# SUMMARY

## THE **EUROFI** HIGH LEVEL SEMINAR 2019

**BUCHAREST** | 3, 4 & 5 APRIL

ORGANISED IN ASSOCIATION WITH THE **ROMANIAN EU COUNCIL PRESIDENCY**

eurofi

**All the publications**
of the Bucharest High Level Seminar
and of previous events are on the Eurofi website:

Summary
Views Magazine
Regulatory Update

**www.eurofi.net**

# EDITORIAL

The Eurofi High Level Seminar 2019 took place in Bucharest during the Romanian Presidency of the EU Council. More than 900 participants from the EU and international public authorities and the financial sector attended this three-day international event.

Over 200 speakers contributed to the 40 sessions of this Seminar, covering the main regulatory and supervisory developments in the financial sector at the European and global levels, the evolutions underway in the macroeconomic environment and also major on-going trends such as digitalisation and the development of sustainable finance. As the European elections were approaching, a common topic of many sessions was also the definition of the main priorities for the incoming Commission in the financial services sector.

In the following pages you will find the summaries of all the sessions that took place during this international Seminar and the transcripts of the speeches.

We hope you enjoy reading this report which provides a detailed account of the views expressed by the public and private sector representatives who took part in this event on the latest regulatory developments in the financial sector and how to improve the functioning of the EU financial market.

Jean-Marie **ANDRÈS**
*Senior Fellow*

Didier **CAHEN**
*Secretary General*

Marc **TRUCHET**
*Senior Fellow*

# CONTENT


The Eurofi High Level Seminar 2019
BUCHAREST | 3, 4 & 5 APRIL
eurofi

Bucharest 2019

# SUMMARIES OF THE SESSIONS

Detailed output of the sessions

# EU AND EUROZONE POLICY PRIORITIES

## Viability and future of the Eurozone

### 1. The European Journey

The Chair welcomed participants to the discussion. Remembering when the euro started and the excitement surrounding it, the Chair asked Pierre Gramegna what can be done now about the structural weaknesses in the eurozone.

#### 1.1. Europe has come a long way since the crisis

Pierre Gramegna stated that the euro was greeted with scepticism by some who said it would never work. It went well for 10 years before the world financial crisis and the subsequent euro-area crisis. With many not fulfilling the criteria of Stability and Growth Pact (SGP), there were those who thought the euro would sink. Instead, Europe has come out of this 'teenage crisis' stronger, with the Banking Union (BU) and the Capital Markets Union (CMU).

The BU was agreed upon at ECOFIN meeting in December 2012, followed the next day by newspaper headlines claiming it would never be implemented. ECOFIN has now implemented 75% of the BU. Banking supervision for the European Central Bank is working fine and the euro-area has been strengthened. Additionally, the activity surrounding Brexit has given more popularity to Europe and the euro now has the support of 75% of people across Europe. It is the second most important international currency, although much remains to be done.

The Chair asked Pierre Gramegna how Luxembourg perceives certain structural weaknesses. Luxembourg has seen immense success and is still growing well. It has no issue with debt, but there is some concern that certain of these weaknesses still persist and have now persisted for a long time.

#### 1.2. Europe must continue with structural reforms and sound fiscal policies to make its economies more resilient and competitive

Pierre Gramegna believes that in the past 20 years no country apart from Luxembourg has been able to fulfil and comply with the rules of the Stability and Growth Pact (SGP) all the time. A number of goals must be achieved. First is that most or all countries must fulfil the fiscal criteria for their own good. The Maastricht criterion is there because it means the appropriate management of public finances. Analysis is needed on how to improve that alongside more economic and social convergence in Europe. In the last six months there has been agreement on strengthening the European Stability Mechanism (ESM) which, by June, will play a larger role in preventing crises and will have more tools for when a crisis occurs.

Second is the new budgetary instrument of the euro-area. Much progress is being made, and convergence is growing on there being two main goals: ensuring that countries that are weakening can still invest to become more productive; and determining how a new budget instrument can make countries that are lagging behind, and cannot fulfil the SGP criteria, undertake the necessary structural reform.

A third goal relates to governance. It is important not to duplicate or complicate mechanisms. At present it is difficult to explain to people that the EU has the right ideas on how to strengthen the euro-area but they will take three or four years to implement. The EU must become faster and more efficient.

The Chair believed that the structural current account deficit and surplus countries look locked in and unchanging. Some countries' public sector debt is actually increasing post-crisis with economic growth in Europe, whereas others' debts are decreasing. Such structural disequilibria are urgent to address, but this is a very difficult issue to solve.

#### 1.3. Reaching greater economic consistency and ensuring the sustainability of our economies

Pierre Gramegna agreed that there are discrepancies in current accounts in Europe, although a retrospective look shows countries becoming more efficient and productive compared to each other. The EU is the export world champion. Part of that is the intra-EU commerce, but Europe is also extremely efficient: productivity, for example, has increased on a regular basis in most countries. Every country should specialise, following leaders such as Germany in cars and machinery, France in aircraft and power, and Luxembourg in finance. With every country specialising, there will be a critical mass and knowledge.

Pierre Gramegna noted that digitalisation is a game changer in the world of tomorrow that will disrupt the business models of today. Europe is a pioneer in the fight against climate change and is far ahead in clean and renewable energy. This is a European success story, but the road was very long.

The Chair asked whether Pierre Gramegna agrees that unless Europe can grow its economy by above 1% over a sustained period these structural problems will remain, or it will be very politically difficult to solve them. It is important to identify key areas for the next political cycle where the EU can ramp up economic growth and get to grips with these structural issues. Pierre Gramegna responded that 1 2% growth is necessary, and will require focus on sustainable growth, as Europe already treats the environmental and social aspects.

### 2. Europe is in the middle of the road

Bruno Le Maire stressed that, looking at the past, many things have already been achieved to enforce eurozone architecture, including financial assistance mechanisms, the first two pillars of the BU (the Single Supervisory Mechanism and the Single Resolution Mechanism) and the procedure to monitor macroeconomic imbalances. Europe is currently in the middle of the road: after the European elections it can either reinforce the eurozone by taking tough decisions to position all 19 member states to be able to face any kind of financial crisis or face the risk of a total weakening of the eurozone.

#### 2.1. Reducing economic discrepancies, addressing banking fragmentation and advancing the CMU are urgent priorities

Bruno Le Maire observed that the current situation sees a striking rise of economic and financial divergence among eurozone member states. There is no future while those differences continue to grow. The first purpose of common monetary union is to reduce this divergence. Divergence in the situations of member states of a shared monetary union only creates structural difficulty.

Strong decisions must be made. First is to reduce banking fragmentation within the eurozone. The BU must be completed in weeks, not years, otherwise it will not take all the benefits possible from a common monetary union. Second, a eurozone budget must be established as soon as possible, with governance that will be decided by the 19 eurozone member states. Third, is to have the CMU. Europe currently does not take growing benefits from the eurozone and EU financial market because there is no CMU. In 2018 equity levels across the world sat at €100 billion in the US, €80 billion in China and €20 billion in Europe. Europe is the first market and the strongest union from an economic perspective, but the level of equity is far from the US and China. Examining the equity figure and lack of a CMU in Europe indicates why there is no European Google. If Europe can take the decisions necessary for an EU 27 CMU, a 19 member state BU and the eurozone budget, it will be the biggest economic and financial power in the world. Tough decisions must be agreed if Europe wants prosperity, growth and more jobs.

The Chair questioned whether participants are confident there can be greater convergence on the structural problems at the heart of the eurozone and disequilibria on the current account side, and how Europe will get there if so.

Pierre Gramegna stated that the EU has achieved 75% of what it needed to do. The markets have recognised the need for deposit insurance at a fully European level, which will provide stability and credibility, and a common umbrella across Europe. Non-performing loans (NPL) must be reduced, and that is about to happen. Reducing NPL is easier in times of growth, and Europe has seen seven years of growth, with growth in all euro-area countries in the last two years.

Pierre Gramegna agrees with Bruno Le Maire that the CMU must be completed. While solutions have been found on 13 of the 16 directives being negotiated, it is unfortunately likely that the press will comment on those three that do not yet have solutions.

Bruno Le Maire emphasised the need for the completion of the last step. It is the most difficult and the most interesting. Europe must achieve BU to mitigate the loss of financial means and tools in the banking market that growing fragmentation causes in the eurozone.

The ECB reports that over €300 billion of liquid assets are locked due to ring-fencing, meaning more new rules are being implemented at the national level. If a European supervisor is sufficient and European rules are enough then Europe must eliminate the new national requirements and rules that lead directly to ring-fencing, which means a loss of financial resources for growth and economic development.

There are two points to tackle as soon as possible. First, the EU continues to add more national requirements, but there is a European supervisor which should lead to a removal of those national rules. Second, the rules differ inside and outside the BU; the requirements inside the BU are greater than they are outside, which is something nobody understands.

### 2.2. A euro-area budget with permanent resources and a euro-area governance should support the competitiveness and convergence of Euro-area economies

Bruno Le Maire outlined that it is up to member states to make the necessary decisions for more convergence within the eurozone. Taking the first step means two things: obeying the European requirements for their budgets and taking structural decisions to improve the competitiveness of their economies.

France leads in this respect, having taken the necessary decisions to obey European law and be under 3% of public deficit, despite the resulting Yellow Jacket movement. France has also taken strong structural decisions to improve competitiveness. The Ministry of Economy and Finance has introduced a full overhaul of the French taxation system, and a reform of the job market and pension system is underway. The European response must be more solidarity within the eurozone and more convergence through a eurozone budget. Explaining these changes to the French public does not make sense without anticipating eurozone solidarity and efficiency.

To achieve more convergence and solidarity in Europe and among member states, national governments and the eurozone budget each has a role to play. There is no time for those crying out for reform but unwilling to move towards more solidarity and convergence in the eurozone. There is no future for the eurozone if one asks for more effort from member states without giving more solidarity. The Chair summarised that Pierre Gramegna also feels that so called surplus countries must make efforts, and that solidarity includes efforts by surplus and deficit countries towards convergence.

### 2.3. Solidarity does not mean a transfer union

Bruno Le Maire stated that solidarity does not mean a transfer union. There should be no transfer union. If Europe faces a crisis, it needs solidarity among the member states. Without solidarity there is no future for the eurozone. Pierre Gramegna agrees. Luxembourg supports more solidarity. He warned that everyone must respect the rules of the SGP over time. There may be difficult years, but that is acceptable. A transfer union cannot be explained. The message to spread is that Europe is about solidarity, a sentiment that started in the 1950s when everybody wanted to make peace.

# Priorities for the upcoming Commission

## 1. Realising Banking Union

While Banking Union has promoted a more resilient banking sector, there is still no integrated market for banking. There are several obstacles to Banking Union being effective: the lack of trust between member states and in European institutions; EDIS and its potential to solve home-host issues; and the need to abolish ring-fencing. Banking Union must deliver on the promise of an integrated market or lose the support of Europe.

### 1.1. The Banking Union has been successful in promoting a more resilient banking sector, but it is still failing to deliver an integrated market for banking business

An industry representative noted that Banking Union is about the creation of a safe and efficient banking sector and the free allocation of capital and liquidity across the eurozone. Europe needs to become a high quality brand name with a single financial market while accelerating economic efficiency and shock absorption capacity. Banking Union is about ensuring a level playing field both within the eurozone and at the global level. The industry representative considered that the Commission has achieved something very significant in the SSM, which plays an important role. The Single Resolution Board and the Single Resolution Fund have also been created, but in practice there have been no bail-ins where some banks were likely to fail. Additionally, there is increasing banking fragmentation associated with liquidity, capital and MREL. There are serious questions there including the free flow of dividends within eurozone banking groups and the unlevel playing field issues linked to the difference between TLAC and MREL requirements.

