths of the EU (single market, abundant savings, level of education…), the implementation of Invest EU, the slight improvement of its fiscal position and lasting zero and even negative interest rates, Europe is still facing a low growth future. Corporate investment and productivity gains are notably much higher in the US and Asia than in EU Member States. Europe's investment gap is estimated at about € 700 bn per year of which € 180 bn per year represents the growing climate gap. To meet Europe's investment needs over the coming decade, something has to change both at the national and EU levels.

Raising potential growth needs to be at the top of the agenda

Monetary policy cannot do everything and cannot replace the domestic reforms needed for long-term growth and reduce unemployment. Productivity growth ultimately depends on the capacity to innovate and to improve business processes. The combination of sound fiscal policies, targeted structural reforms in key areas such as education, skills, innovation, pensions and quality of investments are therefore essential to ensure higher productivity and to improve the competitiveness of the European economy. These internal adjustments efforts are also fundamental for improving the functioning of the EMU and strengthening the international role of the euro. They become more urgent with the long term drag of ageing populations and higher projected pension expenditure. But Europe has also to do more.

Improving the funding of innovative SMEs all along the financing chain

Many European firms are very innovative, operating in niche high-tech areas. But the EU has not one high tech company in the top 15 in the world. One of the EU's weaknesses is the underfunding of innovative SMEs all along the financing chain. The European private investment/venture capital market is much less developed than in the US. For example, the amount of venture capital invested in EU startup companies is 6x less than in the US. Successful start-ups in Europe frequently exit European markets for U.S capital in a context where they are unable to access sufficient scale-up funding. Consequently, the EU must focus its efforts and boost its firepower: a quantum leap for private equity and venture capital in Europe is urgently needed.

Furthermore, Europe is adding an Artificial Intelligence (AI) gap to its digital gap. In 2016, European private investments in Artificial Intelligence (AI) amounted to approximately EUR 3.2 billion, compared to almost EUR 10 billion in Asia and EUR 18 billion in the US. In 2018, China attracted almost half of global investment in AI start-ups ahead of the US with 38%. In such a context, Europe must support more the critical emerging technologies that are key in maintaining Europe's leading role in innovation and global competition.

Addressing financial fragmentation in the EU

The banking industry is more resilient in the EU, but, astonishingly, banking and capital markets are more fragmented than 5 years before. The euro area has a savings surplus of more than €300 billion, or 3% of GDP in 2018, which is not being lent to the other euro-area countries but to the rest of the world. Cross-border Eurozone financing has indeed decreased since the financial crisis. Fragmentation in the single banking market has gone up despite the partial implementation of the Banking Union five years ago; the "sovereign-bank loop" has not disappeared and in certain countries has increased. European financial institutions are in a relatively weaker competitive position compared to their American competitors (which enjoy the benefits of a single market and the economies of scale that it brings), and the EUs' Capital Markets Union project has underwhelmed. The EU is falling increasingly far behind the US and China, risking, unless there are robust new policies put in place, having to accept a growing, probably irreversible loss of sovereignty and global influence.

Given the highly destructive financial crisis, in recent years financial stability has been the overall priority for EU legislators with international agreements (Basel 3) and EU regulations (Solvency II) etc. However, market trends have shown that not just is the EUs' prudential framework for long term investment penalizing, in addition, the implementation of national ring-fencing policies, under the presence of financial stability, have fragmented banking and financial markets further.

This highlights policy conflicts between different priorities and suggests that, until now, stability has trumped all others. It is also true that it is easier to achieve EU agreement on financial stability objectives rather than on growth or public risk-sharing objectives. Integration reduces the latitude of Member States to impose their own specific requirements to seek faster growth. What is really required are collective structural reforms and a more common EU economic policy.

Improving the global competitiveness of the EU financial sector

Sustained zero or even negative interest rates (and low growth) are weakening the profitability of the banking and the insurance sectors, blurring risk premia and encouraging preference for cash savings over bond and long-term investment products. At the same time improving the efficiency of the EUs' financial players is essential to be able to supply optimal financing conditions in terms of quality and cost at a time when technological innovation, the speed of change and increased competition (e.g. new entrants, third country competitors) require significant, constant investment.

In the meantime, most experts believe EU banks are made even less globally competitive by the Basle IV reforms. Consequently, EU legislators should make sure that the implementation of Basel III does not affect the financing capacity of EU banks. Moreover, initiatives like reviving good European securitization can help European banks adapt and improve their performance in the future.

Correcting the current disequilibrium in the monetary union

Finally, banking and capital market integration are dependent on further fiscal discipline and economic convergence at the EU level and by an EU industrial policy. Furthermore, Monetary Union cannot work without fiscal discipline. However, the enforcement of the Stability and Growth Pact has been too lenient since 2003. Fiscal rules need to be enforced more vigorously. This would help to rebuild buffers and ensure debt sustainability.

In the meantime, the symmetry of economic adjustments should be a priority focus. Within a monetary union, there must be a symmetrical adjustment mechanism to prevent a long-run excessive balance of payment surpluses or deficits. The euro area is suffering from not having any such system in place, which creates economic and political tensions. Since the deficit countries have embarked on the structural reforms needed to address their competitiveness gap, surplus countries, which are receiving a massive currency advantage, would be expected to accept some degree of higher relative unit labour costs through higher real wages. This is not a matter of fiscal redistribution or a "union of transfers", but of correcting a "fundamental imbalance" which jeopardises the survival of the euro if nothing is done to counteract it and threatens the functioning of the international financial system.

Maintaining the status quo is no longer an option

Europe must "step change' and redefine its long-term view of the key priorities in the financial services area. Europe should be equipped with a powerful financial sector capable of rivalling that of the US and China. This would involve addressing the concerns of host countries regarding the EU crisis management framework, improving equity financing, lifting barriers to the movement of capital and liquidity between EU countries, showing collective well managed European integration pays the best dividends economically, for all, and thereby overcome the tendency for Member States to look inward, rather than outward.

If we really want an equity-based financing ecosystem in Europe, the lack of powerful pension funds needs to be addressed by member states and regulation has to change. Solvency II today, for example, discourages equity investment by excessive capital charges. More generally the debt -equity fiscal bias in favor of the tax deductibility of interest on debt but not on equity is another serious structural handicap to the development of Capital Markets Union.

Up to now the political will to further integrate European banking and financial markets has been limited despite the evident economic benefits and the new, formidable challenges arising from digitalisation, cybersecurity and the likelihood of Brexit. In such a context, agreeing politically at the highest level on the key EU priorities and the subsequent policy measures for all financial sectors before the Institutions commit themselves to launching ad-hoc legislative proposals is certainly the right way forward. This would create political momentum and facilitate the improvement of the efficiency and the flexibility of the EU legislative process in line with rapidly changing financial markets. It is the right time to do so as a new political cycle is starting for 5 years.

A highest level Tripartite political agreement is now needed

This is the reason why the European Council, on the basis of Commission proposals, taking full account of the views of the European Parliament, should explicitly define the overall level of ambition and priorities and define a new, holistic approach to achieve dynamic and competitive banking and capital markets in the European Union. Selection of the measures must be on the basis of economic impacts, not whim.

There should be a Tripartite EU political agreement between the Commission, the European Parliament and the European Council on the overall plan and rigorous, monitored delivery - a process which will rekindle European belief and long-term dynamism.

Adapting EU legislative processes to EU ambitions

In favour of a more flexible and common EU legislative process for an innovative and competitive financial market

Research and innovation are core ingredients for a secure, competitive European financial sector. Innovation made possible by new, digital technologies is accelerating the transformation of the financial industry and creating new disruption in all financial sectors.

The inexorable shift to digital big-tech and fin-tech, blockchain technology, machine learning or automation processes through intensive data use has triggered criticism that the current European legislative process needs to become more alert and responsive. Many observers consider that the EU regulatory process is too slow, delivers complex and, sometimes, contradictory frameworks and fails to respond efficiently to technological change (e.g. emerging platform models offering a horizontal offer of services).

Excessive regulatory granularity contained in EU primary legislation (Level 1) is also a source of concern. With so much detail enshrined in Level 1, adapting rules as new technology emerges is too slow and too painful an exercise. In addition, little has been achieved through the recent European Supervisory Authorities (ESAs) review - a lost opportunity to correct multiple weaknesses in the EU's supervisory structure.

Increasing the flexibility of the EU legislative process, thus allowing it to respond to technological change and market developments, by adopting implementing rules faster and on a more flexible basis should be a key priority for the new Commission.

The EU regulatory approach should favour regulations (instead of directives) and be founded on a more principle-based approach. EU authorities should have the power to issue no-action letters. Improving consistency when implementing and enforcing regulations across the EU is also an urgent necessity.

Clarifying these common financial priorities at the highest political EU level would certainly provide political momentum and facilitate the improvement of the efficiency and the flexibility of the EU legislative process in line with the rapidly changing financial markets.

Clarifying common financial priorities at the highest political level, and delivering on time

Up to now the political will to further integrate banking and financial markets has been limited despite the evident economic benefits and the new, formidable challenges arising from digitalisation, cybersecurity and the likelihood of Brexit. Regrettably, over the past few years, the EU decision making process has become overly complex, factional and Member State driven, many of whom want to protect the status quo without sufficient reference to or consideration of the European public good and the need to deepen European integration. In addition, unnecessary rivalries between the Commission and the co legislators (EU Parliament and Council) are resulting too often in sub-optimal compromises.

This is the reason why the European Council, on the basis of Commission proposals, taking account of the views of the European Parliament, should explicitly define the overall level of ambition and priorities and define a new, holistic approach to achieve dynamic and competitive banking and capital markets in Europe. The key measures, limited in number, should be chosen primarily in terms of their economic impact and include a strict timetable set for delivery.

Ideally there should be a Tripartite political agreement between the Commission, EP and the European Council.

More use of EU regulations - directly applicable in the Member States - can speed up the EUs' legislative processes...

Regulations should be favoured over directives. The use of directives requires long implementation processes, entails the risk of inconsistencies in the national implementation of Level 1 acts and is exacerbated further by the usual inconsistencies in the transposition of Level 2 rules.

Therefore, EU regulations directly applicable in all Member States should be preferred technique wherever possible, defining with Level 2, the single European rulebook for the Single European financial services and capital market.

Re-establishing a clear distinction between Level 1 and Level 2 will also allow innovation to flourish

The Lamfalussy report, adopted on February 15, 2001, laid out a 4 level structure in order to clarify and rationalize the EU decision-making process and to foster a harmonized implementation of rules (see annexe).

The Lamfalussy process clearly distinguished between Level 1 legislation (primary legislation) and Level 2 delegated acts and implementing measures (secondary legislation). At Level 1, the co-legislators – the European Parliament and the Council, representing EU citizens and Member States respectively - should set out the core principles, allowing the European Supervisory Authorities to develop at Level 2 the detailed rules, based on the realities of the market.

Importantly, by keeping detail at Level 2, it also allows the regulatory bodies to respond more quickly to emerging market trends and risks such as innovation and technological change.

Unfortunately, as K. Swinburne clearly explains in the Eurofi Helsinki Magazine, this clear separation has rarely been maintained. Instead, Level 1 legislation has been fought over frequently resulting in a series of detailed,

complex, prescriptive compromises subject neither to rigorous cost-benefit analysis nor to quality testing.

As long as EU institutions and member states cannot rely on a single supervisor, they are inclined to try to construct "harmonization" by putting many details in the level 1 primary legislation. This is probably one reason why national legislation generally precedes European legislation, (e.g. crowdfunding, crypto-assets, climate disclosure…) which leads subsequently to market fragmentation, something difficult to roll back. Of course, ex-ante national regulatory innovative initiatives may be a first shaping step and contribute to the emergence of the necessary European dimension (if needed) but most of the time they lead to fragmentation along national lines.

Consequently, it is surely time for a more disciplined and fact-based legislative approach – a return to the fundamentals of the Lamfalussy approach. According to K. Swinburne, "It would be a good start, for example, to agree that no Level 1 legislation should include data, formulae or thresholds, or anything that requires calibration on an ongoing basis. Such matters need to be promptly reviewed and adjusted as markets evolve and should not be hard-wired into Level 1."

Re-establishing a much clearer distinction between Level 1 and Level 2 will support financial innovation. With so much detail now enshrined in Level 1, adapting rules as new technology emerges has become a slow and difficult exercise, disadvantaging consumers and businesses. All requirements should be technology neutral.