Europe is currently in a situation of prolonged low interest rates, a flat interest rate curve and ample liquidity. Monetary policy is causing a squeeze on banking margins. There are also ongoing requirements for more capital and a need to invest in technology. The industry must invest because of increased competition, especially from bigtechs. At the same time, the lack of restructuring or consolidation in the banking sector has created unhealthy competition. Ultimately, the consequences are low profitability, squeezed margins and the risk of excessive lending. Politicians like lending, but banks create NPLs when they use volume to compensate for a lack of margins. An official cautioned against underestimating what Europe has achieved. There is now a Single Resolution Fund, for which the backstop has recently been agreed. Priorities in realising Banking Union include: EDIS, the sovereign-bank loop, safe assets, liquidity, resolution, market fragmentation, cross-border banking and home-host issues.

### 1.2. There is a lack of trust between member states and in European institutions

An official considered the process of creating Banking Union incomplete. Europe has invested a substantial amount of political credibility in the project. It is a huge step in terms of the transfer of sovereignty. The industry is not seeing the expected benefits of Banking Union and a centrally supervised system. The discussion of home-host issues remains 'tense' and 'destructive', which reflects the worrying lack of confidence across member states and towards EU institutions. Europe has appointed one institution to supervise its banks and another to manage bank resolution, but the poisonous home-host discussion reflects the lack of confidence in the capacity of those institutions to manage financial institutions in case of difficulties. In order to make progress the industry needs clarity on the Banking Union framework and be ensured that this central project for Europe is moving in the right direction. Otherwise, the financial industry and member states' citizens will lose confidence in the process.

### 1.3. An EU agreement on EDIS might not be sufficient to resolve the home-host issues

Europe must complete the Banking Union. An official highlighted EDIS as the outstanding element. EDIS should solve home-host issues, because it will remove any technical reason for hosts to raise such issues. However, there is no consensus on the expected benefits from EDIS. Indeed, another official suggested that the introduction of EDIS will not solve home-host issues because many host countries also consider resolution and supervision as pending issues. Another official expressed optimism, however. Host countries could not agree on liquidity and equity waivers for pan-European banking groups because of concerns over national deposit guarantee schemes ultimately being liable if something went wrong with a subsidiary. This claim can no longer be made for resolution, because host countries will no longer have to pay for this. A third official felt the subject is not as simple as the first official had suggested. If it were, there would not be so many issues between home and host jurisdictions. An industry representative felt there is more to the home-host issue than EDIS and doubted that it would ever exist. An official felt that Europe has made big steps forward under significant pressure, such as the SSM or SRF. It is essential to explain why Europe needs these policies: because risk is being shared with people across Europe.

### 1.4. The SSM and host national authorities must reach an agreement on abolishing ring-fencing

An official felt that fragmentation and ring-fencing cannot be reduced by a simple fiat at the European level. Europe must give valid, credible and enforceable reassurance to economies with large foreign owned banking systems. Otherwise, there will be debate but no agreement. An industry representative stressed the importance of improving the relationship between home and host countries in order to limit fragmentation. It is necessary for market participants to see clarity on the long-term home-host framework.

## 2. Achieving progress on capital markets union

A strong EU will necessarily rely on deep, integrated capital markets. By channelling the high savings of European households toward the real economy, these capital markets will reduce the cost of capital for European corporates and funding innovation. Deeper capital markets will also give firms an alternative to bank credit, thereby diversifying their sources of financing and improving the resilience of their operations. Europe must deepen the single market and develop larger capital markets with increased long-term investment. Progress has been slow, including specifically on the harmonisation of insolvency and tax laws.

### 2.1. Europe must deepen the single market

An industry representative agreed that Europe must continue to work on Banking Union and the CMU. Taking a broader view, the industry representative suggested that Europe should consider the importance of its financial sector within the wider service sector. Considering the top 30 companies by capitalisation, the industry representative pointed out that 25 years ago over 70% of these companies were in manufacturing goods and energy, and fewer than 30% were into services. 25 years later, 60% of these companies are into services and 88% of these companies are American. There is not a single EU company in the top 30. Without an integrated service sector, it is very hard for European companies to scale up and be competitive at the global level. This is a difficult subject because the service sector is extremely complicated. Its fundamental components are its legal framework, the framework for human capital and its technological capability. Human capital is a particularly difficult issue because professions and the labour market are delicate national priorities.

### 2.2. Europe needs larger capital markets and increased long-term investment

An official emphasised the importance of cross-border long-term investment. Cross- border Investment is crucial for optimizing the allocation of capital, but it is also important because of the need to benefit from private risk-sharing in the eurozone, which public instruments are not yet delivering. An industry representative stressed the importance of remaining optimistic, articulate and modest in this respect. Clearly, Europe is faced with political, geopolitical, demographic and environmental challenges, but there are some reasons for being optimistic. Europe's finance sector is resilient. Brexit should teach the industry the importance of taking part in public debate and sharing its knowledge and expertise. It is also important to remain modest. Improving financial services can increase economic growth, but it has little influence on many of the most important drivers of economic growth: education, technological development and population growth. Ultimately, Europe needs more investment and better investment. 'More investment' means larger capital markets. The single biggest action the industry can take to increase investment is to increase the size and capabilities of the capital markets. 'Better investments' means better capital markets, and better capital markets means capital markets with a sufficiently long-time horizon and a diversity of participants to encourage and facilitate right decision-making. Fiscal, regulatory and supervisory frameworks for financial markets have a systemic bias towards short-termism. The industry representative suggested that Europe could achieve bigger and better capital markets by taking practical measures. The industry must develop and stimulate pension funds and pension products as mechanisms to channel savings into long-term investments. Additionally, there must be fairness and simplicity in the taxation of financial investments. The concept of investment saving accounts is valuable here. Europe must also grow cross-border market access, especially to smaller and retail investors. It is important not to underestimate millenials. They also need to save for their pensions, and approximately 78% of them consider Environmental Social and Governance (ESG) factors in investment decisions. ESG assets are growing globally by 12% per annum. Europe must ensure it takes a fair share of that growth.

### 2.3. Progress on CMU has been slow

An official agreed that Europe is lagging behind in the financing of the economy and investment in start ups. A substantial amount of work has been done on risk capital, but it is difficult for start ups to find sufficient capital within Europe to grow and compete globally. Europe also needs to maintain the ability to play a global role. Whatever the specific outcome is, Brexit will completely change the position of the European Union. It is important for Europe to build and control its own key source of financing and to have a common vision for its marketplace. Additionally, the financing of climate change should be a key priority. Climate change will not only be addressed by finance, but the financial industry can contribute significantly. The official observed that the progress made on the review of the ESAs has been positive but very limited, suggesting that this reflects the risk of a return to national considerations and a lack of ambition in terms of developing a European framework for banking and capital markets. Conceding the slow progress on CMU, another official pointed out that between 2015 and 2018 only three pieces of legislation on CMU were passed, but between 2018 and 2019 this increased to 12. The CMU agenda is very large, however. The official agreed that sustainable finance should be included in the CMU. Europe's 'biggest miss' on CMU has been its failure to agree on a taxonomy.

### 2.4. An EU harmonisation of insolvency and tax laws is crucial, but this is an area where progress is very difficult to obtain

An official suggested that there is a mixed picture on capital markets union. Europe has not come as far as it wished, but there has been progress. The incoming Commission's agenda should be broad: it should be about insolvency, taxation, securities and supervision. Another official agreed that Europe must complete the CMU. Europe has made positive progress although the original proposals were not very ambitious, especially in the field of insolvency. The problem is that finance ministers are responsible for the CMU, but justice ministers are responsible for insolvency, and justice ministers do not view the CMU as a priority. Additionally, the industry needs a truly European securities law. At present there is no European definition of a security. The official concluded by expressing doubt that tax could ever be part of the capital markets union project. In relation to insolvency, a third official felt that there should be some differentiation between corporate and bank insolvency. It would be a significant step forward to be able to use the specific legislation on bank insolvency, which has already been passed, harmonised and European ised, to make more progress towards harmonisation and integration. A fourth official stated that progress on tax and insolvency would take time. The Chair agreed on the importance of insolvency and queried whether a 28th regime could be of assistance here. An official considered that a 28th regime would not work for insolvency. At some point, the superimposed rules of the 28th regime must be connected with the national regime, because insolvency is ultimately about the same creditors. If a company goes bust, there will be creditors in the national realm and external bond holders, but the assets and priorities are the same. There cannot be preferential treatment of creditors, so a 28th regime probably will not work. The Chair hoped that this will not be the case.

The official emphasised the importance of tax. The Commission made a very sensible and modest proposal on moving to a qualified majority, which would have been a significant step forward. This also would have been a step forward for the CMU and the select subset of tax legislation. Unanimity is needed to change unanimity, and Europe is 'lightyears away' from unanimity. As long as the process demands unanimity, it will be hard to make progress. Feeling somewhat provoked on the subject of taxes, another official suggested that it is not necessary to have a harmonised tax regime due to capital markets. This does not exist in the US, where every state has the power of taxation, but Europe needs it where there is a cross-border element linked to an individual, such as in pension products. A pan-European pension product can only work with a harmonised tax system, regardless of where people move during their lifetime.

## 3. Future approaches – new ways of thinking and working

The panellists expressed different views on the way forward, variously suggesting that Europe should redefine its long-term view on the key priorities and escape the debate of 'risk reduction versus risk-sharing'. However, progress has become increasingly difficult due to an increasing domestic focus of public decision makers. In this context, advancing Banking Union slowly might be the only feasible way to make progress.

### 3.1. Europe must 'step back' and redefine its long-term view on the key priorities

An official highlighted the importance of taking a step back, re establishing agreement on the priorities and reiterating the long-term implications of banking and capital markets union. The official noted that France, Germany and other countries intend to establish a group to consider and advise on what should be done in these two areas. Another official suggested that a short report on 'the cost of non Europe' be produced, similar in style to the Cecchini report. The official stressed the need to ensure that Europe has sufficient funding capacity in its capital markets and banking system notably to facilitate the creation of European equivalents of BigTech companies.

The development of these companies demonstrates how important financing is, especially equity and risk financing. Europe does not have the means to create bigtech companies of its own. It will remain a dream if nothing changes.

**3.2. Escaping the debate of 'risk reduction versus risk sharing'**

An official suggested that, under the right leadership, Europe could escape the Groundhog Day like discussion where one country says, 'We must do more risk reduction before further integration,' and another country says, 'We have reduced risk, so now we must integrate further.' It is a painful discussion, which leads to very little. Without anyone giving up their red lines, the conversation at the EU level has recently moved towards a situation in which participants are trying to imagine how future Banking Union might function in terms of the home-host issue, fragmentation, segmentation, EDIS and the regulatory treatment of sovereign exposures. The participants of a working group of the Council are also analysing how they could conduct further risk reduction and the industry is considering what it could learn from the FDIC. This approach has led to a fruitful discussion and some interesting perspectives. This group should publish a report in June.

**3.3. Making progress on EU financial integration has become increasingly difficult as the political and social context increasingly turns towards domestic agendas**

An official suggested that the Eurogroup has tried to avoid the 'real traps', such as the 'trap' of EDIS versus sovereign exposure. This is a toxic proposal which does not work. Instead, the Eurogroup enlarged the project by discussing cross-border issues. This is one way to do it, but ultimately it is very hard to build a union of 27 or 28 countries where national parliaments are pushing for their own national self-interest. Everything is connected to a big project; everything is connected to political circumstances. This is the reason so much work was done on a euro budget. That is how Europe will make progress. It will not make progress by telling politicians that they are stupid or that they are not doing the right actions. Another official stressed the importance of producing economic evidence to inform decision-making. One of the difficulties facing Europe is the entrenchment of certain concepts at the political level. Politicians focus on topics such as risk reduction and risk-sharing, EDIS and the prudential treatment of Sovereign exposures while missing out serious risks such as money laundering. This was not an area of focus and or a key risk, but suddenly it has become a key risk in terms of real risk and credibility risk for the European system.