R. Ophèle in his article for the Eurofi Helsinki Magazine also states that the necessary distinction between legislative and delegated acts should be strictly respected. Level 1 legislation should be restricted to setting out framework principles, leaving technical details to Level 2 or 3. He adds that "EU co-legislators must set realistic implementation dates for all stakeholders, including regulators and regulated entities. And a rational sequence between various levels of texts: Level 1 provisions should only come into force after the necessary key Level 2 measures have been published".

No action letters would improve the efficiency of the EU regulatory framework

As a bare minimum, European authorities need the legal tools to avoid the deadlock which may occur when Level 1 or Level 2 texts are in practice unenforceable or require international cooperation.

When the time comes for implementation, we must be able swiftly to correct legislative provisions that obviously cannot be applied, do not meet the objective set, or create distortions of application between jurisdictions. In such situations, as R. Ophèle explains "EU institutions should have the power to issue no action letters, i.e. an emergency mechanism to suspend the application of the provisions concerned, in an exceptional and coordinated manner across Member States; it would protect stakeholders from proceedings for non-compliance with these rules".

Improving consistency when implementing and enforcing regulations across the EU, in order to avoid fragmentation along national lines

If we really want to develop a Capital Markets Union, we must strengthen the European Supervisory authorities and ESMA in particular. However, the proposals that have just ended, the objective of which was to strengthen the ESAs, have not led to any substantial change.

The time has come to really rebalance and strengthen the distribution of competences and responsibilities in favour of the European authorities if we want innovative and competitive financial markets. Also, it is necessary to apply clearly and consistently the EUs' equivalence regimes.

In this context, the following recommendations for strengthening ESMA are important:

1. Enable ESMA to ensure a better harmonisation of the implementation of the common rules. No one disputes this objective. However, ESMA should be able to conduct investigations directly to ensure that the rules are respected. ESMA, together with the Member States, should be able to define a framework and monitor its application on the spot.
2. Focus ESMA's role on wholesale transactions and leave retail transactions to national authorities
3. Assign to ESMA what cannot be done well at the national level; in particular, the supervision of CCPs (Central Counterparties) should be its responsibility.
4. Brexit opens up new and important challenges: as Europe's most important financial market is leaving the EU, it is essential that the new regulatory system in Europe should be coherent and does not open the door to unfair competition and nationalistic regulatory arbitrage. ESMA should develop a collaborative role between London and the EU and the Commission should draw up a more practical, de-politicized regulatory approach.

ANNEX

The Lamfalussy architecture

The Lamfalussy report, adopted on February 15, 2001, laid out a 4-level structure for clarifying the decision-making process of the EU and fostering harmonized implementation of rules.

- At level 1 the European Parliament and Council adopt the basic laws proposed by the Commission, in the traditional co-decision procedure. As this procedure is usually complex and time-consuming, the Lamfalussy report recommends using it only for setting out framework principles.
- At level 2 the Commission can adopt, adapt and update technical implementing measures with the help of consultative bodies composed mainly of EU countries' representatives. This allows the Council and Parliament to focus on the key political decisions, while technical implementing details can be worked out afterwards by the Commission.

- At level 3, committees of national supervisors are responsible for advising the Commission on the adoption of level 1 and 2 acts and for issuing guidelines on the implementation of the rules.
- At level 4 the report advocates a stronger role for the Commission in ensuring the correct enforcement of EU rules by national governments.

This 4-level regulatory approach recommended by the Lamfalussy report was first adopted in the securities sector and then extended to banking, insurance, occupational pensions and asset management. Enormous efforts were made by the Commission and the regulators during the years 2001-2008 to implement a national wide consistent application of regulation.

But, unfortunately, much of this energy was wasted. Indeed, the Level 3 Committees of national supervisors (CEPS, CERS and CEIOPS) had one common fundamental weakness: they were consultative and had no legal decision-making powers. Therefore, in the event, different national positioning and "options" continued to marr the system.

This process evolved following the establishment of the European Financial Supervision and the creation of the European Supervisory Authorities (ESAs) after the de Larosière report (February 2009).

Post crisis reform: The European Supervisory Authorities

Following the de Larosière report three Authorities were to be created and to replace the Level 3 committees: EBA (European Bank Authority), ESMA (European Securities and Markets Authority), EIOPA (European Insurance and Occupational Pensions Authority). They became operational in January 2011.

The responsibilities of the ESAs include defining common practices and standards for the regulation and supervision of banking, market and insurance activities, and ensuring the consistent application of these measures within the single market.

Their role is to harmonize the national application of directives and regulations. In order to avoid the pitfall of the Lamfalussy powerless Committees, the Authorities were given precise powers:

- to write binding technical standards (the "common rule book"), in conformity with the principles contained in the directives;
- to mediate disputes between two national supervisors within a cross border college of supervisors;
- to mediate in the case of diverging interpretations at the level of national rules;
- to survey, license and register Credit Rating Agencies and CCPs (Central Counterparties);
- to enforce common rules for stress-tests;
- to play a coordination role in crisis situations.

In a very short period of time the ESAs have established themselves and are respected by market participants, Member States, the EU institutions and globally for the professional way in which they have undertaken their duties. In this way the ESAs have contributed to a smoother functioning Single Market for financial services.

The objective however has only partially been achieved since the implementation of EU law is not always consistent across the Union. There remains significant potential to enhance regulatory and supervisory convergence in the Single Market. Integrated financial markets may require more integrated European supervisory arrangements to function effectively, while more centralised supervisory arrangements can, in turn, foster market integration. The ESAs can play a key role in this symbiotic relationship between market integration and supervisory convergence and should be given more direct responsibility for supervision in targeted areas.

3. FINANCIAL REGULATION AND SUPERVISION

The EU should adapt the latest Basel III agreements

1. Context

In 2008, the G20 Leaders agreed on an ambitious and comprehensive strengthening of international bank regulatory standards. The subsequent Basel 3 standards have imposed unprecedented levels of high-quality capital, notably on the EU banking system, which has already implemented these evolutions well in advance of the agreed schedule. The Basel 3 rules also imposed two new minimum liquidity standards i.e. the liquidity coverage ratio (LCR), and the net stable funding ratio (NSFR), which are being rolled out in the EU. Furthermore, Basel 3 introduced a leverage ratio (LR) to constrain leverage.

Regulators at the Global level also aimed to improve risk management and governance as well as strengthen banks' transparency and disclosures. In July 2009, the Committee introduced a package of measures to strengthen the 1996 rules governing trading book capital and to enhance the three pillars of the Basel II framework based on the risk weighting of banks' assets.

The Basel Committee is now seeking to propose measures to address the variability in risk-weighted assets (RWAs) currently observed, which is considered excessive, and increase their comparability and simplicity.

These measures notably include:

- revisions to the standardised approach for credit risk (SA-CR);
- revisions to the internal ratings-based approaches (IRBAs) for credit risk;
- an overhaul of the credit valuation adjustment (CVA) framework;
- a new standardised approach for operational risk (SA-OR), which replaces all existing approaches for this risk; and
- the replacement of the «Basel II» floor with an aggregate output floor.

The removal of internal model approaches for certain risks and imposing tighten constraints on the outcome of internal models, particularly capital floors derived from the standardised approach are intended to address the excessive variability in risk-weighted assets (RWAs).

The Ecofin Council reiterated on 12 July 2016 its support for the work of the Basel Committee to refine elements of the Basel 3 framework by the end of 2016 to ensure regulatory certainty, its coherence and effectiveness, while preserving the risk sensitivity of banking regulation.

The Council also stressed the importance that the Basel Committee carefully assesses the design and calibration of this reform package, on the basis of a comprehensive and transparent quantitative impact analysis, taking into account in its global calibration also the distribution of its impact on the different banking models and across jurisdictions.

It moreover noted that "the reform package would not be 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 of the world.»

On 7 December 2017, the Group of Governors and Heads of Supervision (GHOS) endorsed a package of amendments aimed at finalising the «Basel III framework», the internationally agreed prudential standards for banks developed by the Basel Committee on Banking Supervision (BCBS) adopted in the wake of the financial crisis.

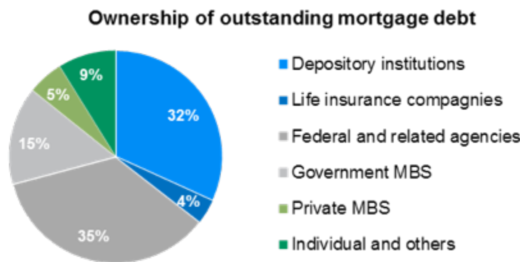
BCBS members agreed to full, timely and consistent implementation of all elements of the package by 1 January 2022 with the exception of the output floor, where the transitional arrangements include a phased-in implementation until 1 January 2027. The implementation of the agreement in the EU would require amendments to existing EU legislation (mainly the Capital Requirements Regulation or CRR).

2. The latest adopted Basel III measures fail to factor in the specific bank risk profiles stemming from regional financing mechanisms

The latest measures adopted by Basel do not achieve an equivalent level of risk mitigation across regions globally, although international standards should be regulatory minima taking into consideration the differences in terms of financing mechanisms and banking market structures between the world's main regions.

Indeed, less than 50% of the financings to US households are held by US banks, that transfer in particular the mortgage loans they originate to Government Sponsored

Entities (GSEs), which fall outside the scope of the Basel rules. This strongly reduces US banks' balance sheets and consequently regulatory capital constraints[1].



Conversely, since in the EU, banks account for three quarters of the financing of the economy unlike in the United States where three quarters of the financing is provided through financial markets, the proposed banking regulations have a three times greater impact on the EU economy than on the US one.

Eventually, US risk transfer mechanisms fundamentally transform banks risk profiles by transferring "conforming loans[2]" risk to GSEs balance sheets, and mainly maintaining in US banks' balance sheets "non-conforming" mortgages. On the contrary, in the EU the banks hold diversified mortgage risk profiles largely dominated by low risk ("prime") mortgages. In addition, the loans themselves are very different:

- A significant proportion of "junior lien" or "revolving" mortgages in the US, higher risk products that do not exist in the EU;
- No recourse to the borrower in the US, unlike in the EU, translating into much better recoveries in the EU.

In this context, it is not wise to assert that the new Basel RWAs calculations involving input and output floors, enable a further effective comparison of bank risk profiles, nor can it be said that the new capital requirements provide similar risk mitigation across regions. Finally, although during certain periods many US banks show higher cumulated write-downs[3], because these banks have higher RWA density[4] the new Basel III evolutions require instead further capitalising... EU banks.

In the global competitive context, the Basel measures to be transposed into the EU, would eventually give US banks operating in Europe an unjustified competitive advantage.

Furthermore, whereas the Basel regulations aim to ensure that taxpayers are no longer called on by developing bank bail-in capabilities, the potential losses on these mortgage loans are taken on by US taxpayers since these loans are guaranteed by the Federal State. The GSEs represent a mechanism for socialising potential losses (bail-out). The situation is different in Europe where mortgage risks are not "socialised", i.e. not borne by taxpayers if necessary, but by the banks themselves, either individually or collectively through IPSs or other frameworks, such as "Credit Logement" guarantees in France.

3. Although it is the quality of loans that is essential for financial stability, the planned Basel approach reduces the risk sensitivity of banking practices

In 2010, Basel 3 regulations corrected the quantitative and qualitative prudential shortcomings - notably liquidity and maturity transformation issues - brought to light during the crisis. In parallel, in the wake of the subprime financial crisis, internal models for credit risk, approved by the supervisory authorities, were gradually adopted by many European banks in line with the Basel 2 schedule. Immediate and massive increase in capital ratio requirements were implemented by adding new buffers[5].

The adoption of these measures has made it possible to de-risk bank balance sheets because these regulations address liquidity and transformation risk and impose capital requirements based on the individual risk profile of each bank.

Such an evolution is a primary explanation of the variability of Risk-Weighted Assets (RWA) observed. Indeed, the variability of RWAs seen in Europe is linked to:

- The differences in customer risk profiles for banks and the specific features of the various domestic markets.
- A significant part of the variability of RWAs in Europe is also caused by the discretionary constraints that have been imposed on banks by national regulators looking for additional safety nets. The EBA has concluded in this respect that in Europe the variability of RWAs is 66% due to differences in business model and supervision[6].

However, global regulators who are concerned by this variability are proposing the introduction of caps and floors into the forthcoming Basel proposals. This reflects their reluctance to take into consideration the low probabilities of default (PD's) and low loss given defaults (LGD's), ob-

[1] Federal Reserve data as of Q1 2019.

[2] FICO scores are used by Fannie Mae and Freddie Mac to establish minimum eligibility criteria for different types of loans. While the precise cut-off varies by loan type and the presence of other risk factors, both Fannie and Freddie have adopted minimum FICO score thresholds of 620. 620 corresponds to a default rate of 8.2%.

[3] See Chart 6 in "TOWARDS MORE CONSISTENT, ALBEIT DIVERSE, RISK-WEIGHTED ASSETS ACROSS BANKS" Mayte Ledo https://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/RevistaEstabilidadFinanciera/11/ref0321%20.pdf

[4] The risk-weighted assets (RWA) density ratio is RWA compared to total assets .

[5] The minimum CET1 requirement shifted from 2% to 7% + systemic buffers, with a total average "capital demand by the SSM reaching 11.5% in the SREP 2018 exercise.

[6] "two thirds of the dispersion for non-defaulted assets can be attributed to other drivers such as differences in underlying credit risk, use of credit risk mitigation, modelling and supervisory practices. The geographical location of the exposures, notably the different economic conditions and other country-specific aspects, also play an important role. Regarding SMEs, the size of the enterprise influences variations in RWAs." EBA - 18 December 2013 - https://www.eba.europa.eu/-/eba-publishes-reports-on-comparability-of-risk-weighted-assets-rwas-and-pro-cyclicality.

served by banks and validated by supervisors, and to reflect them in adjusted RWAs. This Basel approach eventually reduces the risk sensitivity of banking practices which was the major breakthrough of the Basel framework.

4. The proposed measures will affect all EU banks including small and mid-sized ones, which represent the backbone for financing the economy in many EU countries

Overall, the results of the Basel III capital monitoring exercise, based on data as of 30 June 2018, show that European banks' minimum Tier 1 capital requirement would increase by more than 25% at the full implementation date (2027). The leading factors of these increases are the output floor (9.1%), operational risk (3.3%) and standard and IRB approaches with a similar impact of 2.7% each. Medium and Small banks' expected increases of T1 MCR are respectively +9.7% and +10.7% while G-SIIs should face an increase of 28,6%.

Small and mid-sized banks, for which it is costly to adopt internal models, have to use a standardised approach. Although Small and mid-sized banks expected regulatory shortfall is expected to be limited, the issue in this case is that this international standard approach is not particularly well-suited to the actual levels of risk of European markets, which should reduce accordingly the risk sensitivity of the framework. Indeed, the international standardised approach for credit risk is defined according to the region of the world that has the worst level of risks (which is not Europe).

Such a negative impact is particularly strong in Europe because small and mid-sized banks in EU countries represent a large part of the financing of the European economy.

In addition, the complexity of the new standardised approach which also serves as a floor for the IRBA, will significantly rise. This will lead to higher IT and compliance costs for especially those banks for which it was meant to be a less complex, though more conservative approach to follow. We therefore urge those concerned to fundamentally reconsider these planned changes. Some in the industry call in this respect to pay attention notably to the calibration of the leverage ratio and to review risk weights[7].

5. Basel rules would raise capital requirements by more that 20% for European banks, whose profitability levels are already too low, triggering a new wave of deleverage, with dramatic consequences for the still fragile recovery in Europe

The return on capital of European banks slightly grew from 2,2% in 2013 to 5,6% in 2017, compared with 8% for US banks in 2017[8]. This is due in particular to the high level of competition in the EU and the difficulty of increasing credit rates in the current monetary environment. For example, the best US companies have to pay interest rates that are twice as high as those paid by firms in Europe (3.3% versus 1.7%). This competitive environment explains why the price-to-book ratio for European banks is around twice as low as for US banks[9]. One explanation would be that investors consider that European banks are riskier than their US counterparts. However, this is decidedly not the case since Credit Default Swap (CDS) levels for most major European banks are similar to those of large American banks (they range from 40 to 200 Basis points).

However, with the adoption of projected prudential measures, European banks could see their Tier 1 capital ratios decline from 15.3% to 11.5%. Compensating for this deterioration would further reduce their profitability ratios. The return on capital seen in 2017 would mechanically drop from 5,6% to 4,5%, which would trigger a new wave of deleverage and mean that many of these banks would no longer be able to cover their costs and perform their intermediation role. The EBA[10] has simulated that to comply with the new constraints EU banks should retain 10% of their earnings over the full transition period to make up for the shortfall, while banks unable to generate profits would be left with a shortfall of 50bn€ requiring they issuie rights in financial markets, should it be possible.

6. These proposals would also have several adverse effects

In addition, the Basel proposals will have adverse impacts because they would require a consolidation of the industry in Europe, calling into question the valuable diversity of bank business models in Europe. These changes would also reduce the banks' effective close relationship with their customers, which is one of the strengths of the financing systems in certain EU countries today.

The regulations being considered by the Basel Committee are also detrimental to the role played by banks in the monetary policy transmission mechanism to the real economy. These prudential measures would also require an increase in financing costs, which would go against the effect targeted by the ECB through its quantitative easing policy.

7. Certain banks in Europe face excessive levels of non-performing loans. A general increase of capital levels of all European banks would not solve this issue, which is independent of the volume of RWAs

In Europe, the main issue is the existence of pockets of vulnerabilities linked to an excessive level of Non-Performing Loans (NPLs) in certain regions i.e. inappropriate provisioning policies rather than underestimated RWAs[11].

[7] ESGB website: https://www.wsbi-esbg.org/Our%20Positions/Banking%20Supervision%20and%20Regulation/CRD/Pages/default.aspx

[8] Fed St Louis - U.S. Banks with average assets greater than $15B

[9] See "Recent developments in banks' price-to-book ratios and their determinants" ECB May 2019

[10] EBA report p 5

[11] One key finding was the importance of defaulted assets which account for over half of the variation in risk weights and expected losses. The underlying portfolio mix represents around a third of the variation in the overall Global Charge (GC) and Risk Weights (RW) for non-defaulted assets. EBA - 18 December 2013 - https://www.eba.europa.eu/-/eba-publishes-reports-on-comparability-of-risk-weighted-assets-rwas-and-pro-cyclicality.

These were caused mainly by the European sovereign debt crisis and its economic implications, significantly and suddenly affecting the profitability of many businesses in these countries. This happened in a legal context in some of these countries, in which banks were not in a position to quickly exercise their guarantees due to inefficient insolvency rules.

Requiring a further recapitalisation of generally healthy and resilient European banks as a direct result from increased RWAs would not help to tackle the issue posed by high levels of NPLs, existing bank overcapacity and insufficient cost to income ratio in the EU, and on the contrary would slow the much-needed efforts to address digitalisation and energy transition challenges .

8. It is still essential in Europe that the SSM should continue its policy to maintain models that it launched in 2014

Internal models for weighting risks need to be continuously maintained. More specifically, it is essential to permanently check that RWAs are consistent with the actual risk behaviour of banking assets (back testing) and make any adjustments required. This is what the SSM embarked on in 2014 with a review of these models spread over four years (TRIM).

Lastly, stress tests are regularly organised for the top 130 European banks by the EBA and SSM to check that capital levels are sufficient to cover the losses recorded in banks' portfolios faced with adverse scenarios. These stress tests show that banks are sufficiently capitalized to absorb stressed losses, which support the ECOFIN statement that no significant capital is needed.

9. Conclusion

In conclusion the RWAs of European banks, approved by their supervisor, although lower than in certain regions, are reliable and constantly improving. We believe that the latest Basel evolutions, which were not designed with the objective of an equivalent level of risk mitigation across regions in mind, should not be accepted in their present state by the European Union. In addition, they do not address the main EU issues i.e. remaining pockets of high level of NPLs, low profitability linked to the persistently low rates and the intense competitive environment in Europe. Above all, not only do they create a permanent unlevel playing field between American and European banks to the disadvantage of the European banking industry, but they reduce the impact of accommodative monetary policies on mortgages, SME and project financings, which eventually mostly benefit sovereigns and large corporates.

Moreover, these measures may actually worsen the situation of EU banks impacting their profitability and triggering further deleveraging. Moreover, these unprecedented levels of regulatory capital discourage possible movements of concentration, in particular cross border ones.

Finally, as a consequence of this, the creation of jobs and growth being the main objectives of the current European Commission would be highly endangered due to a lack of credit capacity in the finance industry which cannot be compensated by the Capital Markets Union project.

They would also compromise the benefits of an international regulatory framework that has led the banks to lend with a primary focus on their customers' risks and would reduce the attractiveness of the Single Supervisory Mechanism´s action that it launched in 2014 to maintain models.

Banking fragmentation issues in the EU

While we have come a long way since the establishment of the Single Supervisory Mechanism (SSM) four years ago, the Banking Union is far from complete. An efficient banking Union would break the sovereign- bank vicious circle, foster a more effective allocation of resources across the Eurozone (e.g. companies would be able to tap wider and cheaper sources of funding in all parts of the euro area), help to achieve a better diversification of risks thus contributing to private risk sharing within the Union.

Despite the challenges faced in recent years, with the emergence of new competitors and low levels of profitability, many European countries' banking systems remain oversized and still have surplus capacity. In addition, international consolidation processes have been few and far between, and this pattern has not changed since the launch of Banking Union.

The limited strength of private risk-sharing channels in the euro area reflects both the underdevelopment of capital markets and a highly segmented banking system at the national level. There is little progress in cross-border lending, especially in the retail markets, or in other words, in lending to households and firms. Expanding this foreign activity would be important for the sound working of the euro area.

1. The Banking Union is failing to provide the expected degree of financial integration

The existence of the SSM and the SRM have not had any marked impact on the banking industry's structure in Europe. Indeed, the banking sector in Europe is too fragmented, not concentrated enough and oversized.

1.1. A fragmented banking landscape in the European Union

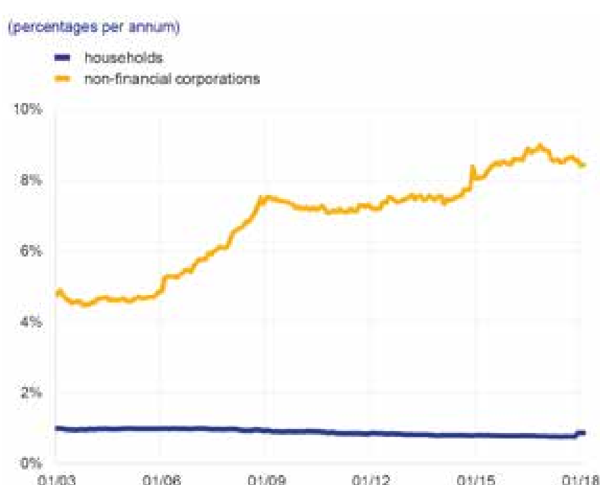
Indicators are continuing to signal banking fragmentation in Europe. The share of cross-border loans to households and cross-border deposits from households remain negligible at around 1% (***see Chart 2***). Direct cross-border loans to firms accounts for only around

8% and this figure has hardly changed since the creation of the banking Union (***see Chart 1***).

The share of cross-border deposits in the euro area from firms is also very low (around 6%) and has fallen slightly over the last few years. The level of foreign bank penetration is, overall, relatively low for a banking union.

Moreover, despite the quantitative easing policy of the ECB, the doom loop between banks and their sovereigns is far from being resolved. According to EBA, on average, 65% of a medium sized bank's Tier 1 capital, is on the domestic sovereign, but in the whole distribution there are banks which have up to eight or nine times their Tier 1 capital on the domestic sovereign.

Chart 1 Share of cross-border loans in the euro area for NFCs and households



Source: ECB (BSI). Note: Cross-border loans include loans to other euro area Member States for all maturities and currencies.

Chart 2 Share of cross-border deposits in the euro area for NCFs and households

Source: ECB (BSI).

1.2. An Oversized banking system in Europe

The fragmented banking sector across domestic lines leads to overcapacities of the banking sector in many countries; according to the IMF[1], the European Union is particularly concerned by overbanking, i.e. an "overly marge banking sector that in the end affects the profitability of the banks in the system".

Many indicators point to this excess capacity (***see Table 1***). For instance, efficiency indicators – such as cost – to -income ratios (around 69% in the euro area, and 60% in the United States) or branches per population (44 per 100,000 inhabitants in the euro area and 26 in the United States) illustrate this overcapacity.