An industry representative felt that the openness of European financial markets is important. If Europe wants to develop into a major reference financial market, it must be open. It must be open if it wants to be attractive to external financial investors. After Brexit, Europe should return to a more rational approach. Another industry representative felt that the discussions on these subjects often focus on the hurdles to progress. Perhaps it would be better to bring together a smart group of people into a room and allow them to play around with new technology to bring things to the next level. The effects of disruptive technology and other external factors on capital markets are often underestimated. This will not be the next crisis, but there will be events related to these topics which are not being considered.

**3.4. Taking small steps might be the only feasible way to make progress**

An official stressed his belief that people who believe in 'big steps' make 'big mistakes'. Taking small steps is the only feasible way to make progress and, crucially, it encourages the involvement of citizens. Europe should have learned how essential it is to convince citizens of the importance of this work. The industry must explain and discuss this process with citizens. Market participants need to sit on panels with citizens and explain the importance of this work. It is important to continue to work steadily, as Europe has been doing over the past few years.

**3.5. Europe should not wait until the next crisis to fix these issues**

An industry representative considered it vital that Europe should not wait for the next crisis to fix these issues. There is a deep belief in the EU that a crisis is necessary to move things forward. There is a belief that the political gap cannot be reduced unless there is the tension of a crisis. Europe must behave in a different way. There will always be a crisis; that is part of life. It is better to be prepared for a downturn in the economic cycle. The approach to these topics should be bold and yet humble. Over recent months, there have been serious difficulties in respect of money laundering. The decision taken to monitor this is very important. The industry must be aware that this will happen, and it must react without endless discussions on fragmentation. The industry representative noted the worrying trend of politicians imposing preconditions before discussing certain points. In discussions on fragmentation, someone will say, 'We cannot discuss this without fiscal union', or, 'We cannot discuss this without political union'. This is simply a nice way of saying that something will never happen. If this is not the message, the industry representative advised that this should be made clear. To avoid this kind of conversation, the Commission should have a simple agenda. The investors need an agenda with clear steps. The French like concepts, but the world prefers a clear agenda with simple steps. It is important to announce what action the Commission will take. If the Commission does this, Europe will take action. Europe needs to stick to a well-constructed agenda. This is what a company would do.

# Fundamental conditions for a fiscal union

Since 2012 increasing attention has been devoted to the highest institutional level in order to reflect on a fiscal capacity for the euro-area. There seems to be growing awareness among EU institutions and Member States on the need for such an instrument although divergences remain concerning the functions, forms and funding of this new dedicated euro-area budget. The Chair, Harald Waiglein, opened the discussion noting that this exchange of views would focus on the fundamental conditions for a fiscal union, querying whether Europe is ready for this.

**1. The EU needs a fiscal union**

**1.1. The definition of fiscal union**

Alessandro Rivera highlighted the importance of a proper definition of 'fiscal union'. The term must be defined before a design can be produced. One definition of fiscal union would be a centralised pool of resources for managing shared policies by central institutions. Tuomas Saarenheimo agreed on the need to define fiscal union. The term is used with widely different meanings. Tuomas Saarenheimo felt the ESM is not part of a fiscal union; rather, it is an international organisation similar in nature to the IMF. This difference in view reflects the different ambitions for the role the ESM might play, rather than what it is today.

### 1.2. The process of fiscal union is underway

Alessandro Rivera suggested that the process of fiscal union has already started in Europe. It is not the case that Europe could establish an ideal fiscal union which did not exist previously and therefore reap a huge benefit. Fiscal union is already being built. European institutions are developed to tackle problems that emerge during the life of the Union. Europe has pooled resources from the beginning of the European Community. Risks have always been mutualised, which is necessary for a fiscal union. This mutualisation already exists in the ESM, the Single Resolution Fund and the common backstop. Europe already has centralised borrowing capacity in the balance of payments facility and the ESM. Additionally, discussions are underway at the Single Resolution Fund to expand further borrowing capacity.

### 1.3. Progress towards a fiscal union requires a strengthening of democratic accountability

Alessandro Rivera stressed that the benefits to be reaped by making progress towards fiscal union must be measured against the costs, acknowledging the need to manage sensitive technical, economic, legal and constitutional issues. Alessandro Rivera suggested that progress towards complete fiscal union would necessarily have to be accompanied by progress in terms of political union and increased accountability. Alessandro Rivera felt that this would happen in the very long run. Noting that many people are aware of the complex discussions between Italian parties and the President of the French Republic, Alessandro Rivera described how Emmanuel Macron and President Juncker both appeared in the Italian media recently. This is being done precisely because the two presidents, in one way or another, feel themselves accountable to the Italian and European electorate. The same thing could not have happened 15 years ago. As an economist, and not a lawyer, Alessandro Rivera felt this is a measure of accountability.

### 1.4. Towards a safe asset

Alessandro Rivera felt that the history of the European Union demonstrated the need to be pragmatic. Europe does not have everything it needs, but it is more important to assess Europe's progress towards its goals. This can be measured on the basis of two variables: the amount of resources available at the central level and the institutions that are created to manage these resources. Europe has institutions which can be developed to help reach this objective, but the process needs more resources and additional institutions, i.e. a different borrowing capacity arranged towards a proper safe asset at the European level. Tuomas Saarenheimo suggested that the discussion on safe assets is 'too clever'. In federations, federal bonds are the safe asset. If Europe seeks to create a safe asset, it should build on federal bonds. The alternatives being debated contain highly uncertain risks. There is a reason these safe assets do not exist elsewhere.

## 2. A fiscal union would not complete EMU

### 2.1. A fiscal union would not stabilise the monetary union

Tuomas Saarenheimo felt there are many reasons to have a fiscal union in Europe, but the stabilisation of the monetary union is not one of them. There are endless opportunities for the Union to spend common resources more effectively than using the current process of spending individually at the national level. 1% of GDP is not the optimum level of resource for Europe. It needs a distribution of the provision of public goods between the federal level and the state level.

### 2.2. A fiscal union could add new fragilities to the monetary union: fiscal integration would indeed shift responsibilities from national elected bodies to the hands of European non-elected bodies, thus narrowing the scope of democratic decision-making

Tuomas Saarenheimo suggested that a fiscal union which is part of a European monetary union would have two key features. First, there would be a common pot of money which would be collected and distributed to member states for the purposes of convergence, competiveness, perhaps investment and at some point, in time perhaps stabilisation, although this is not "on the cards" currently. Second, there would be increased central control over national fiscal policies. This is different from what exists in any federation, and it is different from what the EU has done previously. The monetary union follows the same monetary policy for the entire EU. The Banking Union is the single regulatory framework for the whole union. Europe is seeking to build a capital markets union. There is also a customs union. The common factor in each of these projects is a single policy for the Union. Fiscal union is completely different, however. It entails tailored policies for the 19 eurozone countries, and they are decided at the centre. This is a recipe for trouble. It has the potential to become a serious political liability. It breaks down the accountability structures in national political systems. However, Tuomas Saarenheimo noted that some countries might appreciate outside intervention if they do not trust their domestic political system. These countries might prefer to delegate decisions to an external body. In any case, this would undeniably reduce the democratic nature of economic policy making. Tuomas Saarenheimo agreed with Alessandro Rivera's point about how this links the issue of fiscal union to political union. There will never be fiscal union unless Europe manages to proceed with political union.

Harald Waiglein understood that Tuomas Saarenheimo's point is more about governance and queried whether, as Robert Mundell had said in 1961, "in an optimal currency area some sort of budgetary risk-sharing mechanism is necessary even if this cannot be achieved in the current political system".

### 2.3. The significance of fiscal integration for the stability of EMU is not obvious

Tuomas Saarenheimo felt the role of the fiscal budget in the matter of stability is overstated. A reasonable amount of research has been conducted on this in a variety of countries. The role of a central fiscal budget in stabilising asymmetric shocks at the state level is very small. There are countercyclical elements in the United States such as Medicare, Medicaid and food stamps, but the procyclical elements on the expenditure side counteract this, meaning that the net effect is zero. The only reliable stabilisation comes from taxation, which is very small. The United States' expansionary budget of 2009/10 is a relevant example here. Data shows that the expansion went more to the states which were better off, and not to the states which were worse off.

Alessandro Rivera did not agree completely with Tuomas Saarenheimo's comments. There are many analyses of the degree to which a centralised federal budget contributes to the impact of asymmetric shocks in federations. Whatever the degree of impact, it complements another important feature of the US system, which is the capacity of the private sector to deal with transfer flows between states. This does not happen to a satisfactory extent in Europe. Europe must continue the work on a Banking Union and a capital markets union. Currently during periods of crisis there is a tendency for the private sector to withdraw its support rather than be countercyclical. Something is needed at the central level to enhance the performance of the monetary union. There are also several structural issues which must be addressed. Alessandro Rivera felt it would be useful to provide a simplified view of how dynamics could develop within a monetary union. When there are competitiveness gaps, there are countries with structural commercial surpluses and countries which become less competitive and accumulate commercial deficits. The first country accumulates financial assets; the second one accumulates financial liabilities. This contributes to increasing the spread and the difference in the cost of funding.

Alessandro Rivera queried how this could be managed, wondering whether it could be managed through fiscal discipline or an agenda of structural reforms, which would apply to both the least and most competitive countries. This leaves downward salary adjustment as an adjustment mechanism for the least competitive countries. Alessandro Rivera suggested that this model would be suboptimal, because it would systematically lead to suboptimal public investment. Additionally, it is dangerous because it facilitates crisis inside and outside the monetary union. It does this internally due to the creation of gaps that may become unmanageable and externally by making the monetary union heavily dependent on trade and external demand. To address this, Europe needs a centralised tool that can contribute significantly to reducing gaps and boosting convergence by facilitating structural reforms for countries with competiveness gaps and investments to fill these gaps.

# BREXIT IMPLICATIONS AND PROGRESS MADE WITH G20 REFORMS

## Short-term implications of Brexit for the EU

### 1. Preparedness of the financial sector for Brexit

#### 1.1. Preparation is generally satisfactory despite current uncertainty

The Chair introduced the session by mentioning that there have been many preparations for Brexit at both the national and European levels including for the worst case no-deal scenario. There however remain questions about whether all players are prepared and if the financial industry will be able to function smoothly and ensure a continuity of service in all situations.

An official believed that the level of preparation within the financial industry is generally satisfactory. Everything that can be done to prepare Brexit has been done, but that does not preclude there being risks. But the only way for there to be no risk would be for the UK financial sector to remain in the EU, which is not what the UK wants, so there is a trade-off. There is risk from moving from having a single market with the UK to not. This is however also an opportunity to demonstrate the benefits of the single market.

A policy-maker noted that the level of uncertainty regarding Brexit is such, including around what course the UK wishes to take, that the only thing to do is to prepare for all eventualities. Europe is completely prepared. The Commission has published no less than 90 stakeholder-preparedness notices, including 10 for financial services and encouraged all stakeholders to prepare for a no-deal scenario. Those messages have been heard. Financial firms, the larger ones in particular, are increasingly well prepared. Gradually smaller firms are also preparing for Brexit. The endgame is not known, so preparation means being able to cope with a large variety of risks. This is very costly since some risks will never materialize and it is not certain whether all risks related to Brexit are correctly priced in at this stage, but this is now a sunk cost and the focus should be on the future.