Table 1 Some comparative indicators of the US and Euro Zone banking sector

	Euro area	United States
Size of banking system (% of GDP)	280%	91%
RoE (avg 2013–17)	4.5%	9.0%
Cost-to-income	69%	60%
Branches (per 100,000 inhabitants)	44	26
Publicly traded banks (% of total assets)	52%	78%

Sources: CCFS (2018), EBF (2018), Banks around the World (2018), Badenhausen (2018) and own calculations

Banks in Europe therefore have to face a much more competitive environment than in the United States and therefore a much stronger pressure on their margins.

Moreover, lasting low interest rates have negative consequences on EU banks profitability - it compresses net interest margins - which penalizes them vis-à-vis their American counterparts. Indeed, as of 31 July 2019, the target federal funds rate is currently 2.00- 2.25% in the United States while the ECB interest rate on the main refinancing operations (MRO) is at 0% since more than 4 years.

1.3. Not concentrated enough

Bank Merger & Acquisition (M&A) transactions within the Euro Area have been on a steadily declining trend, both in terms of number and value, since the year 2000 (***see Charts 3 and 4***). Cross-border merger and acquisition activity among banks within Europe have practically disappeared. Indeed, bank Merger and Acquisition within the euro area has been on a steadily declining trend both in terms of number and value, since the year 2000.

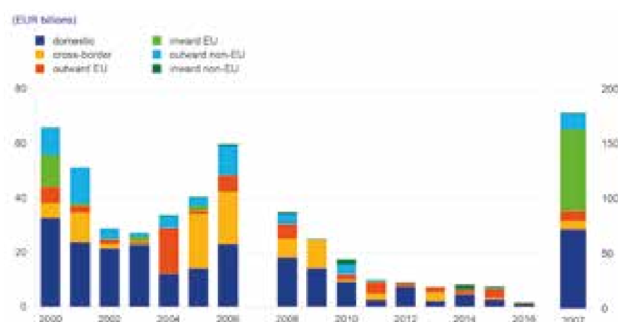
The EU banking system is much less concentrated that the US one: the market share of the top five US banks within the United States was more than 40% in 2016, whereas the market share in the Eurozone of the top five European banks stands at more or less 20%[2].

[1] IMF, Global Financial Stability Report, October 2017.

[2] Compared with other jurisdictions, only a few banks exited the market in the euro area. Many banks were bailed out and kepts alive due to a lack of European crisis mpanagempent tools. The Single Resolution Mechanism is thus an important step in the right direction.

In 2018, there were only $5,0 bn of mergers between European banks, the lowest level for man than a decade and a tiny fraction of the €193,8 bn of such deals done on the eve of the financial crisis in 2007, according to date from Dealogic[3].

Chart 3 Bank M&As involving euro area banks – value of transactions



Sources: Dealogic and ECB calculations.

Notes: "M&As" refers to transactions where the acquired stake is more than 20% of the target bank. The data do not cover participation by governments or special legal entities in the restructuring or resolution of credit institutions. Transactions whose amounts are not reported are excluded. "Domestic" refers to transactions that take place within national borders of euro area countries. "Cross-border" M&As involve euro area targets and non-domestic euro area acquirers. "Inward" refers to M&As by non-EU or non-euro area EU banks in the euro area and "outward" indicates M&As carried out by euro area banks outside the euro area.

Chart 4 Bank M&As in the euro area - number of transactions

Sources: Dealogic and ECB calculations.

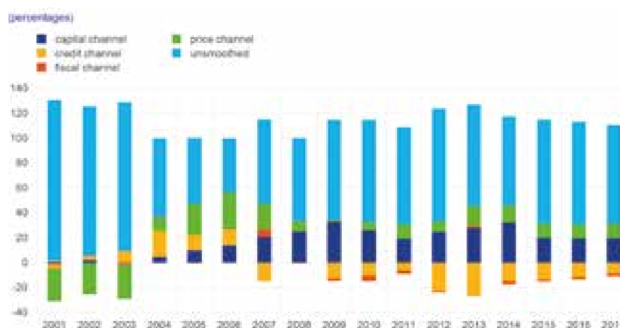
2. Why have we seen such a decline in banking M&As?

For three major reasons:

- Until now, the largest banks (GSIBs) are penalized in terms of their capital requirements in proportion of their size (G-SIB buffer). One can understand why they do not wish to be bigger given these disincentives. At the same time, regulation fails to fully acknowledge the prudential benefits associated with the geographical diversification of exposures;
- Furthermore, in an environment where digitalization and fintech challenges may be seen as a higher priority in a time of business reassessment, the largest banks are reluctant to absorb banks burdened with NPLs all the more so since a European securitization market is still underdeveloped due again to regulatory constraints. One can add that another obstacle to merger activity is the structure of the banking industry: only 30% of the significant banks in the euro zone (directly supervised by the SSM) are publicly traded companies. Most of the non-listed banks in the Eurozone are saving banks, regional banks or cooperative banks;
- Lastly the EU legislative prudential framework does not recognize trans-national groups at the consolidated level but as a sum of separate subsidiaries ("national or solo approach") notably due to the insufficient trust of Member States vis a vis the institutional set up of the Banking Union. Moreover, ring-fencing policies (capital, liquidity, bail-in instruments, leverage ratio...) by host supervisors, applied to subsidiaries of transnational banking groups, which are located in their countries, discourage large EU banks to increase the number of their subsidiaries in the EU. Finally, in the current political context, no State would be happy to see the disappearance of one of its banks due to a takeover by a bank in another European country.

3. Overall, since 2007, the credit channel (i.e. cross-border lending and borrowing) has been acting in the euro area as a sock amplifier rather than a shock absorber (*see Chart 5*)

Chart 5 Consumption risk sharing in the euro area and its channels



Source: ECB calculations. Notes: The chart displays, by year, the contribution of capital markets (via cross-border ownership of productive assets), credit markets (via cross-border borrowing and lending), fiscal tools (via public cross-border transfers), and relative prices (via changes in the domestic consumer price index relative to the euro area average index) to the smoothing of country-specific shocks to real GDP growth. The respective contributions are calculated using a vector-autoregression (VAR) model whose parameters are estimated over a ten-year rolling window of annual data, applying the Asdrubali and Kim (2004) approach enhanced for relative price adjustments. The bars display the share of a one-standard-deviation shock to domestic GDP growth that is absorbed by each respective risk-sharing channel. The shares are computed on the basis of the cumulative impact of the shock on the variables capturing each risk sharing channel over a five-year horizon. Year-to-year variations in the shares reflect changes in the re-estimated model parameters. The remaining portion represents the portion of the shock to country-specific real GDP growth that remains unsmoothed and is fully reflected in country-specific consumption growth. The individual bars may fall below 0% if one or more of the channels involved has a dis-smoothing effect on country-specific consumption growth. All bars together total 100%.

[3] Two- thirds of Europe's banking consolidation in 2018 was from domestic deals, such as Banco Santander's takeover of Banco Popular for €1 in June or Intesa Sanpaolo's acquisition of two failed domestic rivals in Italy's Veneto region for a token price. The value of European cross-border deals done in 2017 exceeds all such deals agreed in 2018.

Whereas they used to be mostly cross-border in the pre-crisis period, they have increasingly become of a domestic type. Furthermore, as unveiled in research by Raposo and Wolff (2017), domestic M&A transactions have become increasingly of a 'controlling participation' type, whereas cross-border transactions have become increasingly of a 'minority participation' type. Certainly, all of this was, to some extent, driven by the post-crisis inward-looking bank restructuring strategies put in place by supervisors and Member States.

According to A. Enria[4], overall, since 2007, the credit channel (i.e. cross-border lending and borrowing) has been acting in the euro area as a shock amplifier rather than a shock absorber.

Private risk sharing has indeed been impaired in the euro area, and a fortiori in the EU. This should be a concern, as it is through risk-sharing channels that the overall system becomes, at the same time, more resilient and more productive.

4. What are the consequences of this geographical nationalization of the European Banking system and regulatory framework?

As explained by Jacques de Larosière in a speech delivered in October 2018 at the European Financial Committee, the consequences of this fragmentation are severe and notably mean:

- Weak profitability of banks[5] (in 2017, the return on equity was 3,9% on average in the European Union as opposed as 9,5% in the United States) at a time of particularly rapid technological innovation. Only banks with healthy profits can invest in technology, talent and scale.
- Reducing costs through economies of scale is more difficult and in addition, there is much less transfer of technology and knowledge;
- Competitive disadvantage for Pan-European banks versus US ones, which benefit from a large domestic base;
- The EU resistance to asymmetric shocks is weaker (in the United States the capital and credit markets absorb alone more than 50% of the consumer impacts; in Europe is only 10% because of the lack of capital mobility and of credit which stay within national borders. In total, including the fiscal element, more than 2/3 of the shocks are absorbed in the US whereas it is only 1/5 in Europe.

Conversely further banking integration would foster resilience against economic shocks. A geographically diversified loan book and deposit base make banks less vulnerable to domestic banks and thus reduce the volatility of their lending and income streams; private risk sharing via the banking channel would thus be made possible by a higher degree of risk diversification enabled by diminishing the domestic bias, be it in the shareholding of banks, in the attribution of credit or in the detention by banks of domestic sovereign debt.

It is evident that « ring fencing » is a significant contribution to explain these consequences. If we continue to condone ring-fencing and hinder cross-border banking consolidation, the risk is to see banking groups split into branches instead of subsidiaries.

Despite remarkable achievements in terms of balance sheets cleaning, regulatory harmonisation, and deepening institutional integration within the Banking Union, where the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are up and running, financial integration is lagging behind. The Banking Union is failing to provide the degree of financial integration that we would have expected. Rather than smoothing idiosyncratic shocks to individual Member States, the banking sector still operates as a shock amplifier.

If the EU wants to keep up with the US and China economically as well as politically, it must break out this downward spiral and strengthen its banking industry. Only competitive and profitable banks can take on the risks necessary to finance sustainable growth. This is why a financial integration agenda for the Banking Union should rank high among the priorities of legislators and authorities for the next five years. Furthermore, EU legislators should make sure that the implementation of Basel III does not affect the financing capacity of EU banks.

[4] A. Enria, "Fragmentation in banking markets: crisis legacy and the challenge of Brexit", Speech, BCBS-FSI High Level Meeting for Europe on Banking Supervision, 17 September 2018.

[5] Price-to -book values for most banks in Europe are still below one and for many banks, their RoE is still below their cost of equity (CoE).

Making the Banking Union effective: what priorities?

The establishment of the Banking Union was not the result of a collective visionary reflection by EU leaders on how best to address the fundamental issues that are deeply rooted in the EU financial markets: unsustainable fiscal deficits and debts, lack of a true macroeconomic surveillance leading to increasing non- performing loans (NPLs), regulatory fragmentation, an excessive number and dispersion of banks in the EU, the low efficiency of the banking market in Europe...

The idea only got traction in the midst of the European financial and sovereign crisis and was motivated by the need to ensure financial stability and contain the increasingly evident risks to the survival of the single currency. The Banking Union was thus created to break the link between banks and States and solve the banking crisis.

The Banking Union remains unfinished business

The Banking Union has been successful in promoting a more resilient banking sector. Banks are more resilient, liquid and with less leverage. There has been a significant reduction of the level of NPLs (more than half since 2014). Furthermore, a new EU framework needed to deal with this issue has been established.

However, the "sovereign bank loop" has not disappeared and in certain countries like Italy, Portugal, Spain ... has even increased[1]. NPLs continue to pose a risk to the viability of the most affected banks and to economic growth and financial stability in some Member States. The Banking Union is also still failing to deliver an integrated domestic market for banking business. Despite the implementation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), the banking sector in Europe is too fragmented, not concentrated enough and oversized.

In addition, the EU legislative framework does not recognize trans-national groups at the consolidated level but only as a sum of separate subsidiaries ("national or solo approach") notably due to the insufficient trust of Member States vis a vis the institutional set up of the Banking Union. These ring-fencing practices (increased capital buffers or Pillar 2 requirements for subsidiaries, application at the local level of specific capital, liquidity and MREL requirements) represent an obstacle to the emergence of truly transnational banking groups within the Banking Union because they hinder the effectiveness of the allocation of capital and liquidity within banking groups and reduce economies of scale.

As Andrea Enria has stated several times: "rather than smoothing shocks to individual member States", the banking sector still operates as a shock amplifier".

Consequently, many banks consider that the Banking Union represents a source of costs for significant supervised entities – contribution to the Single Resolution Fund (SRF) and possibly for the backstop of this SRF[2], MRELs, compliance costs – but has not produced beneficial effects.

The present note suggests more radical approaches to solve rapidly the NPL legacy issues and proposes an optional approach to solving the "home-host dilemma" thus making the Banking Union more effective.

Over the last decade, substantial efforts to reduce risks have been made

A wide range of measures introduced since the financial crisis have strengthened bank' solvency, leverage and liquidity positions in significant and practical ways and have substantially improved governance within and supervision of the banking sector;

The average Tier 1 capital ratios of euro area banks directly supervised by the Single Supervisory Mechanism have remained stable, amounting to 15.54% in Q4-2018, compared to 15.63% in Q4-2017.These stronger capital positions are also reflected in higher leverage ratios. The average leverage ratio remains well over the requirement of 3%, standing at 5.28% in Q4-2018. Euro area banks have also maintained their resilience to liquidity shocks, as the liquidity coverage ratio stood high at 145.61% in Q4-2018.

Putting the NPL legacy issue fully behind us requires more radical approaches

Thanks to active measures taken and to a more vibrant market[3], there has been a significant reduction - by almost 50% since 2014 - of the level of NPLs (from 1 trillion to 580 million). Furthermore, a new EU framework to deal with this issue has been established.

However, this major legacy and the age of NPLs[4] of the crisis continues to differ significantly between Member States.

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[1] As a proportion of Core Equity Tier's, the highest domestic sovereign exposures in the Eurozone are Estonia (787%), Finland (280%), Portugal (184%), Italy (177%), Spain (165%).

[2] The Fund today stands at just under €33 billion. It is on target to reach 1% of covered deposits by 2023, which would be somewhere around €60 billion. If the Single Resolution Fund is depleted, an agreement was achieved in June 2019 in order to allow the ESM to act as a backstop and lend the necessary funds to the SRF to finance a resolution. To this end the ESM will provide a revolving credit line. The common backstop will be in place at the latest by 1 January 2024. The size of the credit line(s) will be aligned with the target level of the SRF, which is 1% of covered deposits in the Banking Union (currently estimated at around €55 billion). If the credit line provided by the ESM to the Single Resolution Fund (SRF) is used, it was decided that the SRF will pay back the ESM loan with money from bank contributions within three years.

[3] Between 2016 and 2018, we saw more and more transactions, sellers and buyers. In 2018, according to an interview of A. Enria dated 14 June 2019, banks from across the euro area sold or securitised around €150 Billion NPLs. Over the same period, they sold around €30 billion foreclosed assets.

[4] For the banks with the highest levels of NPLs, more than half of their NPLs are older than two years and more than a quarter are older than five years (see A. Enria opus cite).

The dispersion in the holdings of non-performing loans (NPLs) is concerning: Indeed, the amounts that are still not sufficiently provisioned are considerable especially in some countries (perhaps close to 100 billion euros out of a total of 580). Greece and Cyprus have still (4th Quarter 2018) respectively 42% and 34% of NPLs as a percentage of the assets in their banking systems (against a 3,2% average for the European Union)[5].

In such a context, it is important that the national governments and parliaments should provide an appropriate legal framework. But banks with high levels of NPLs should also engage with borrowers in trouble and identify those who can be restructured. More systemic or radical solutions involving domestic (and EU) public finances need to be designed, identified and implemented in order to handle this problem in the near future and notably before the related economies become less resilient.

To solve the home -host dilemma, the Banking Union needs credible, unconditional and unlimited support provided by parent companies to euro area subsidiaries based on European law and enforced by European authorities

The distinction between home and host supervisors and the "national bias" still exists for banks operating across borders in the Banking Union. Indeed, regulators still believe that capital and liquidity will be trapped in individual Member States if a pan European banking group fails. This perception is particularly acute in countries that are strongly dependent on foreign banks for the financing of their economies. This lack of trust between national authorities is one of the most damaging legacies of the recent financial and sovereign debt crises.

Consequently, ring-fencing policies are applied to capital -including the use of macroprudential buffers in some SSM countries-, liquidity and bailinable liabilities. This clearly distorts the functioning of free banking markets, fragments them, contributes to the low profitability of banks in the EU and impedes the restructuring of the banking sector in Europe, which cannot benefit from the economies of scale of the single market compared to US banks for instance, which can rely on a large unified domestic market.

In addition, defining prudential requirements at the group level should contribute to enhancing financial stability. For instance, the main benefit of defining MREL only at the group level rather than also on the level of each subsidiary (internal MREL) is that it increases flexibility. In the case of a loss in a subsidiary that would be greater than the amount of internal MRELs prepositioned in the country of this subsidiary, it would be easier to mobilize the required capital using centrally held resources from the parent company. If all resources have been pre-allocated, it is unlikely that any local supervisors would accept that internal MRELs located in their jurisdiction should be released and transferred to another one.

In such a context, it is essential to consider transnational banking groups of the euro area as unique entities from an operational, regulatory and supervisory perspective, and not as a sum of separate subsidiaries ("the solo approach"). To ensure such an objective, it is necessary to tackle the root cause of domestic ring-fencing practices.

In order to reassure local supervisors, European transnational banking groups that wish to operate in an integrated way, need to commit to providing credible guarantees to each subsidiary located in the euro area in case of difficulty and before a possible resolution situation ("the outright group support"). This "outright group support" would consist of mobilizing the own funds of the Group to support any difficulties of a subsidiary located in the euro area. Since the level of own funds and the creation of MRELs have considerably increased the solvency of EU banking groups, they should be able to face up to any difficulty of their subsidiary located in the euro area. This group support should be based on EU law and enforced by EU authorities. These guarantees should address the question of group support for subsidiaries during going concerns and not only during resolution. They could be adjusted regularly depending on the risk profile of the banking group.

This commitment is the key condition for these banking groups to define prudential requirements at the consolidated level. Given the high degree of banking intermediation in Europe, compared to other jurisdictions around the world, striving for a smoother movement of capital and liquidity, across EU countries, is essential.

In order to create a climate of confidence and trust, host countries should be associated with and involved upstream in the establishment of living wills.

A European approach to the liquidation of these transnational banking groups is also required

In addition, if the group was to go into liquidation (and not only local subsidiaries), a European approach to the liquidation of these transnational banking groups is also required. Indeed, even though these transnational banking groups are supervised at the EU level and the impacts of this liquidation would impact the whole euro area, liquidation is still managed at the national level (entity by entity) and this can require the public money of the Member State of the entity. A common liquidation regime for these banking groups should ensure an equal treatment of creditors of the same rank within the group and the addressing of possible costs at the EU level. In an interim stage one solution could be to extend to subsidiaries the liquidation approach currently used for branches, whereby resolution is managed under the regime of the parent company. This would allow all the subsidiaries of the Group to be treated under the same liquidation regime.

An alternative solution could be to facilitate the validation by supervisory authorities of the transformation of subsidiaries into branches for banking groups who wish

[5] In Italy, at the end of Q3 2018, the NPL ratio was 12,4% and in Portugal 12,6%.

to operate in a more integrated way. This requires that national supervisors and Parliaments should receive the necessary information to understand the risks national depositors are exposed to from these branches and the possible impacts on the financing of their economies. This may require developing specific reporting instruments and processes for the local authorities to continue to be able to appropriately supervise local activities and thus contribute to supervisory decisions taken at the SSM level that may impact their jurisdiction.

These are the main conditions for the abandonment of the "national and solo approach" which would contribute to build a single banking market in Europe, increase the competitiveness of the EU banking sector and favour the emergence of pan European banks.

Finally, when the more fiscal and structural convergences (such as a reasonable level of public debt in all Eurozone countries, ...) are achieved, the more positive integration trends will creep into the Union and reduce the incentives for national authorities to "ring fence" transnational banks in terms of capital and liquidity, thus strengthening banks in their capacity to become pan-European players.

In other words, a monetary union and all the more so a Banking (or capital) Union are not workable without economic convergence and fiscal discipline.

Medium sized bank resolution: challenges and tools

1. What is at stake

1.1. Europe is still a region with thousands of small banks

This is not only a characteristic of Germany, Italy or Austria but also of the United States: 7000 small US banks and 6300 in Europe (EU 28) at the end of 2017.

There are roughly 3,300 banking groups in the euro area, 119 of which are "significant institutions" directly supervised by the ECB. The ECB supervises in particular the 8 Global Systemically Important Banks (G-SIBs), which are located in the euro area[1]. There is therefore in the Banking Union a dual system, with G-SIBs subject to stricter rules as regards the level of prudential requirements and the resolution regime.

Germany, Austria and Italy are home to four-fifths of all the supposedly "less significant" institutions, whose balance sheet total amounts to 80% of annual economic output in Austria and Germany. And in Germany, it is precisely these institutions that provide funding for small and medium-sized enterprises, which, in turn, form the bedrock of the economy. All in all, the "less significant" institutions in Germany finance 70% of the regional economy[2].

In practice, the bulk of Less Significant Institutions are smaller euro area banks whose assets do not exceed €30 billion. If we look at the overall balance sheet total of the euro area banking system, scarcely 18% can be attributed to the "less significant institutions".

Does this mean that small and medium-sized institutions and their services are completely unimportant and so do not require good supervision? Not at all! "Less significant" institutions can indeed be significant for the stability of the banking system. The Less Significant Institutions (those which are under the 119 threshold) are supervised by their national supervisors, under the oversight of the ECB.

Given the lack of governance of some of those banks, it would be appropriate for the SSM to exercise more often its call-upon power.

1.2. Main features of the current EU crisis management framework

In the Banking Union, unlike in some other jurisdictions, there is a clear distinction between the resolution regime[3] and the insolvency regime. The former is a single EU framework, applying to all banks that are failing or likely to fail and meet public interest criteria. The failing banks that do not meet the public interest assessment are liquidated through the domestic insolvency regimes, which vary substantially across jurisdictions.

EU Resolution is for the few, not the many. Most banks (98%) will continue to fall under normal national insolvency proceedings in the same manner as any other failing business is dealt with. However, for 'systemically important' banks - whose failure would have a ripple effect on the rest of the economy - this new concept of resolution has been introduced. But it is the exception, not the rule.

The European resolution framework[4] introduces some constraints on the management of bank failures. Indeed, it not only substantially constrains any possibility of providing public funds to failing institutions but also imposes a minimum amount of creditors' bail-in (8% of

[1] BNP Paribas (FR), Deutsche Bank (DE), BPCE (FR), Crédit Agricole (FR), ING (NL), Santander (ES), Société Générale (FR), and Unicredit (IT). Because of the systemic threat they pose to the financial system, G-SIBs should - according to the principles agreed by the G-20/FSB - be submitted to a specific set of rules and enhanced supervision.

[2] S. Lautenschläger, Caught in the middle? Small and medium-sized banks and European banking supervision, 22 February 2016.

[3] The idea of resolution is, put simply, to ensure that a bank that runs into trouble can be dealt with effectively, having the smallest possible impact on the taxpayer - in other words, no more bail-outs - and at the same time, causing the least amount of damage to the wider economy.

total liabilities) as a precondition for the use of the Single Resolution Fund (SRF). In addition, all entities that could possibly be subject to resolution must issue a sizeable amount of bail-in-able securities (minimum requirement for own funds and eligible liabilities (MREL)).

Moreover, the state aid rules impose some restrictions on the use of Deposit Guarantee Schemes (DGS), especially when the governance of these Schemes is under the control of the public sector.

Unlike the US where TLAC requirements only apply to US G-SIBs, in the EU, the bail-in tool could be applied to any credit institutions[5]. For that purpose, the Bank Recovery and Resolution Directive (BRRD) requires banks to comply with MREL requirements (Minimum requirements for own funds and eligible liabilities) that are determined by resolution authorities on a bank-by-bank basis[6] and may include, for banks that expected to be resolved and not liquidated, where appropriate, a subordination requirement.

The banks that should go to liquidation (98% of them) are subject to an MREL level equal to their capital requirements. But if those banks have losses, someone has to absorb them: the shareholders/creditors (even uncovered depositors) or the national taxpayers (bail out). If the bank goes to liquidation, the national resolution authority is not involved.

In addition, use of public funds is permitted under article 44 of BRRD in exceptional circumstances after the bail-in of 8% of the creditors liabilities and the contribution of the Single Resolution Fund for 5% of the total liabilities. MREL is therefore a cornerstone of the EU resolution regime and the solvency support.

1.3. Medium sized banks raise specific resolution challenges in Europe

These banks, and notably those which are considered significant and are therefore in the remit of the SSM and the SRM, are characterized by the low level of junior debt and the difficulty of raising these MREL type securities: indeed, you need a market to raise securities which is not necessarily easy for a bank with little track record in placing listed debt.