A regulator agreed that most of the preparation work has now been completed. It has been very costly but much has also been learned. Clients have been repapered when necessary in most cases. Paradoxically the high level of uncertainty concerning the Brexit negotiations has pushed market players and public authorities to speed up their preparations. Member states have all warned their industries to prepare for the worst outcome and many of them have also issued legal decrees providing for a transition period covering intermediaries (i.e. banks and insurance) and also OTC derivative activities. From an administrative and legal point of view, almost everything is in place.

An industry representative noted that at the time of the referendum their organisation had all activities based in the UK (a bank and a broker-dealer) with branches in certain other EU countries. All services were passported throughout the EU. A great deal of preparatory work has been conducted to make sure that everything would be ready for the initial Brexit date i.e. 29 March. New parallel entities were created in Germany (a new bank and a new broker dealer). The domestic and EU public authorities were very supportive during that process, but it required a major investment in real estate, people, systems, etc. Some problems are still to come. One question is whether customers are prepared, and there the picture is mixed. Very large customers are well prepared. With smaller customers the situation is not as clear, and they need a great deal of assistance and guidance, which can lead to conduct risk in the way information and assistance is provided.

#### 1.2. Measures taken to ensure continuity in the securities and derivative markets

An official emphasized that in order to ensure business continuity, it seemed sensible to focus first on systemically relevant activities. That primarily concerns central securities depositories (CSDs) and clearing houses (CCPs) based in the UK and providing clearing and settlement for EU based customers and counterparties, for which temporary equivalence arrangements have been put in place. An area that has not been addressed is systematically important private market participants that might provide important services for financial companies in the Union, because banks and other financial institutions are expected to take care of themselves. Efforts were made nevertheless by the public authorities to raise awareness about the need to prepare for Brexit.

The Chair mentioned that solutions in the OTC derivatives market had been left to the member states and wondered whether this would lead to sufficient consistency in the market.

An official explained that this was the case in this area because OTC derivatives are not covered by EU directives or regulations. Some countries require licensing for third-country OTC activities, so it is up to them to deal with their licensing rules with respect to Brexit. Other countries have no specific rules, so the situation there will continue as it is.

### 2. Expected short-term impacts from Brexit

#### 2.1. Fragmentation, operational and volatility risks

Firstly, a policy-maker emphasized that Brexit will create fragmentation which will inevitably lead to additional costs for the financial sector and its customers. One of the primary benefits of the Single Market is the possibility to scale up and achieve economies of scale. With Brexit there will be scaling down and increased costs, at least in the short-term. In the longer term, there may be some adaptations and improvements, at least for the EU27, depending on how the capital markets union (CMU) evolves.

An official indicated that the risk of fragmentation should serve as a wakeup call to complete the Banking Union and to work harder on the CMU in order to further integrate EU financial markets. Part of the attraction of London for European financial institutions based there, is the legal system and the ease of doing business there, thanks to the wide ecosystem located in the City. A question is how some of these aspects could be developed in the EU. There is a need to think about how to make the legal systems in the EU, especially in the area of insolvency, more attractive for well-functioning debt markets in particular. This is an essential component of the CMU. Unfortunately member states are generally very reluctant to change insolvency rules for instance.

An industry representative added that fragmentation could also create operational risks, although these will probably not be systemic. There will indeed be regulatory fragmentation with Brexit, and dealing with that will require more work and preparation and will also create inefficiency. For example it will be more difficult to centralize sales and marketing resources in the UK, as is the case at present. There is the question of how to utilise these resources in the future. The new bank and broker-dealer subsidiaries that the speaker's organisation has set up in Germany are not yet autonomous and need a great deal of support. This will require service-level agreements (SLAs) and also collateral management, therefore potentially creating some operational risk.

There is also a culture and people risk due to these changes, the industry representative added. For example it is not certain that there will be enough resources available in Frankfurt with the appropriate experience to answer the needs of all financial firms These governance aspects are understated in many reviews of Brexit. The industry representative's organisation will be moving from a unipolar world, with a single hub running its European business, to two hubs one in London and another in Germany. The governance of the firm will need adjusting to make that new structure work.

The industry representative reiterated that the main short-term issue is preparation. There will be risks and it is a painful process, but it will be manageable. There are also opportunities for growth as Brexit is a 'generational change' to be seized, which requires looking beyond the short-term to see what the longer-term possibilities might be. There will be cost implicit in the changes, but there will also be the possibility for new growth, new efficiencies and new structures.

Brexit moreover creates potential volatility risks. A policy-maker believed it is fair to assume that there will be some volatility or market stress in the short-term, albeit not systemic, in areas where preparation is less strong. In the long-term, that will evaporate because there will be other trends. In addition, depending on how liquid markets are, they should able to eventually absorb Brexit impacts. A regulator agreed that volatility is highly likely because Brexit is a unique event, although it is difficult to predict precisely what will happen. However, public authorities are prepared to react to any excessive volatility.

### 2.2. Risks related to back-to-back trading

The Chair mentioned that some people in the UK believe that a large part of Brexit-related impacts can be alleviated with back-to-back trading arrangements[1] which involve deals taking place in the EU and being in effect booked in London where the related risk would be passed. An official believed that this type of evolution is not the intention of European supervisors. This has been addressed in the recently adopted investment firm directive in particular. However it does not make sense to try to keep all of the risk in the EU if EU and UK regulation and supervision are deemed equivalent, following assessments of the nature of the risks and how they are being dealt with. If that is not the case, there have to be some circuit-breakers in place to avoid shifting risks to another jurisdiction that cannot be controlled and could have repercussions later for the EU were something to go wrong e.g. in the context of a cross-border bank resolution.

The industry representative explained that there is a "regulatory glide path" to get to a situation where organisations are fully operational. Risk management, marketing and booking have to be progressively adapted, but this is not yet finalised. The objective is to de-risk the Brexit project as much as possible, including the risk management of trades. That may require some form of guarantee or insurance provision by the group company or some form of back-to-back arrangement. Trying to keep risk within the EU is not necessarily the best approach in all cases, so a balanced approach will be necessary. Over time, the right structure will be found. The industry representative's organisation will act in accordance with the requirements and rules of the national competent authorities. There is much complexity in this area with different legal clauses and appropriate judgement is needed in their enforcement. Back-to-back structures can work and be helpful in some cases, but there must be caution and the feasibility and conditions should be analysed on a country-by country basis.

### 2.3. Expected impact of Brexit on the provision of financial services to the EU

A policy-maker noted that another potential risk is the under-provision of financial services in the EU and the UK following Brexit, but hopefully that will not be the case thanks to all the preparations. For CCPs and CSDs, the Commission took two measures to facilitate transition, so in the short-term the risk should be eliminated, both for the UK and the EU in this area.

An official noted that the equivalence decisions for CCPs and CSDs based in the UK was necessary because European CSDs and CCPs currently would not be able to absorb all the volume. Whether that will still be the case at the end of the transition period if it is put in place will have to be further assessed.

A regulator added that another potential issue is the impact of Brexit on the financing of the EU economy. However, at present, banks are by far the main funding source providing around 75% of financing, and more in some member states where SMEs are largely predominant and / or where capital markets are under-developed. Therefore, even if there might be some impact from Brexit in the short-term, it should not be the case in the medium to long-term because banks should be able to provide the resources needed and also be able to face up to any shocks following the increases in capital that have been made in the previous years.

A policy-maker agreed that there would be no financing risks in the short-term in the EU, where there is no shortage of banks and transitional measures have been taken for CCPs and CSDs. In addition a number of banks based in the UK are assessing plans to move some activities to the EU27. The real issue is preparing the longer term. This could be 'wasting a good crisis' because Brexit should be a catalyst for developing the CMU and diversifying the financing of SMEs in the EU. Significant efforts have been made to develop instruments such as securitisation, pension funds, covered bonds etc. and to further integrate certain markets such as investment funds but there is a risk of not realising fully the opportunity to grow capital markets in the EU if financing needs are covered by other channels.

## 3. Longer term issues and opportunities regarding the UK's future relationship with the EU

### 3.1. The risk of regulatory and supervisory divergence between the UK and the EU

The Chair believed that it is difficult to anticipate at this stage what will happen after Brexit. The UK may decide to follow EU rules and obtain equivalence or on the contrary progressively detach itself from the EU and play a more global role, endeavouring to bridge EU, US and other capital markets. Many people in London are in favour of the latter which involves a stronger participation in global organisations and their strengthening in line with the important role already played by the UK in multilateral organisations such as the Financial Stability Board (FSB).

An official and a policy-maker believed that there is not that much space for deviation between the EU and the UK, because many rules in financial services, such as bank capital requirements and total loss-absorbing capacity (TLAC), are based on rules driven by G20 decisions.

A regulator agreed that room for manoeuvre for the UK to depart from the EU financial framework should be limited because there is pressure from other third countries such as Asian countries for example to use common rules. Deviations are possible but they will take some time. In addition supervisory cooperation works well between the UK and other EU countries and it is expected this will remain unchanged, at least in the short-term. There is currently a harmonised approach to supervision in the capital markets across Europe. ESMA, on behalf of the different member states, concluded a memorandum of understanding with the UK and, so far, cooperation has been very good.

An industry representative agreed that the point about rules defined at G20 level is very important. The UK has generally been at the forefront of strong regulation for global financial activities and the expectation is that that will remain the case. This should provide an element of stability in the longer term, regardless of whether there is some form of 'enhanced equivalence' with the EU. However, around the margins, there will be differences and those may be challenging matters to manage for banks as there is potential for additional complexity and risk. The fact that regulation is partly a political act that will inform short-term behaviour of the UK needs to be considered, because the argument that too much equivalence with the EU would effectively undermine Brexit and its potential benefits exists in the UK.

### 3.2. Improving third-country equivalence arrangements

A policy-maker reported that a paper on equivalence and how it could evolve in the future was issued by the Commission at the beginning of 2017. Equivalence arrangements will be evaluated on a case-by-case basis. Many relevant regulatory areas are G20-driven, so there is not much space for deviation. However putting in place an equivalence agreement on insurance with a faraway country is different from doing so for the whole UK banking sector because of its size, importance for the EU and proximity. In this case it will not be possible to grant equivalence and let the business get on with it. A continuous monitoring will be needed in order to ensure that regulatory changes are not made 'through the back door'. Although the denomination might be the same, it is a different approach to equivalence.

Following a remark that the way equivalence was assessed (i.e. line-by-line or based on general outcomes) would also make a significant difference, a regulator believed that this would not be the main issue in the short-term. The equivalence assessment exercise would be quite straightforward with the UK at the starting point because the rules and the supervisory practices are the same at present. The difference will come subsequently and be in terms of how to continue to monitor possible changes. Having a common supervisory authority at the EU level for financial markets would ease the exercise. It is extremely inefficient to do it at the member-state level, as the same exercise would have to be repeated many times.

An official emphasized that going towards a system of enhanced equivalence with something like continuous monitoring of equivalence would require a great deal more resources at the European level and this would not be achieved in the short-term. At present there are relatively few financial areas where equivalence is proposed and they do not need much monitoring. Going beyond this is a political decision and requires budgetary resources and changes in the institutional organisation that need to be decided and cannot be implemented in the short-term.

1. So-called "back-to-back" trading allows an entity in one jurisdiction to carry out a duplicate transaction in a larger location. So a deal done on the ground for a client in a given EU country can actually be booked in London. Banks, which already use the mechanism routinely to book business from Asia, Africa and Latin America through London, could do the same for transactions originated in the EU27. This would allow them to continue centralising their European capital needs and risk management in London and reduce potential needs for staff movements. EU supervisors e.g. the European Banking Authority has however cautioned that local operations must not be "empty shell" units and the scale of transactions involved must not be excessive.