As emphasized by the Financial Stability Institute and Mr. Restoy, 70% of significant banks under direct supervision by the SSM are not listed, 60% have never issued convertible instruments. F. Restoy recently explained[7] that those banks are typically too large to be subject to straight liquidation, as they may generate adverse systemic effects, but they might be also too small and too traditional to issue large amount of MREL-eligible liabilities that could facilitate the application of the bail-in tool resolution. Thus, in this view, the depositors of such banks would be inordinately called upon in the case of resolution, which could lead to unacceptable social consequences.

However If depositors in medium-sized banks are exempted from the consequences of resolution, this contradicts the principles of BRRD and would mean that uncovered depositors in medium-sized banks have more rights than taxpayers («bail-out ») or stakeholders of the whole banking system (intervention of the DGS). Taxpayers and the DGS would be subsidizing banks that were unable to issue sufficient MREL.

Therefore, solutions need to be found for the orderly exit of traditional medium (or small) sized deposit-taking banks, notably for the significant banks, without disrupting financial stability

It would be more intelligent to keep the options open and, like the FDIC, decide, case by case, which is the best solution: liquidation or resolution (merger…). All this seems to justify a two-tier approach (big and systemic banks on the one side and small and medium sized on the other side). The latter could benefit from lower standards in terms of levels of MRELS. But one has to be very cautious on this. It is a fact that those medium sized banks are often riskier and inappropriately managed.

2. Defining a common application of the 'public interest criteria'

If a bank does not qualify for the precautionary recapitalization and is declared by the supervisory/resolution authority to be failing or likely to fail, the choice is between liquidation or resolution. This decision is a prerogative of the Single Resolution Board (SRB) for the banks under its remit, and it hinges on an assessment of the existence of public interest. In other words, European resolution decisions are strictly binary: the SRB acts only when banks satisfy a strict European public interest test. All other cases are invariably handled at the national level, enabling divergent courses of action to be pursued along national lines.

But resolution and liquidation differ substantially when it comes to the scope of legislation that is applicable to the use of public funds. While resolution is governed by the BRRD, liquidation is regulated by national insolvency

[4] The choice of resolution tools depends on the specific circumstances of each case and builds on options laid out in the resolution plan prepared for the bank. The EU Regulation allows the application of four resolution tools They consist of powers to: (i) effect private sector acquisitions (parts of the bank can be sold to one or more purchasers without the consent of shareholders); (ii) transfer business to a temporary structure (such as a "bridge bank") to preserve essential banking functions or facilitate continuous access to deposits; (iii) separate clean and toxic assets between "good" and "bad" banks through a partial transfer of assets and liabilities; and/or (iv) bail in creditors (mechanism to cancel or reduce the liabilities of a failing bank, or to convert debt to equity, as a means of restoring the institution's capital position).

[5] The main aim of bail-in is to stabilise a failing bank so that its essential services can continue, without the need for bail-out by public funds. The tool enables authorities to recapitalise a failing bank through the write-down of liabilities and/or their conversion to equity so that the bank can continue as a going concern.

[6] For setting the MREL, the 8% is a benchmark, not a floor.

[7] F. Restoy, How to improve crisis management in the Banking Union: a European FDIC? Financial Stability Institute, 4 July 2018.

laws and will be managed by national authorities[8]. While the use of public funds in resolution would be subject to both BRRD scope and State Aid scope – thus requiring a preliminary bail-in up to at least 8% of total liabilities, the use of public funds in liquidation is only subject to State aid burden sharing requirements.

Consequently, since the scope of EU law regulating the use of public money in resolution and liquidation is different, a substantially similar operation conducted under these two different frameworks can lead for similar banks to very different outcomes for (i) the acquiring bank; (ii) the banks' creditors and (iii) the taxpayers. depending on the level of the jurisdiction – (i.e. European, national, regional).

However, these criteria are vaguely defined in European law and there are currently two definitions of "public interest ": one at the EU level, and one by national authorities. Indeed, the question of whether the resolution of a bank deemed failing or likely to fail is in the "public interest" or whether such a bank should be liquidated in the absence of public interest has been assessed differently at the EU and at the national levels. Some ailing banks that have been turned down by the SRB were subsequently found to be of public interest by national authorities.

The Veneto banks[9] cases have made it clear that, depending on national insolvency law, resolution tools may be used at the national level outside the BRRD framework, despite the absence of a 'public interest' determined at the EU level by the SRB. Such actions remain subject to the EU State Aid framework but escape from more restrictive conditions under the BRRD. This is what Andrea Enria, Chair of the European Banking Authority (EBA) called "two different definitions of "public interest" [...] one at the EU level and another one by national authorities".

While the definition of critical functions seems clear as regards the SRB's assessment of the existence of public interest, it is not equally clear what role it plays in the EU discipline on liquidation aid, as the 2013 Banking Communication does not include guidelines on how the local effect of liquidation should be evaluated. In the absence of clarity on what constitutes a serious impact on the regional economy, the rules on liquidation State Aid leave room for governments to effectively re-instate at the regional/local level the public interest that the SRB had refused at the national/European level.

One way to overcome this problem, which undermines the credibility of the Europe's resolution framework, could be to ask the SRB to provide an explicit assessment of the impact of failure at the regional/local level, to ensure the assessment is homogeneous.

In any case, the identification and the publication by the Single Resolution Board of the list of significant banks of public interest would make more predictable the resolvability of failing banks.

3. Lessons to be drawn from the US FDIC experience

It would be appropriate to be inspired by the remarkable experience of the FDIC. Why is the FDIC system more efficient[10]? This superiority comes from:

- The fact that the FDIC is a national organization (not 19 Jurisdictions).
- The plurality of options: no hard-wired obligations (8%- 5%) but a pragmatic, flexible, least cost principle base[11]. Thus, the FDIC takes on the risks of some losses in relation to transferred assets rather than requiring creditors to absorb minimum losses in relation to their claims.
- The FDIC has the capacity to select healthy banks in order to purchase some of the assets of the failing banks.
- The FDIC usually agrees to absorb a significant portion of future losses on assets because this method produces a better net recovery than an immediate liquidation.
- Operations of the FDIC are backed by the unlimited credit line from the Treasury which allows the FDIC to gain time and not be threatened by purchasers which are eager to buy the assets at the lowest possible price.

The experience of the FDIC shows abundantly that size is not the major criteria for resolution. What is important is to get the best solution/deal out of an ailing bank. This requires experience, intimate knowledge of the banking system, the capability of negotiating with other banks without being paralyzed by some mechanistic prescriptions.

In a way, the US gives us a lesson: the 15 systemic banks have the necessary capital requirements (including TLACs, stress tests, etc.…) and the other medium and smaller ones have, de facto, a level playing field which is shaped by the FDIC. FDIC is guided by common sense principles: it is free to choose the best solution, case by case.

The FDIC model seems an appropriate way to wind up medium-sized and small banks while protecting insured depositors.

4. What could be done?

It is essential to improve the EU crisis management model for medium sized banks in order to safeguard financial stability. This is also a condition for the Banking Union to achieve its main objectives.

Defining precisely the public interest criteria in a single way, identifying the banks which are meeting those criteria

[8] In the US, the FDIC will be the managing authority in charge of the insolvency process.

[9] The Veneto banks - which did not pass the SRB's 'public interest test' that is required for a bank to be 'resolved' at the EU-level - have been liquidated through a special insolvency procedure under Italian law. That special insolvency procedure involved resolution tools and state aid. Albeit the SRB concluded that the resolution was not warranted in the 'public interest', the Commission indicated that EU state aid rules foresee the possibility to grant State aid to mitigate any economic disturbance at the regional level. Consequently, BRRD bail-in rules were not enforced, the Italian government made available 17 billion euros, and creditors were "in fine" better off than in a resolution which would have entailed a more stringent bail-in of creditors than this liquidation.

[10] See R. Masera, Community banks and local banks, 2019.

[11] Liquidation of banks: Towards an FDIC for the Banking Union? In- depth analysis, European Parliament, February 2019.

and publishing the list of these banks would make more predictable the resolvability of failing banks.

In addition, during the next five years, EU Institutions should specifically work on the treatment of the failure of medium sized banks, which are significant (under the remit of the SSM and the SRB) but who do not meet the public interest criteria by:

- Pursuing the harmonisation of specific aspects of the national frameworks including creditor hierarchies and insolvency tests. This would facilitate the application of the NCWO principle under which creditors should not bear losses above those they would suffer under liquidation in accordance with national insolvency procedures. This would also ensure that the resolution framework and the insolvency regime are consistent.
- Introducing some public risk sharing in the crisis management framework as in the US or the UK. Indeed, If the credit line provided by the European Stability Mechanism (ESM) to the Single Resolution Fund (SRF) is used[12], it was decided that the SRF will pay back the ESM loan with money from bank contributions within three years, although this period can be extended by up to another two years. Consequently, it will be fiscally neutral over the medium term. If no agreement can be achieved to progress to some limited public risk sharing in the Banking Union (e.g. public guarantee to refinance the backstop in case the SRF has not been able to pay back the ESM), it seems difficult to make the EU crisis management framework evolve towards the US FDIC model.
- Achieving an agreement on EDIS and entrusting the Single Resolution Board (SRB) with administrative liquidation powers, along the lines of the FDIC to deal with failing significant banks that do not meet the public interest test. As a manager of EDIS, the SRB would be empowered to decide on the transfer of insured deposits of failing non-systemic bank to an acquirer, or the creation of a bridge bank, with the possibility of granting some support subject to constraints. In this perspective, the insolvency procedures for non-systemic banks would include a depositor protection objective and EDIS funds could be used in managing bank failures - e.g. for early intervention purposes or to finance resolution (i.e. a transfer from the failing institution to an acquiring bank)-. The EU regime would therefore evolve into a fully-fledged European FDIC model.

If there is no political will to move towards a European FDIC, then Europe should move towards a two-Tier system:

On the one hand, banks that are equipped with the proper buffers, MREL toolbox and that could have access to the Single Resolution Fund: the EU G-SIBs and the Significant Institutions with public criteria.

On the other hand, banks that are exempted from having the full range of instruments, in return for which they are liquidated immediately in the event of a problem.

Regarding the Significant Institutions (under the remit of the SSM and the SRM) without public interest, they could be submitted to a lower level of MRELS in order to absorb possible losses exceeding own funds. However, it must be clear that these banks have to be liquidated if they are likely to fail. Indeed, it would be desirable to avoid "free-riders" sailing between these two positions, claiming not to have the means to raise MREL, but claiming to be too important locally/nationally to be liquidated.

These financial institutions affect the profitability of the entire EU banking system: not only can they sell their financial products and services at a lower price because they do not have to charge MREL, but they can also force other banks to contribute more to the SRF to pay for their potential failure. These banks must either reduce their size or merge together to form larger groups capable of raising MREL and becoming "resolvable".

[12] In the event that the Single Resolution Fund, which is financed by contributions from the banking sector is depleted, an agreement was achieved in June 2019 in order to allow the ESM to act as a backstop and lend the necessary funds to the SRF to finance a resolution. To this end the ESM will provide a revolving credit line. The common backstop will be in place at the latest by 1 January 2024. The size of the credit line(s) will be aligned with the target level of the SRF, which is 1% of covered deposits in the Banking Union (currently estimated at around €55 billion). After the establishment of the ESM common backstop, the Direct Recapitalisation Instrument for banks will be removed from the ESM's toolkit of financial assistance instruments.

PEPP: what needs fixing?

Europe's population is ageing. In 2060, for every retired person there will be on average only two people of working age, compared to four today. As a result, despite the important reforms carried out by many EU Member States, state-based and occupational pensions will come under increasing pressure. Citizens will need to save more to complement their retirement income from state and occupational pensions.

At the same time, European markets for personal pension products are fragmented and uneven, in some parts of the Union even non-existent. Market fragmentation prevents personal pension providers from maximising economies of scale, risk diversification and innovation, thereby reducing choice and increasing cost for pension savers. Finally, cross-border selling, and the portability of existing personal pensions are very limited.

To address these concerns, the new EU Regulation on a Pan-European Personal Pension Product (PEPP)[1] of June 2019[2] provides citizens with more quality choice when saving for retirement. The PEPP regulatory framework lays down the foundations for a pan-European personal pension market, by ensuring standardisation of the core product features, such as transparency requirements, investment rules, switching right and type of investment options.

The PEPP will be a voluntary third pillar pension product that will complement existing state-based and occupational pension systems, as well as national private pension schemes without replacing or substituting them.

The PEPP is designed to give hundreds of millions of savers in the EU more choice when saving for their retirement and to provide them with more competitive products while ensuring strong consumer protection. PEPP will also create new opportunities for providers to tap into a European-wide single market for personal pensions. This market is estimated to grow from € 0.7tn to €2.1tn over the next decade, assuming tax incentives for PEPP. The new PEPP Regulation is also a key initiative of the European Commission's Plan for an EU Capital Markets Union as it seeks to channel more savings into long-term investment in the EU.

The PEPP Regulation mandates the European Commission to adopt an important number of technical acts (3 delegated acts, 9 regulatory technical standards (RTSs) and 2 implementing technical standards (ITSs)) based on the technical advice or on draft technical acts to be submitted by EIOPA within 12 months after the entry into force of the Regulation.

These technical acts concern in particular the details/presentation of the PEPP key information document (KID) and of the PEPP pension benefit statement (PBS), the specification of costs and fees covered by the 1% fees cap for the Basic PEPP, the minimum criteria for risk mitigation techniques for the investment options, EIOPA's product intervention powers and the content and presentation of additional information for supervisory reporting.

The PEPP Regulation will apply 12 months after the publication of the technical standards. The first PEPPs may appear on the market soon after the entry into application of the Regulation.

The PEPP Regulation does not cover tax aspects. However, the European Commission has recommended[3] Member States to grant PEPP the same tax treatment as is currently granted to similar existing national pension products, (even when not all criteria are fully met) and to exchange best practices on the tax treatment of such products with a view to bringing closer their tax rules, in order to facilitate the portability of such products.

A very challenging monetary environment for the development of savings products and the PEPP

Unlike American savers, European savers are characterized by risk aversion, especially since pension systems are almost exclusively pay-as-you-go systems and not funded though defined contribution plans as in the US.

Moreover, lasting zero or event negative long-term interest rates encourage retail savers to hold funds in standard deposit accounts, such as checking accounts instead of other investment options. In other words, persistent zero interest rates discourage savers from investing in financial investments and encourage preference for liquidity (hoarding). One can observe that retail investors in the EU indeed prefer cash savings over bond purchasing, which do not generate enough return and higher safety. At the same time, the gloomy economic outlook and high levels of equity markets do not encourage equity investment in Europe.

Persistent zero interest rates are « de facto » insufficient for taking risks, eventually blur risk premiums and reinforce the caution of savers to strengthen their risk-free savings mattress.

Guaranteeing the capital of savers in such a monetary environment is really challenging.

[1] Based on the European Commission's proposal of 29 June 2017 (Proposal for a Regulation of the European Parliament and of the Council on a pan-European Personal Pension Product (PEPP) - COM/2017/0343 final - 2017/0143 (COD)).

[2] Text already adopted by the European Parliament and the Council and published in the OJEU on 25 July 2019.

[3] Recommendation C (2017) 4393 final on the tax treatment of personal pension products, including the PEPP.

AIFMD Review

1. The AIFMD review process

The Alternative Investment Fund Managers Directive (AIFMD) requires a review of the Directive (review of the application of the AIFMD; its impact on investors, AIFs and AIFMs within the EU and in third countries; and the degree to which the objectives of the Directive have been met).

The first stage of the review has been completed with the publication on 10 January 2019 by the Commission of a report commissioned from KPMG intended to provide and assess evidence for the Commission's review. This report is based on a survey of stakeholders most affected by the AIFMD[1] and also on an evidence-based study carried out in 15 representative Member States and some non-EU countries that are important fund domiciles such as the US and the Channel Islands.

The Commission has indicated that it will continue its work on the AIFMD review, taking into consideration the information and conclusions contained in this report, alongside other sources of data and further analysis. The intention is for the Commission to issue its own report on the functioning of the AIFMD to the EU Parliament and Council in 2020.

2. Key findings from the AIFMD review report published in January 2019

Generally the report is positive and concludes that the AIFMD has played a major role in helping to create an internal market for AIFs and a harmonized and stringent regulatory environment for AIFMs. Moreover, most areas of the provisions are assessed as having contributed to achievement of the specific and operational objectives of the directive.

The report however identifies several areas of potential weakness related notably to an insufficient harmonisation of rules across EU Member States, the imposition of additional requirements by Member States and uncertainty around certain definitions. Many of these issues have already been raised previously and some of them are already addressed by on-going work at the EU level (e.g. issues related to the cross-border distribution of AIFs) or at the global level (e.g. calculation methodologies for leverage). This report does not propose recommendations on how these potential weaknesses might be addressed and it remains to be seen how the Commission will approach these issues in the future steps of the review.

Reporting: Some requirements may not be essential or overlapping with other EU legislations according to the survey. There are differences across Member States in terms of data delivery methods and additional information may be required on a periodic or ad hoc basis, although normally there is no room for national discretion. Requests were made by respondents to the study that any future amendments to reporting should take into account the cost impacts and also the possibility of using new technologies, since AIFMD reporting is considered to represent a significant part of overall transaction and operational costs. Some industry respondents also called for a more regular publication of aggregated data by the authorities in order to provide more information on the market.

Leverage: The evidence-based part of the study noted that the use of high leverage is rare in EU AIFs and concluded that AIFMD leverage provisions appear effective in the monitoring and mitigation of systemic risks. Some industry respondents called for the harmonisation of calculation methodologies for leverage across different legislation (notably AIFMD and UCITS) and for considering the interactions with the on-going work at IOSCO on leverage (covering in particular methodology for calculating leverage).

Disclosures to investors: Different issues were raised in responses with some stakeholders believing that requirements on disclosures to investors are excessive and prevent investors from getting a clear understanding of the implications of investing in the AIFs concerned, while others pointed out insufficient disclosures of fees, costs and charges for certain types of AIFs (e.g. private equity). There were also suggestions that inconsistencies of disclosure rules with other EU regimes and duplications could be avoided.

EU passporting regime: Although the EU passport for management companies is working well, the cross-border distribution of AIFs across the EU is still limited and lags behind UCITS products. Definitions of and rules pertaining to 'marketing' also vary across Member States. These issue have been addressed in the recently adopted EU legislative text on the cross-border distribution of funds.

Depositary and asset segregation rules: Some respondents noted that some of the AIFMD depositary rules are interpreted differently in different Member States[2] but it is not clear whether and to what extent this has impaired the effectiveness of the internal market in AIFs. There was an overall sense that the depositary rules adopted a one-size-fits-all approach, which does not accommodate different asset classes or geographies. In addition, although depositary rules are consistent between AIFMD and UCITS, asset segregation rules are slightly less stringent in AIFMD. However respondents believed that applying more stringent rules to AIFs would hinder investments from AIFs in certain third-countries or via certain counterparties.

Investments in non-listed companies: The requirements regarding notifications and disclosures to national com-

[1] i.e. AIFMs, depositaries, investors and distributors as well as industry bodies

[2] for example, it was said that there are differing national approaches to the total look-through provision and to the cash monitoring duties.

petent authorities were considered by many respondents to be overly burdensome for many smaller AIFMs (e.g. private equity / VC AIFMs). A lack of clarity of the meaning of 'non-listed companies' and of the application of rules to investments in unlisted special purpose investment vehicles and unlisted UCITS and AIFs was also pointed out, as well as the lack of improvement of the information provided by AIFs / AIFMs to controlled companies.

3. Current status and next steps regarding non-EU AIFMs and AIFs

Some respondents to the KPMG study called for passports to be introduced for non-EU AIFMs (which is a possibility in the AIFMD, to be further determined by the Commission[3]), some also suggesting that existing national private placement regimes (NPPRs) should be maintained in parallel in any case.

AIFMD and related passporting rights indeed apply to EU AIFMs and non-EU AIFMs managing AIFs registered in the EU, but not to non-EU AIFs. Non-EU AIFs can however be marketed to professional investors in certain individual EU countries via national measures (e.g. NPPRs or specific authorisations granted by Member States[4]) i.e. provided they comply with each EU country's national regime.

The possibility for non-EU AIFs marketed by non-EU and EU AIFMs to benefit from passporting rights conferred under the AIFM Directive was due to be potentially authorized two years after the entry into force of the Directive (22 July 2013), depending on advice given by ESMA. However, these rights have not yet been extended to non-EU AIFs. Assessments of twelve third countries[5] have been conducted by ESMA in 2016[6] to determine whether there are significant obstacles regarding investor protection, competition, market disruption and the monitoring of systemic risks that would impede the application of the AIFMD passport to these countries. Although no significant obstacles were identified for some of the countries (Canada, Guernsey, Japan, Jersey, Switzerland), some issues were raised concerning other countries, for example the US with respect to competition and market disruption criteria regarding certain fund categories or Bermuda and the Cayman Islands with respect to investor protection and effectiveness of enforcement criteria.

[3] According to Recital 64 AIFMD: "After the entry into force of a delegated act adopted by the Commission in that regard, which will, in principle, taking into account advice given by ESMA, occur 2 years after the deadline for transposition of this Directive, a basic principle of this Directive should be that a non-EU AIFM is to benefit from the rights conferred under this Directive, such as to market units or shares of AIFs throughout the Union with a passport, subject to its compliance with this Directive. This should ensure a level playing field between EU and non-EU AIFMs."

[4] According to the AIFMD, Member States may implement NPPRs for non-EU AIFs, managed by both EU and non-EU AIFs, and authorised EU AIFMs may manage non-EU AIFs that are not marketed in the European Union. A Member State may allow the marketing of a non-EU AIF managed by an authorised EU AIFM in their territory without a passport. The same applies for EU feeder AIFs for which there is no EU master AIF managed by an authorised EU AIFM. AIFMD also provides that the marketing of a non-EU AIF managed by a non-EU AIFM to professional investors in the territory of a Member State may be allowed if certain transparency and cooperation conditions are met.

[5] Australia, Bermuda, Canada, Cayman Islands, Guernsey, Hong Kong, Japan, Jersey, Isle of Man, Singapore, Switzerland, and the United States.

[6] cf. ESMA's advice to the European Parliament, the Council, and the Commission on the application of the AIFMD passport to non-EU AIFMs and AIFs, 12 September 2016, ESMA/2016/1140.

Financial policies for dealing with third-countries

1. Objectives and characteristics of existing EU third-country regimes

1.1. Objectives and benefits

'Equivalence' is the main approach used by the EU for managing cross-border activity with third-country jurisdictions in the financial sector and is the basis for the third-country regimes contained in a number of EU regulations[1]. It allows financial institutions based in a non-EU jurisdiction determined by the Commission to have a regulatory, supervisory and enforcement regime equivalent to the corresponding EU framework to operate in the EU, relying on compliance with their home country regulation and supervision[2].

From the EU perspective, equivalence regimes are primarily a tool for managing cross-border activity and capitalizing on the benefits of an open and global financial market, in a safe way with regard to financial stability and consumer protection[3], and also maintaining a

[1] Jurisdictions across the globe use different methods to manage internally the various risks and challenges deriving from cross-border activities. These methods range from applying the domestic regime in cross-border situations, to deferring to third-country rules and supervisory outcomes, to fully exempting certain cross-border activities – Source Communication from the Commission on equivalence in the area of financial services – 29 July 2019.

[2] This is in line with G20 deference principles. In 2013 during the St Petersburg summit the G20 leaders agreed that "jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes".

[3] The Commission stated in the recent Communication on "Equivalence in the area of financial services" published on 29 July 2019 that the EU equivalence policy satisfies three objectives: (i) it reconciles the need for financial stability and investor protection in the EU, on the one hand, with the benefits of maintaining an open and globally integrated EU financial market on the other; (ii) it is pivotal in promoting regulatory convergence around international standards; (iii) it is a major trigger for establishing or upgrading supervisory cooperation with the relevant third-country partners.

level playing field vis à vis third-country jurisdictions[4]. These regimes also support regulatory and supervisory cooperation in the areas covered. Although they do not aim to increase market-access possibilities per se, this may be a result of their implementation, thus allowing EU customers to benefit from a wider range of services and products while avoiding regulatory and supervisory overlaps for industry players.

Absent an equivalence regime, third country firms need to establish a legal entity (i.e. a subsidiary in the EU) to provide services across the Union. Nevertheless, individual Member States may still provide access to third country providers in some cases or for certain types of customers, but only to their home market.