# Third-country EU market access post-Brexit

## 1. The current features of EU equivalence regimes

### 1.1. Equivalence provides open access to the EU for jurisdictions deemed equivalent

A policy-maker noted that it is often asked if the EU equivalence system is necessary in a context where markets are increasingly global. This system is necessary because, while financial services are sold across borders, the applicable rules differ. International standards are provided by the FSB, Basel and IOSCO in many areas but these are high level principles meaning that detailed rules and the way they are implemented differ across jurisdictions. Without a supranational, global financial supervisor, different approaches are inevitable. The equivalence system allows the EU to remain open within the global financial system and at the same time to manage financial-stability risks, since there is the possibility of withdrawing equivalence if necessary.

A regulator explained that third-country equivalence arrangements are available notably in several capital market areas such as CCPs and trading venues and also for credit rating agencies. The process for granting equivalence is lengthy and quite challenging both for the EU and third-country authorities, but it is a "generous" and far-reaching system. Once it is granted there is full access to the EU and reliance on home regulation and supervision. The typical alternative that would allow the same level of access is full authorisation and supervision of third-country entities, possibly with certain exemptions, which is the model that prevails in other regions.

A market observer echoed the previous speaker's comments regarding the generosity of the EU equivalence system in the financial sector. The situation is quite different in other sectors. For example, when cars are imported into the EU from non-EU countries there are no equivalent norms. Non-EU manufacturers have to comply with EU norms strictly at all times, and these may change over time. Firms are directly liable to EU sanctions if a non-compliant car is imported into the EU, even if the firm is based outside the EU.

A Central Bank official considered that the benefits that open global financial markets provide in terms of economic growth, efficiency, risk-sharing and supporting financial stability need further promoting. Equivalence is a way to achieve this, with many successfully examples in the EU. The UK has agreed to use this initially to allow non-UK CCPs to operate in the UK after Brexit. The speaker mentioned that the future UK regime is still to be defined. The UK authorities are working on a framework aiming to provide certainty and based on transparent assessments.

An industry representative agreed that equivalence is an effective tool for making global markets function. Benefits for end-clients include access to services at an appropriate price and to a deeper pool of liquidity.

### 1.2. A system based on equivalent outcomes and deference to the home country

A Central Bank official stressed that equivalence determinations should be based on equivalent outcomes, e.g. by assessing whether regulations deliver the same level of resilience. It should not be a 'line-by-line' or box-ticking comparison. The G20 has also confirmed that deference to home regulation and supervision is the appropriate way to organise supervisory cooperation.

A policy-maker stated that the EU equivalence framework does not require identical rules, it is outcomes-based (i.e. rules are considered as equivalent if they have the same outcome) and is applied proportionately. Outcomes need to be more closely aligned for jurisdictions whose financial institutions are systemic to the EU because it is a risk-based system. That was set out in the EMIR 2.2 and the investment firm review. In these recent legislative texts, rules were strengthened for the more systemic firms, but for non-systemic ones they are largely unchanged.

A regulator broadly agreed with the need for outcome-based equivalence and confirmed that this has been the case for all recent EU equivalence decisions. Out of 31 decisions the speaker has been involved in, only one had necessitated some extra rules and that was in a very specific area. The assessment process was moreover transparent, has been detailed and results are publicly available. There are however limits to what is possible with an outcomes-based approach because of regulatory arbitrage risks and possible weaknesses that might develop in the system as a result of it. In some cases greater consistency of rules is necessary to avoid regulatory arbitrage. This has been the case within the EU where there has been an evolution towards the use of regulations rather than directives. There may therefore be limits to the use of an outcomes-based approach to equivalence in the case of the UK financial system, given its strong interconnectedness with the EU.

## 2. Changes expected with the review of the ESFS and the implementation of EMIR 2.2 and the investment firm review

A regulator noted that some changes to the EU equivalence system have been initiated because of issues posed for EU supervisors. A first issue are the resources and time needed to perform equivalence assessments, which sometimes hinder progress, because it is not only individual firms that need to be assessed, but the whole regulatory and supervisory system of a third-country jurisdiction. The European system of financial supervision (ESFS) review will provide the European Supervisory Authorities with more powers and resources that should allow performing more regular assessments of the third-countries concerned.

A second issue relates to the relative "generosity" of the current equivalence system. There is a question of whether it is responsible for EU supervisors to always fully rely on the supervisors of third-countries deemed equivalent to appropriately manage risks to the EU27 that might come from that country. This has led to providing EU27 supervisors with additional powers in certain cases. This issue has been tackled with EMIR 2.2 concerning third-country CCPs. Tier-one CCPs (non-systemic ones for the EU) will continue to operate under the current equivalence arrangements but tier-two CPPs (systemic ones for the EU) will have a direct supervisory relationship with the EU with the possibility of comparable compliance. Similar steps have been taken in the investment firm review. That is welcome because MiFID II regarding professional services is reliant on a patchwork of national systems, creating the risk of regulatory competition. As a result it may be more attractive under certain parts of MiFID II to service EU customers from outside the EU rather than from inside, justifying additional measures in the investment firm review to repair this.

An official agreed that the investment firm review and EMIR 2.2 regulation offer improvements. The old regimes were not designed for a potential Brexit situation resulting in a major financial centre with systemic institutions for the EU outside the Union, so differentiating in a proportionate way between more and less systemic institutions in the way equivalence is applied is key. In addition equivalence cannot be a one-off box-ticking exercise, especially for institutions that are systemic for the EU, as it is essential to be able to track possible evolutions that may happen on the ground. The future basis will be cooperation between supervisory authorities in order to examine how rules are applied and implemented over time. Cooperation must also be implemented in a proportionate way. More systemic institutions that are highly relevant to financial stability require more intense supervisory cooperation. A policy-maker confirmed that although requirements have been strengthened in the context of equivalence arrangements for systemic CCP and investment firms, they remain unchanged for the other ones.

The Chair noted that these changes will presumably be applied erga omnes to all jurisdictions and not only to the UK as there must be a level playing field across jurisdictions.

## 3. Predictability of equivalence arrangements

### 3.1. The process for withdrawing equivalence

A Central Bank official stated that equivalence arrangements must provide market participants with sufficient stability and confidence over time. In theory, equivalence can be withdrawn at no notice according to the EU framework, which goes against the objective of stability. Market participants need to know that decisions will be maintained and that any necessary changes will be phased in over time. In addition there should be a review process of equivalence decisions. Rules should be allowed to diverge to a certain extent over time, provided that resilience and consumer protection outcomes remain equivalent. This is why equivalence assessments must be based on outcomes. An industry representative agreed that there is potential to improve the EU equivalence system. The possibility of short-notice withdrawal is the main concern regarding these arrangements, given potential consequences for customers. A more effective and transparent process for addressing any divergence or disagreements between the EU and UK would improve the reliability of equivalence arrangements and facilitate planning by industry participants.

A policy-maker responded that the withdrawal of equivalence is not a "light process" and if it is eventually decided, this is the result of an in-depth assessment normally performed by one of the ESAs at the request of the Commission. This is also usually a public and transparent process during which sufficient time is left to react to the advice provided by the ESA. Therefore it is difficult to say that withdrawal happens at no notice. Moreover reviews of changes in situations are an on-going process that is already performed. This is the case for example if a third-country changes its rules significantly, if there is a break-down in trust between supervisors (e.g. related to money-laundering issues) or if a third-country starts discriminating against EU firms. The EU might also change its own rules, which would require a review of third-country rules against the new ones.

The Commission and the European Parliament also recognise the need for predictability, resulting in improvements made in the context of the recent investment firms review. The process that may result in the withdrawal of the registration of a third-country firm is framed in great detail and has been thoroughly thought through. There must be evidence of divergence and dialogue with the home supervisor and withdrawal only happens in situations where it has not been possible to find remedies. In addition an article of the investment firm review establishes that the Commission will issue an annual report on how equivalence powers are used. This reporting is specifically for investment firms for the moment, but the intention is to move towards a broader and more regular public reporting on equivalence arrangements both concerning the past and what is intended in the future.

The Chair questioned whether there is the intention to put in place a more defined procedure including mandatory legal timeframes for decision-making in order to avoid equivalence decisions being strung out for political reasons. The policy-maker responded that the current process is public and sufficient time is left to react to the advice provided by the ESAs, but strict timetables are not being considered. An official agreed that it is difficult to tie the review of equivalence arrangements to short timetables, unlike merger cases for example. However over time it is expected that the process can move towards more predictability in terms of steps and timelines. The first annual report of the Commission on how equivalence powers are used should provide Member States and the EU Parliament with an opportunity to discuss present arrangements.

### 3.2. Tackling systemic risks posed by third-country institutions in the context of equivalence arrangements

A market observer stated that it is necessary to maintain the capacity to withdraw EU equivalence agreements at short notice if discrepancies develop between the EU and third-countries deemed equivalent, relating to regulations and their application and if this poses systemic risks to the EU. The fact that jurisdictions trust each other today does not mean that it will always be the case if the government or parliament changes and political objectives may evolve.

Secondly, it is difficult for third-country authorities to address all issues concerning the EU and the equivalence system must not be taken to the extreme. For example, it is difficult for a Central Bank to commit to delivering the liquidity needed in a crisis if it has no say in the regulation of the entity concerned. If a problem happens within the Eurozone, the ECB may request changes to be made to the practices of a given CCP to allow the Eurosystem to step in with liquidity if necessary, even if the ECB has no direct power over this CCP. But if the CCP is in a different location outside the EU then the ECB has no power even if there is a commitment to provide liquidity via a swap. This is also very much a question of relative weight. If the EU market relies nearly totally and for a long period of time on a monopoly situated outside the Union, as with certain types of derivative contracts on which the UK has a quasi-monopoly, then Central Banks in the EU cannot commit to providing liquidity and the potential systemic risk is "enormous". Conversely, when this is not the case and some derivative contracts are abroad but important contracts are within the remit of a Eurozone Central Bank, then it is easier to work on the basis of equivalence. This is not a problem at present, but could become one after Brexit.

A Central Bank official commented that independent Central Banks do not typically guarantee to extend liquidity solely because an equivalence arrangement exists. Existing and strong supervisory and Central Bank cooperation arrangements can however be built on. This cooperation ensures that a Central Bank can feel confident in extending liquidity in its currency via a swap line to another Central Bank – and not to a private sector entity - because it has the appropriate insight and information. The domestic Central Bank can then take the credit risk of lending to the party concerned if this is necessary.

Brexit, depending on its final outcome may challenge the current equivalence system, an official stated. The starting point is an identical set of rules, but the EU will need additional safeguards to tackle potential financial stability risks that may develop with the UK leaving the Union. The most prominent issues have been tackled with EMIR 2.2, but problems may appear in other areas. Once all these issues have been addressed, the EU will probably be content with granting equivalence to the UK for a wide range of activities. A challenge will however come when the EU amends its regulatory framework at a future point in time to better mitigate risks and if the UK supervisor, either for technical or political reasons decides that they do not want to follow these changes because they do not want to be a rule-taker. How to deal with that possible challenge will be the real issue for the EU regarding the equivalence process, the speaker believed. Predictability is an important aspect but the EU also needs to be able to adapt its rules, if needed.

The market observer noted that Brexit will remove the authority of the EU supranational institutions (notably the ESAs) created in the aftermath of the crisis vis-à-vis the UK. That is also a potential risk for the interpretation and implementation of the regulations, even if they stay the same. The UK public authorities will continue on the same lines for a time, but future evolution is uncertain.