1.2. Equivalence determination process

Present equivalence decisions are a unilateral and discretionary decision by the Commission that may decide to adopt, suspend or withdraw an equivalence decision as necessary. Depending on the circumstances, such decisions can take effect after a transition period. The Commission may also grant a time-limited equivalence or set conditions or limits to equivalence decisions. In addition EU equivalence frameworks do not confer to third-countries a right to be assessed or to receive a positive determination.

Equivalence decisions are taken after detailed assessments of the third country's regulation and supervision, on the basis of technical advice from the European Supervisory Authorities (ESAs) concerned. This involves a technical dialogue with the competent authorities of the third country whose framework is being assessed.

Assessments of equivalence are performed for a given jurisdiction and in a particular financial area. This is meant to be an outcomes-based process assessing regulatory and supervisory results (i.e. not a word-for-word comparison of legal texts)[5].

The legal acts of EU legislations set out the conditions and criteria for assessing equivalence and equivalence provisions are tailored to the needs of each specific act. As a result there are differences across financial legislations in the way equivalence mechanisms are built. In its latest Communication published in July 2019, the Commission states that it would be extremely difficult to implement a uniform assessment and decision-making process encompassing various areas of equivalence and that policy-makers, regulators and other stakeholders now accept this heterogeneity as long as some common principles are respected. These principles include having a risk-sensitive approach for determining equivalence guided by proportionality (i.e. assessments should be proportionate to the nature of services and the risks posed to the EU financial system and may, as a result, be more demanding for countries whose markets have a bigger potential impact on the EU); enhanced transparency towards the interested third country and the public at large; and an on-going monitoring of equivalence decisions.

1.3. Monitoring and review of equivalence decisions

After an equivalence decision has been granted, it is up to the Commission, in cooperation with the relevant ESAs, to monitor the effects of equivalence decisions and also of any changes introduced over time by third countries to their regulatory, supervisory or enforcement regimes. This involves maintaining a dialogue with third-country authorities. In the coming months, the Commission is due to work with the ESAs in order to step up cooperation on monitoring in line with their respective mandates.

The equivalence frameworks in force do not provide as such specific procedures for monitoring equivalence decisions. Monitoring results feed into a potential review of an equivalence decision, which involves a more structured and strictly defined analysis. Following these assessments the Commission has the power to launch procedures to amend, alter or even withdraw an equivalence decision, when it deems it necessary.

1.4. Financial activities covered

Equivalence regimes are only available for certain financial activities at present. Equivalence regimes exist for financial services related to securities and derivatives transactions (MiFID, EMIR, CSDR, SFTR) and for services and products targeting professional customers and eligible counterparties (investment services under MiFIR, AIFMD) and reinsurance activities. There is also an EU equivalence regime for credit rating agencies and financial benchmarks.

However, most core banking and financial activities are not subject to an equivalence regime providing access to the single market. This includes deposit-taking and lending in accordance with the Capital Requirements Directive; payment services in accordance with the Payment Services Directive; and investment services for retail clients. In addition there is no third-country regime for investment funds targeting retail clients (UCITS and AIFs) and most insurance activities except reinsurance[6].

According to the July 2019 communication of the Commission referenced further up, 17 pieces of EU legislations contain third-country provisions and on this basis over 280 equivalence decisions have been taken for more than 30 countries, across various parts of the financial industry. Further equivalence assessments are underway in areas such as benchmarks and statutory audit.

[4] Equivalence determinations take into consideration impacts on the level playing field in the internal market. They also take into consideration fairness in the treatment of EU players active in third countries and subject to local rules and supervision and also the treatment that third countries afford to EU regulatory frameworks.

[5] According to the Commission 2017 staff working document and July 2019 Communication.

[6] Source : European Parliament think-tank – Third country equivalence in EU banking and financial regulation – August 2019.

2. Equivalence arrangements in the context of Brexit

2.1. Equivalence as the basis for the future EU-UK relationship in the financial sector

Once the current transitional arrangements[7] are over, the UK will be considered as a third country and EU passporting rights will no longer apply to financial service providers established in the UK.

Equivalence, when it is available in EU legislation, is due to govern the provision of financial services from the UK to the EU post-Brexit, whether or not the deal negotiated between the EU and UK is finally implemented, since it does not contain any specific provisions for financial services. For financial activities that are not covered by an EU third-country regime the only option is to provide services through an entity authorized in the EU.

This explains why most financial institutions based in the UK that operate at present in the EU on the basis of passporting have set up or developed subsidiaries in the EU27 in anticipation for a hard Brexit. It is generally believed that these changes will allow a continuation of services with no significant disruption post-Brexit. However the impact of these changes on the current financial services market structure in Europe and their implications in terms of cost, complexity and efficiency of the provision of financial services still need evaluating. The current hub-and-spoke model (with the City of London as the hub for many financial activities in the EU[8]) may evolve towards a model closer to a multiple hub model. This is nevertheless dependent to a certain extent on the volume of transfers of activities from the UK to the EU that will eventually happen and on further progress on EU27 initiatives to further develop and integrate financial markets, such as the CMU.

2.2. Issues and questions raised by the existing EU equivalence regimes in the context of Brexit

A number of questions and issues were raised during the EU-UK negotiations on Brexit regarding present EU equivalence regimes, which the UK considered as "inadequate for the scale and complexity of EU-UK financial services trade". The main criticism made by the UK relates to the unpredictability of equivalence arrangements that can be withdrawn unilaterally "at any time" by the Commission and their limited coverage in terms of sectors.

Different suggestions were made by the UK to improve equivalence arrangements[9], but these were rejected by the Commission on the basis that they were not compatible with the objectives of the current EU approach to equivalence and would potentially impede the regulatory and decision-making autonomy of the EU. Regarding the predictability of equivalence arrangements, the Commission stressed that although steps and timelines are not strictly defined, a withdrawal of equivalence only happens after an in-depth assessment normally performed by one of the ESAs. Efforts (described further down) are also underway to improve the transparency of the process and public consultation.

Another issue raised by the UK is the perceived "politicization" of the equivalence determination process. This usually refers to the fact that some assessments might take into account criteria that go beyond purely technical regulatory aspects. The Commission however explains that this is normal since equivalence assessments have to take into account several micro and macro dimensions including investor protection, potential systemic risks, as well as AML, market disruption or level playing field aspects, in order to ensure that EU markets and customers are not exposed to unwanted risks as a result of equivalence agreements. Moreover efforts to improve transparency of assessments should help to alleviate these concerns.

3. Improvements made to EU equivalence processes and further proposals

3.1. Improvement of EU equivalence processes

While considering in its working document on equivalence decisions (February 2017) that the experience with equivalence as a mechanism to deal with cross-border regulatory issues is "broadly satisfactory", the Commission acknowledged that some areas of improvement of equivalence processes needed considering.

Following calls by third-countries and financial industry stakeholders for greater transparency, and accountability of equivalence processes, efforts have been made to improve the information provided regarding the way

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[7] Transtional arrangements put in place by the EU, some EU Member States and also by the UK in certain areas (including derivatives and CSDs) that could be potentially prolonged by an additional transitional phase until the end of 2020 in case of agreement on a EU-UK deal. The UK adopted in November 2018 a temporary permission regime for a period of 3 years for financial firms operating in the EU and that wish to continue carrying out business in the UK. This temporary regime aims to mitigate disruption risks while EU firms seek authorisation or recognition by the UK authorities. The Commission has not provided a similar mechanism for UK-based firms but implemented in December 2018 several contingency measures: (i) a temporary equivalence decision for 12 moths for the central clearing of derivatives, (ii) a temporary equivalence decision for 24 months for CSD services for EU operators using UK operators; (iii) delegated regulations facilitating novation for a period of 12 months of certain OTC derivative contracts being transferred from the UK to an EU27 counterparty.

[8] A range of financial markets, excluding direct retail financial services, have become over the years increasingly integrated and more concentrated with much of the activity and infrastructure either located in London (e.g. securities and derivatives clearing) or managed out of London (e.g. delegation of portfolio management of EU27 investment funds) or accessed through London. Underlying factors include EU single market rules, technology, network effects and the search for scale (economies of scale, competencies…).

[9] Proposals made by the UK included putting in place a "super equivalence to UK" for all financial sectors on the basis that the EU and UK regulatory and supervisory starting points are equivalent; transforming recognition into a reciprocal process with both jurisdictions retaining autonomy in decision-making and monitoring arrangements; and also making withdrawal subject to clear timelines and notice periods. The UK also suggested that EU and UK regulatory requirements should be to allowed to diverge over time so long as an equivalence of outcomes is preserved, which would require an on-going and shared review process of equivalence decisions and possibly a specific dispute resolution mechanisms, if the UK is no longer subject to the ECJ.

EU equivalence processes work and how equivalence assessments are progressing. Recently the Commission has adapted its internal processes and generally submits for public consultation draft equivalence decisions with a 30-day feedback period. Suggestions have been made by certain stakeholders that equivalence processes could be further improved without impeding their objective e.g. further increasing the clarity of requirements or defining more precisely possible withdrawal procedures.

The outcome of the European system of financial supervision (ESFS) review should also facilitate the monitoring of equivalence arrangements. Each ESA is to perform monitoring work on equivalent third countries and submit a confidential report to the European Parliament, Council, Commission and the other two ESAs "summarizing its finding of its monitoring activities" on an annual basis. Moreover the review will provide the European Supervisory Authorities with more resources that should allow performing more regular and detailed assessments of the third-countries concerned (including the monitoring of regulatory and supervisory developments and relevant market developments in third-countries).

3.2. Mitigation of systemic risk posed to the EU by third-country entities

A further issue identified by the EU authorities is that third-country jurisdictions may involve different risk exposures for EU financial markets due to the systemicity of their financial sector or of certain entities and that equivalence decisions and their supervision and monitoring need adapting consequently, favouring appropriate cooperation between home and host supervisory authorities.

This issue was addressed in the EMIR 2.2 review regarding systemic third-country CCPs with Brexit as a backdrop. The current equivalence regime entails full reliance on third-country rules and supervisory arrangements and only leaves very limited powers for EU supervisors to intervene should a risk affecting EU financial stability emerge in a third-country CCP. This is considered to be particularly problematic in the case of the UK, given that UK-based CCPs clear a large share of euro-denominated swaps. In addition EU central banks of issue (CBIs) are not involved at present in supervisory decisions regarding these third-country CCPs, which may have implications for EU monetary policies.

In EMIR 2.2. a reinforcement of the supervisory framework for systemically important third country CCPs wishing to provide services in the EU has been adopted, with new monitoring powers granted to ESMA (e.g. in terms of information provision, possible on-site inspections…) and a stronger role for EU CBIs in the supervision process. Systemic third-country CCPs are also requested to comply with some material EMIR rules (or equivalent ones).

Proposals have been made to assess the opportunity of extending this approach to other third-country infrastructures such as CSDs.

The Investment Firms Regulation moreover introduces new assessment criteria as well as additional safeguards and reporting obligations for third-country firms established in equivalent jurisdictions in the existing equivalence framework of MiFIR. Under the new equivalence regime different categories of third-country jurisdictions are created. For jurisdictions where the scale and scope of the services provided is likely to be of systemic importance for the Union, equivalence can only be granted following a detailed and granular assessment by the Commission. In addition the role of the ESAs in monitoring the activities of such firms in the Union is enhanced.

3.3. Proposals made at the global level by IOSCO to improve equivalence regimes

In a recent report on "Market fragmentation & cross-border regulation" (June 2019) based on a survey conducted at the international level, IOSCO recognized the potential positive features of equivalence and deference in mitigating fragmentation and fostering global markets.

The areas of improvement identified in this report are consistent with those mentioned by the Commission: insufficient clarity and transparency of the equivalence assessment process and variability across jurisdictions; the difficulty of developing a clear understanding of foreign regulatory frameworks when regulatory philosophies and approaches differ (e.g. principles-based vs rules-based approaches); the frequent lack of "clear processes and procedures" in place for the on-going monitoring of equivalence arrangements; and the possible need to differentiate more between systemic and non-systemic sectors and entities in deference approaches.

Measures have been proposed by IOSCO to improve collaboration and cooperation between supervisors such as making a greater use of its regional committees to discuss regulatory issues on a regular basis and develop more common understanding of the different financial markets and legislative frameworks. Other suggestions made by IOSCO are to provide a central repository of memoranda of understanding (MoUs) in order to facilitate access to them and to increase the use of global supervisory colleges. Suggestions were also made to enhance the clarity and efficiency of deference processes e.g. with the use of common and more standardized material.

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