## 4. Issues related to equivalence determination

### 4.1. Standards according to which equivalence should be assessed

A Central Bank official considered that international standards, when they are available, should be the basis of outcomes-based assessments for equivalence determinations between the EU and third-countries. Much has been done to promote consistency of rules on a global basis through the work of a variety of global standard setters. Using these standards will ensure the stability of equivalence arrangements over time and facilitate deference to third-country authorities in line with the G20 intent.

The Chair believed that international standards are fine, but not granular enough at present to be a basis for equivalence arrangements, so an individual evaluation of the equivalence of jurisdictions will still be necessary. However moving towards more granular international standards and a consistent implementation of these is an important objective going forward in order to avoid creating a complex matrix of bilateral equivalence determinations, as the number of significant capital markets increases internationally. A market observer added that international norms are far from covering all financial sectors and agreed that their limited granularity means they can be interpreted differently. Jurisdictions who trust each other today may not tomorrow, if governments, parliaments or the atmosphere change.

A Central Bank official replied that comparing the specific wording of two sets of rules to determine equivalence does not work. It is outcomes that must be assessed. For example the outcomes of clearing requirements applying to CCPs are very clear. They include requiring CCPs to hold financial resources to allow them to withstand the default of their two largest clearing members in extreme but plausible stress events. It is possible to assess whether the same level of resilience is achieved even if detailed rules are somewhat different across jurisdictions.

### 4.2. Resources and time needed

The Chair raised the question of whether there could be a first-mover advantage to the detriment of the UK if the EU has multiple equivalence determinations to perform with different regions and resources are too limited to conduct them simultaneously. An industry representative considered that the UK financial services sector is currently in a situation where all rules are equivalent to the EU. This should be the starting point, and a couple of years should be allowed to figure out the future roadmap. The Brexit cliff edge is often talked about but there is also an equivalence cliff edge. A great deal of anxiety had arisen among clients around whether UK-based CCPs would get an equivalence determination before this was eventually agreed. Defining how regulatory cooperation will work in the future between the EU and the UK, together with a transparent timetable for implementation, should be the priority, rather than spending all the time planning for a no-deal tail-risk.

Another industry representative suggested that moving towards a more consistent and horizontal approach to equivalence arrangements across sectors and regulations would also be an improvement. This would avoid starting each assessment separately from scratch and help to reduce the duplication of work across equivalence assessments, which are very resource intensive. More resources dedicated to these processes would also allow the improvement of the predictability of equivalence determinations in terms of delays.

The Chair added that the more intensive monitoring of equivalence arrangements once they are agreed in the case of the UK would also be potentially very demanding in terms of resources, which is another factor worth considering.

### 4.3. The potential technical and political dimensions of equivalence determinations

Answering a question about the possible political dimension of some equivalence determinations, a Central Bank official considered that they should be purely technical.

A policy-maker stated that the distinction between the possible technical and political nature of equivalence assessments, which is often raised concerning EU equivalence arrangements, is too limitative. Equivalence assessments are not technical box-ticking exercises. As rules are reviewed and compared between jurisdictions different elements come into consideration. For example banking rules would not be declared equivalent if there are money laundering issues. Insurance rules would not be declared equivalent if there are auditing issues and the underlying accounts of firms cannot be trusted. Assessment is therefore more comprehensive than a technical box ticking. The chair noted that clarity on the definition and objective of equivalence assessments and the way to conduct them is essential.

An official stressed that equivalence supervisory arrangements rely on reciprocity, so the better the cooperation between supervisors is and the more technical the approach is from both sides, the more reliable the process will be. The risk of politicisation cannot be ignored. Both sides must be aware of this and endeavour to keep the process as technical as possible and managed between supervisors. The existing process offered by the Commission is based on factual and objective assessments, which puts the EU in a position to react if it becomes unduly politicised from the other side.

An industry representative believed that equivalence should be primarily a technical assessment, evaluating if different rules provide the same level of safety and efficiency for a specific product or activity. Involving politics in this process changes the way assessments are conducted and that is not the objective. It is important also to consider the end state following an equivalence decision. For example, the risk that an equivalence decision may create a situation where one system becomes fully dependent on another for certain products or activities, that was previously mentioned regarding certain derivative products, can be considered as part of the technical assessment. Avoiding political interference requires greater supervisory cooperation in order to monitor evolutions and foster a better understanding of each other's motives and preoccupations.

Another industry representative noted that the so-called political aspects of equivalence are often at the point of entry when it is granted, so appropriate cooperation is needed from the start of the process. A third industry representative considered that politics are hard to eliminate in this context. One difficulty is that the UK does not want to be a rule taker due to the importance of its financial sector. If it ends up in this situation, the discussion risks becoming quite political and antagonistic between the EU and the UK. A fourth industry representative emphasized the importance of having sound judgement despite the uncertainty of Brexit and the related transition. This involves making sure that relevant rules and laws are being appropriately enforced in any case.

## 5. Future supervisory cooperation and information sharing between the EU and the UK

The Chair noted that equivalence determinations take place at a discrete point in time. The difficulties arise when laws start to diverge. Managing this requires monitoring and resources. An industry representative considered that trust and transparency between the regulatory communities and participants is fundamental for the future EU-UK relations.

Another industry representative emphasized that the first level of cooperation is information sharing, which is not always easy. Large banks deal with different authorities worldwide; it is difficult to fulfil all expectations and in some cases there are restrictions concerning the information that can be shared. This requires the establishment of memoranda of understanding (MoUs) in order to avoid banks being faced with contradictory or duplicate requests. The second level of cooperation includes regular interactions between supervisors and the private sector. This helps to better understand for example the practical implications of regulations in terms of IT systems, information and reporting, which are not always fully considered. Even a basic requirement may require a huge amount of work to put in place. Better information sharing between regulators and the private sector would also help in this respect.

Supervisory cooperation is a "two-way process", the industry speaker stated, which makes it quite challenging. Different regulatory and political decisions will drive developments going forward, but the way the market evolves as a consequence and the behaviour of large market participants in this context also need to be considered. A broad understanding of the situation is required, as is the sharing of information and the reciprocal understanding of red lines in order to develop the future market in a harmonised way. The objective is to move to a new equilibrium in the market post-Brexit, and to ensure that the transition towards this new situation is as short as possible with minimal disruption. The better this is planned and managed jointly between the public authorities and the industry in the EU and UK, the easier the transition will be. It requires understanding and working together. Public-sector initiatives will drive evolution, but private market participants' reactions will be important also. In addition this must not be limited to the EU and the UK, because other financial centres outside Europe are actively operating in Europe and need to be considered as well.

A regulator noted that exchanges with third-countries based on an MoU during equivalence assessments and subsequent work have gone well. Supervisors tend to rely on each other due to limited resources. The UK however will be a third-country in a specific situation post-Brexit, with a capital market very highly interconnected with the EU. Information currently exchanged between the UK and the EU27 goes far beyond what can be usually managed with an MoU. There are far-reaching reporting requirements on both sides, involving specific formats e.g. concerning data needed for market abuse supervision or to support the MiFID II transparency regime. The result is that EU and UK markets will continue to be highly interconnected post-Brexit, but regulated from two different standpoints. Hence, we will need to consider how to cooperate with the UK regarding data exchange issues. These data issues will be difficult to tackle with just an MoU.

A Central Bank official felt that supervisory cooperation is often discussed as a burden or an additional cost, which is not the case. Experience shows that cooperation creates a better outcome. The lead supervisor's process benefits from the other authorities' input, insight and resources when combined inspections of financial entities are conducted. Cooperation also works well between Central Banks and underpins the availability of swap lines, should they be needed.

# Taking stock of G20 financial reforms

In 2009, the G20 launched a comprehensive programme of financial reforms to fix the fault lines that led to the global financial crisis in order to build a more resilient financial system. The reform programme has four core elements: making financial institutions more resilient; ending too-big-to-fail (TBTF); making derivatives markets safer; and enhancing the resilience of non-bank financial intermediation. A regulator emphasised that the source of prosperity in the future will emerge from the efficient allocation of capital in a global marketplace. Market fragmentation must be addressed through regulatory and supervisory cooperation, but currently there does not seem to be a clear way forward.

## 1. Addressing market fragmentation through regulatory and supervisory cooperation

International market fragmentation is a priority for regulators and supervisors across different jurisdictions. An increased use of equivalence regimes and better quality market data can drive this agenda forward.

### 1.1. Addressing market fragmentation is one of the priorities of the Japanese G20 Presidency

A regulator highlighted the importance of the G20 statement from the 2009 Pittsburgh summit. This statement committed the G20 nations to take action at the national and international levels to raise standards together, ensuring a level playing field and avoiding market fragmentation, protectionism and regulatory arbitrage. After 10 years of effort, reform measures have largely been implemented to enhance the resiliency of the global financial system, namely the Basel III, OTC derivative reforms and the resolution framework. However, some stakeholders have expressed concern that markets should have become fragmented along national lines, despite the fact that the G20 nations were committed to defer to each other in OTC derivative regulations and other areas. For its G20 presidency, Japan has proposed that market fragmentation should be a priority in G20 discussions.

However, it is difficult to define the scope of this discussion, because some market fragmentation is intended and reflects differences in domestic policy mandates or responsibilities. Due to the fact that these differences can have a positive effect on financial stability, it is necessary to consider carefully any trade off between the benefits of increased cross-border activity and the need to tailor domestic regulatory frameworks to local conditions. Subsequently, in discussions at the FSB and the G20 there is broad agreement that the industry should focus on regulatory and supervisory market fragmentation, which is often unintentional and can have a negative impact on financial stability and market efficiency. Market fragmentation can be driven by inconsistency in both the timing and substance of the implementation of international standards, extraterritorial applications of international rules or location policies that require transactions to be conducted within certain jurisdictions, or when incompatibility exists between home and host regulatory requirements.

The Japan FSA's approach to market fragmentation is to be practical and pragmatic due to its belief that small and practical approaches provide better solutions to complicated issues than big, principle based approaches. The Japan FSA is currently arguing for a practical approach to various stages of regulatory development. For example, international standard setters could consider the implications of implementation during the process of developing standards and cross-border supervisory cooperation could be enhanced.

### 1.2. The use of deference will prevent the fracturing of a global financial market

Another regulator emphasised that regulators could best promote the global market through the use of deference. The full promise of the G20 reforms cannot be realised by a single nation, but it can be actively defeated if each jurisdiction expects all others to adopt the breadth, depth and detail of their own rule set. In order for a global market to exist, each jurisdiction must recognise the sovereignty of other jurisdictions. The regulator expressed pride at the ongoing work of the CFTC under the leadership of Chairman J. Christopher Giancarlo, who has been advocating a deference based approach. In the coming months, the CFTC will be making concrete proposals on how the CFTC determines what a substantial risk to the United States is and how the CFTC's deference process will function. The CFTC has done comparability determinations with the EU and Singapore on swap trading platforms and with Japan and Australia on uncleared margins. These were done with an outcome based approach which considered how each regime identified and targeted specific risks.

One consequence of an approach that does not rely on deference might be more fractured marketplaces. This can happen when one jurisdiction imposes relatively punitive rules and fractures liquidity within its own markets or because the jurisdiction tries to impose these punitive requirements on other jurisdictions or on the provision of services to their market participants. As a result of the CFTC's own poorly constructed regulatory regimes, in the past US market participants were banned from foreign trading venues. It is important for the industry to ask itself whether it is approaching financial regulation from the perspective of deference and in terms of open markets, diversified risk and the efficient allocation of capital.

### 1.3. The reliability and the quality of market data still needs to be improved

*1.3.1. There is a difference between the banking sector and the non-banking sector*

An official noted that there is a significant amount of data on the banking sector and a regular reporting culture. Technological advancement such as the use of blockchain could facilitate real time reporting for industry players, however. These systems would enable supervisors to look directly at a financial institution's ledgers. Overall, the quality of data available is sufficient, given the level of safety and soundness being sought. Beyond banking, however, the situation is somewhat different. There are still significant swings in the FSB's annual non bank financial intermediation report from year to year, which are caused by improvements in data collection. Data collection in this area remains nascent, and the issue of cross-border data-sharing continues to be a challenge. Trade repository is another area where improvements have been achieved, but these are relatively recent. Once there is consistent data, a time series must be established before a credible analysis of the data can be made. The industry is quite far away from this point. It is possible to measure size, but interconnectedness is more important in relation to network effects and substitutability, which are very difficult to grasp in the current data sets.

*1.3.2. There is a stark difference in data between the cleared and uncleared markets*

A regulator suggested that the difference between the cleared market and the uncleared market is 'night and day', adding that this is a frustration he had had for some time. The cleared space is doing very well on data, however. It is one of the unsung benefits of central clearing that only a few entities report a substantial amount of information to supervisors in a standardised format. The CFTC has a number of years' worth of this data and now has real time visibility into client level positions across Futures Commission Merchants (FCMs), and institutions that also deal with cleared swaps in clearing houses. This data is a benefit of the reforms that have led to central clearing.

However, things are very different in the uncleared space. This area has been a source of frustration for 10 years. Previously, the CFTC knew what entities should report and instructed entities to do this, but it did not instruct entities in how they should report data in this space. This meant that the CFTC could not synthesise data. Data arrived in a variety of different formats and fields were left empty across multiple market participants. After a number of years of frustration, the CFTC returned to the international level to seek agreement on a uniform format for what is reported and the syntax in which it is reported in order to achieve visibility into the uncleared space. CPMI IOSCO has agreed to the LEI, the legal entity identifier, the UPI and the UTI, along with approximately 100 other critical data elements. Through Chairman Giancarlo's swap data road map, the CFTC will be one of the first regulators to propose rules concerning the adoption of those data fields. The regulator expressed hope that the CFTC would be able to finalise on this proposal relatively quickly after this point in order to intake data in such a way that it can then be synthesised and processed.

*1.3.3. A way forward?*

Another regulator felt that most regulators and supervisors are asking for highly similar data sets, but their templates or the details of their precise requirements could differ. These small differences place a huge cost on regulated entities. Therefore, while it is difficult to achieve true coordination with regard to data requirements, it may be possible to seek common elements before implementing data requirements in a different jurisdiction.

## 2. Resolving the fragmentation between the global and EU levels is not within sight

There remain several outstanding challenges with regard to fragmentation. The implementation of the Basel reforms has slowed, and regulators must prevent further fragmentation between jurisdictions. Resolution remains a key EU policy challenge.

### 2.1. The global banking framework: mission accomplished?

*2.1.1. A slowdown in the implementation of the Basel prudential framework causes concern*

An official expressed pleasure at the fact the focus is no longer on Basel III or the Basel Committee itself but on the implementation of Basel rules. This is exactly as it should be, and it is how things are today. Three of the BCBS's key priorities are: promoting full, timely and consistent implementation of the Basel Committee's post-crisis reforms; evaluating the effectiveness and impact of these reforms as they are implemented; and monitoring emerging risks. The industry has made good progress on implementation, but lately there has been a lamentable slowdown. Part of the reason for the slowdown is bandwidth. There is a substantial amount of work taking place. The industry is still addressing the lessons of the crisis 10 years on. There is work taking place on supervision, implementing the Capital Markets Union, and on recovery and resolution. There has been a slowdown in relation to areas such as the net stable funding ratio and the counterparty credit standard. The slowdown has happened either because there is a case of 'selective amnesia' regarding what happened 10 years ago or because people were simply not around then.

*2.1.2. The banking industry has not been over-regulated*

An official described how market participants often queried the need for various rules. Again, this appears to be some kind of amnesia. They ask whether rules such as the NSFR or the 72.5% output floor are necessary, which leads to a discussion about whether regulation has gone too far. The official reiterated their emphatic and unequivocal view that the industry had not gone too far on regulation. The industry has not been over regulated. If anything, it has under implemented. In the two biggest jurisdictions in the world, the EU and the US, there has been a slowdown in implementing some of the rules as and when agreed. The official considers it 'preposterous' to query whether regulation has hindered bank profitability and bank soundness. If anything, regulation has strengthened banks and banking systems. All around the world there are strong and well capitalised banking systems. It is very dangerous to suggest that regulation is impeding progress or the recovery of the system.

In Europe and in other jurisdictions there is still a lack of confidence in the banking system. Price to book value ratios are considerably lower in Europe compared to the rest of the world. There are a number of headwinds such as interest rates, challenges from non bank players and highly competitive markets in some countries in Europe. Ensuring the proper implementation of the Basel rules would be an important step forward to restore confidence.

### 2.2. Regulators should curb the tide of fragmentation so that banks continue to serve global customers and markets

*2.2.1. Cost is directly impacted by regulatory fragmentation*

An industry representative noted that the discussion had focused on the topics that their institution also considers to be extremely important. The representative's institution is one of the few very large global banks. It plays in around 40 countries, meaning that the topic of fragmentation is particularly germane to it and impacts its business on a day to day basis.

Fragmentation can be approached through the customer shareholder lens, which all industry participants must consider, and the financial stability lens. From the customer shareholder perspective, banks take on less risk now than ever before. The representative's institution pursues a strategy called 'responsible growth'. It is fundamental to this strategy to remain at the top of the credit spectrum. The institution seeks to be a 'lighthouse in the storm'. It is expecting to be a shock absorber in the next downturn through the resources at its disposal in terms of both capital and liquidity. However, this means that its revenue does not grow particularly quickly; maximum growth is estimated to be approximately the rate of GDP growth. This means the institution is focused on cost, and cost is directly impacted by regulatory fragmentation. The industry representative described how his team perform 17 different risk weighted asset calculations from 40 countries. Having these 17 calculations on one platform would be an advantage but using one risk weighted asset calculation formula would be far better. Each one of the industry representative's teams has to engage with its regulator in a different way, on a different schedule and using a different template. There are very real costs here and the money that is spent on this removes the ability for the institution to innovate for its customers.

In respect of financial stability, the industry representative felt that the most disturbing trend relates to liquidity and capital. The representative's institution has $540 billion of liquidity and $160 billion of CET1. Very little of this capital sits in the centre, because it is pulled down into operating subsidiaries. As capital rules are 'armour plated' in many countries, there is increasingly less capital and liquidity available at the centre to travel to where a crisis occurs. The industry is blindly walking into an environment with less financial stability instead of more.

*2.2.2. As risks move into unregulated areas of the financial system, regulators should ensure that their mandates, powers and resources are still fit for purpose*

Responding from a query from the Chair, the industry representative agreed that there is no level playing field between traditional banking and non bank financing. There is more inspection, more sets of standards and in general more regulation at present. Regulators and governments should empower themselves with the powers to go beyond the banking system and regulate non-banking and shadow finance organisations. Additionally, many regulators and Central Banks are doing exactly this in respect of cyber security: extending their powers into the technology space. So much of bank infrastructure is moving into the cloud, and therefore the technology companies who have so far avoided inspection and regulation should become subject to it.

### 2.3. Achieving an effective resolution framework remains challenging

*2.3.1. Liability versus control*

An official considered that resolution policy is vital, because a substantial amount of fragmentation is a question of liability versus control. For instance, if resolution and deposit insurance cannot be fixed at a European level, it is difficult for national Central Banks or supervisory authorities to know what to do. The world learned the hard way that institutions cease to be international when they fail; they die nationally. If this is still the case, institutions will continue to die nationally. This is the origin of ring-fencing. The resolution regime must be credible, and there must be a European deposit insurance scheme. This will enable Europe to erase some of this national fragmentation. As long as liabilities are national, control will remain national.

*2.3.2. The absence of global accounting standards makes the task more difficult*

The Chair felt it remarkable that the EU and the US do not have a common accounting standard to determine what an impaired asset is, noting that this could make things 'pretty tricky' in particular circumstances of stress. An official pointed out that there is some convergence, although the Chair is correct in terms of the terminology. This is not only true of the US and the EU; terminology from all over the world is not consistent. The Basel Committee published a paper several years ago on problem banks, in which it agreed on a common vernacular for these terms. There are still differences in the IFRS's international standards and FASB. Importantly, though, the Basel framework smoothes out these differences. There will be differences between the expected credit loss framework in IFRS 9, which came into effect in Europe and most of the world in January 2018, and the US Current Expected Credit Losses framework, which will come into effect next year. They are slightly different, but the philosophy is the same: they are forward looking instead of backward-looking.

*2.3.3. Banking fragmentation is increasing due to the lack of a common, transparent and predictable resolution regime*

An industry representative considered that the SSM is a virtuous idea from the perspective of a bank. There is a single rulebook and one conversation with a single regulator, which regulates in a consistent way, using a consistent framework and methodology. This could save vast quantities of money, because banks could manage capital and liquidity in one way, using one rule book, with one set of calculations and by reporting once in one framework. The question is whether it is possible to propose something similar for G-SIBs around the world. An official suggests that the completion of banking union will enable Europe to reach out to other major markets in the world and discuss cross-border resolvability. A substantial amount of market participants' frustrations have their root causes in resolution and resolvability. Additionally, liquidation is an important topic. In Europe there remains wide divergence in practices. Europe is relatively comfortable with capital and liquidity requirements as they stand, but it is not comfortable with ring-fencing. If this issue is addressed, there will be space for further cross-border activities, better utilisation of the benefits of diversification and more freedom for capital and liquidity to move around within global institutions.

# FINANCIAL STABILITY CHALLENGES

## Key macro and micro risks

**1. Increased uncertainty and risk is negatively impacting on the global and EU macroeconomic outlook**

While there was broad agreement between the panellists on the macro risks facing EU financial markets, the panellists highlighted several different trends contributing to the negative macroeconomic outlook.

### 1.1. There is consensus on the list of global risks

A Central Bank official felt there has been a series of negative surprises at the global level, including the resurgence of trade tensions between the US and its partners, tensions around the Italian budget, the British Parliament's rejection of the Brexit deal and the gilets jaunes movement in France. An official agreed, suggesting that the list of global risks comprised: political risks, including Brexit; trade tensions; potentially distorting market developments associated with the normalisation of monetary policy; cyber-risk and other risks associated with technological developments; and higher indebtedness of private sector agents and jurisdictions.

### 1.2. Continued low funding costs and the 'search for yield' environment can lead to the mispricing of risks and encourage excessive risk taking

A regulator considered that the present situation in Europe is similar to the situation it faced several years ago. At that time, Europe did not have buffers which it could release to support growth. Europe, however, has lost the opportunity to build-up these buffers over the past several years. The regulator emphasised that this is the shared responsibility of many of the Eurofi attendees. The pushback against the use of macroeconomic policy from the financial sector is driven by the belief that macroprudential policy kills growth. This has created a situation where Europe does not have the instruments required to support growth. The continuing low interest rate environment, which is a structural problem, leads to a situation in which bubbles are developing while there are also serious risks to growth. These issues could have been tackled if Europe had activated the systemic risk buffer and the countercyclical capital buffer. The deceleration of growth could be accompanied by proper monetary policy, but monetary policy cannot at present deliver this.

An industry representative noted that global debt is higher and perhaps riskier in some areas than it was 10 years ago. There is a great degree of financial, political and social fragmentation in a context of low growth and low inflation. In terms of the European financial sector, however, the main risk is the extended period of low interest rates. Low interest rates are among the root causes of the low profitability of European banks. While banks' balance sheets have improved quantitatively and qualitatively, profitability has returned to the low levels observed in 2009, 2012 or 2015. The low profitability of banks delays the reduction of non-performing loans and the strategic investment in new technologies. If the European banking sector retrenches, there will be an implication in terms of employment and then growth. This is a 'doom loop'.

A regulator suggested that political uncertainty, including Brexit, could be a significant risk. This is a difficult topic, because each new development in politics is unique. While much has gone wrong from a political and institutional perspective in relation to Brexit, the Brexit process has been marked by an absence of market incidents and strong institutional discipline. Measures such as reciprocation and recognition have resolved the problems related to the 'cliff edge' effects and a number of things are now functioning well. One important question to answer is whether the financial market is strongly underpricing the impact of Brexit on the real economy or the events that could follow the Brexit process. The regulator considered that the financial sector has developed the capacity to understand institutions. It understands that Central Banks have a clear policy function, which is to anchor monetary expectations and avoid deflation. It is important for the industry to understand that the policy functions of Central Banks may no longer be targeted on supporting the financial sector when the market exits the current situation. It is clear that Central Banks cannot conduct monetary policy to support the interest rate margins of banks or to protect pension funds or the insurance sector. Market participants could be surprised to discover that the profile of monetary policy has not been completely priced.

### 1.3. The economic impacts of these uncertainties

A Central Bank official noted that these global uncertainties had weighed negatively on the global and European macroeconomic outlook, which is now less favourable than anticipated. However, Europe is not heading towards a recession; rather, expansion is slowing. This situation exacerbates the risk faced by financial institutions and raises greater concerns over the sustainability of high debt levels, especially in the event of an upward shock to interest rates or a downward shock to activity. This growing uncertainty feeds the risk of an abrupt downward correction in financial asset prices, which appear elevated from a medium-term perspective.

An official agreed that there had been clear signs of a deceleration in global economic activity over recent months. This phenomenon has led to several international organisations revising downwards their forecasts for growth for 2019 and 2020. Most Central Banks are signalling that the process of monetary policy normalisation could take longer than anticipated. Therefore, any eventual risks associated with that process are being pushed backwards.

### 1.4. The additional risks linked to the sovereign Central Bank loop

An official highlighted the risks posed by the ECB sovereign loop, which relate to the large holdings of private sector assets by the ECB. A Central Bank official agreed that Central Banks around the world hold significant portfolios of government debt, but this does not threaten the capacity of Central Banks to act during periods of market stress. The question is about the impact of market movement on Central Banks' balance sheets when portfolios are held to maturity. The Central Bank official however doubted that this would have a significant impact.

An industry representative considered that this issue depends on the time horizon. However, there is a risk in the Central Banks' search for 'a new normal'. The current environment is one of low interest rates for longer periods of time. The typical recession signals that market monitors, such as the inversion of the yield curve, are impacted by the composition of the balance sheets of Central Banks. While QE was necessary, the resulting inversion of the US yield curve has made the market nervous, because they are no longer able to read the business cycle.

### 1.5. The long-term risks to financial stability posed by digitisation, 'big techs' and climate change

A Central Bank official felt that digitisation is the most important risk to the financial sector. Cyber-risk and digitisation are issues on which market participants should cooperate. It is vital for the industry to understand the implications of these risks and to run scenarios and verify on both an individual and a collective level that their schemes to address this are appropriately adapted and have a compatible, ensuring collective resilience.

Additionally, BigTechs are changing the structure of the financial industry. These organisations have pricing policies which affect the P&L of incumbents. This raises an issue for supervisors, because these market participants are outside the financial sector. So far, the regulation and supervision strategy has addressed third-party service providers indirectly through contracts and the management of contractual relationships between banks and providers. The indirect reach of third-party providers raises a fundamental question about the scope of regulation and whether these market players should not also be subject to regulation, since they have a significant impact on the financial industry and contribute to systemic risk.

The other important long-term risk is climate change. The industry must determine its exposure to climate change risks, but it can also contribute to financing the green transition.

## 2. Mitigating these risks remain challenging

There are several factors which make addressing macroeconomic risks difficult and there are several outstanding challenges.

### 2.1. The room for manoeuvre regarding monetary, fiscal and macroprudential policies is limited

Macroprudential policies can only play a limited role in addressing these risks. In particular, macroprudential policies may be needed to smooth a possible credit contraction because European banks have not built the necessary prudential buffers, because Europe has not built the necessary monetary and fiscal buffers. The few countries that have enacted macroprudential policies have done so because of financial instability risks. Such risks have not been sufficiently reduced for these countries to consider reversing these policies. On the contrary, due to the deceleration in the economy and an extended period of low interest rates, financial imbalance risks could further increase, which may necessitate additional pro-cyclical macroprudential policies. The room for manoeuvre on fiscal policy is relatively small. Some countries have some space due to their comfortable fiscal situation, which should be exploited if necessary. In respect of monetary policy, the fact that interest rates are at record lows means there is not enough 'dry powder' for monetary policy to counteract deceleration.

An industry representative agreed that monetary policy is not a viable instrument. Interest rates have been 200 basis points lower than nominal GDP growth for nine years in the US and five years in the eurozone. Central Banks have 'bought a lot of time', but monetary policy cannot alleviate the consequences of ageing societies or raise productivity and GDP. The industry representative highlighted the importance of making smart use of available fiscal space. This should not be used to stabilise short-term economic downturns but rather to raise potential GDP with a long-term investment strategy. A French style industrial policy would make sense at the European level. This would involve the public financing of public infrastructure projects aimed at developing knowledge and acquiring new technologies. Additionally, Europe needs greater coordination between national policies. Tax policy should be a level playing field.

### 2.2. It is the right moment to activate macroprudential tools to address corporate-sector leverage

A Central Bank official felt it is important not to be excessively 'gloomy' on the topic of low interest rates. The time is right to take action, particularly in respect of macroprudential policy tools, because the market is in the upper part of the financial cycle. In that context, one important risk is corporate-sector leverage. While non-financial firms may appear on a global average basis not to be a cause for concern, a deeper analysis demonstrates that there are pockets of risk in the non-financial corporate space. France provides a compelling example of this. In France the level of corporate debt is growing faster than the euro-area average. Looking deeper, a subset of large groups has had very high levels of leverage. In 2017, France took macroprudential action by using the large exposure limits of banks and activating the countercyclical buffer. This was intended to increase the shock-absorption capacity of the banking system and ensure that credit will continue flowing in less favourable economic circumstances, but this kind of tool reaches its limit when credit is being provided by institutions other than banks. One of the issues here is about how to extend macroprudential policy to these players to ensure they also contribute to the resilience of credit flows in the case of a downturn in the financial cycle.

A regulator congratulated the French authorities on their use of macroprudential tools. In reality, the legislation only permits these problems to be addressed via the banking system. This puts banks at a long-term disadvantage. Lending from the non-banking sector impacts on how the countercyclical capital buffer is calculated, although banks ultimately pay for it. While the non-banking sector does not generate systemic risk, the regulator emphasised that it does amplify it. The industry must learn how to address this amplification. Additionally, while forbearance can be useful, it is not good by definition. There must be a proper legislative basis for the use of economic policy tools and a good calibration of regulations. This is an area where legislators must take decisions; it is not sufficient merely to discuss these problems.

### 2.3. Understanding the implications of regulation

The regulatory environment means that banks are well prepared, but banking regulations can produce unintended consequences. An industry representative expressed doubt as to whether he could provide an optimistic view. Clearly, the financial industry is more resilient than it was 10 years ago. There is more capital and liquidity, and the industry is safer. However, in areas like Europe and Japan the banking sector is probably not fulfilling the needs of society at large.

In respect of regulation, the industry representative feels there is a paradox. The more granular and prescriptive rules are, the safer the banking sector is. However, the complex and detailed nature of these rules incentivises banks to take a tactical approach to compliance. The sector is resilient, but it may not be functioning properly. The industry is doing everything it can in terms of interest rates and monetary policy, but money is not circulating. When more rules are introduced, banks take a tactical or siloed approach. These banks do not make profits and vulnerabilities are not addressed, which leads to the introduction of more rules. This vicious circle must stop somewhere. The industry cannot blame regulation, but regulation must be considered from a holistic perspective as opposed to on an individual basis.

The industry representative considered that the industry is prepared for the next shock. As a G SIB, MUFG is in the process of complying with all of the post-financial crisis reforms. However, it is important to understand what kind of shock is contemplated by specific regulations. The discussion so far has covered financial shocks, but a shock could be provoked by a cyber-attack or a natural disaster. There are now many requirements concerned with preparing for financial shocks, such as stress-testing. The efforts centred on recovery and resolution are also important, because they will create tools for the recovery of liquidity and capital. However, the industry should consider the possibility of unintended consequences. The use of a standardised approach might create risk by incentivising financial institutions to react to stress in the same way. Ultimately, the industry might create one risk by addressing another. Additionally, the industry representative noted that the transition to risk-free rates could challenge banks' business models.

### 2.4. Bank overcapacity and profitability remain challenging in Europe

Banks are able to address these risks, however. They have more and better-quality capital as well as larger liquidity buffers than before the global financial crisis. Risk and compliance functions have now become an essential part of their organisations. In Europe, the banking sector has been made more resilient through major institutional reforms, including the creation of the Single Supervisory Mechanism and the Single Resolution Mechanism. More broadly, the financial system operates in a sounder regulatory framework due to the G20 financial reforms.

An official emphasised the importance of acknowledging that the solvency position of financial institutions in Europe has improved markedly. Secondly, European authorities have done a terrific job in promoting a significant reduction in non-performing loans. The key problem is profitability. This is partially caused by the low interest rates produced by expansion in monetary policy, but there are also much deeper structural reasons for it. Certainly, there is overcapacity in the European banking sector. It is not the case that the ECB should raise rates to restore profitability. This would have several other negative implications. Ultimately, the problem is about revenue. The official side should promote an orderly restructure of the industry such that the remaining banking institutions have a sustainable business model.

An industry representative noted that overcapacity is a difficult topic to address, but the solution is not further regulation. Over-banking cannot be directly addressed by regulation. This problem is not merely over-banking but the over-supply of deposits. If there is insufficient demand, not much can be done. The banking business is about taking and managing risk. Banks follow money, and money follows demand. The solution to this problem is to create real demand. This problem must be solved in the whole economy, not just in the banking sector. The industry representative conceded that there is no clear-cut answer to this problem.

### 2.5. Addressing the deficiencies in the EU crisis-management framework

An official stressed the importance of considering scenarios in which risks could occur and understanding the institutional arrangements in place to manage the situation. There is now a state-of-the-art resolution framework in Europe. No other jurisdiction in the world follows more closely the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions. This should provide a basis for managing a crisis of systemic institutions with no or very limited involvement of taxpayers. There is now a fully effective resolution authority; there are common rules to be applied in crisis situations; and the SRF should facilitate the resolution of institutions. Additionally, the ESM backstop for the SRF has now been agreed.

However, there is a general concern about how this system will function in practice. There is uncertainty about the functioning of the new resolution framework in a cross-border context. The rules are not yet sufficiently clear on the distribution of MREL between subsidiaries across pan-European banking groups. These arrangements must preserve financial stability while avoiding excessive constraints on pan-European groups. Additionally, it is unclear whether the ESM facility for the SRF will be sufficient, considering the potential for bank runs during resolution. It would be an incredible mistake not to implement mechanisms to ensure institutions receive liquidity support in these circumstances. There are also concerns around how resolution will function for small and medium-sized institutions. The problem is particularly severe for institutions which are too large to be liquidated according to domestic insolvency procedure but too small to meet the CRF's resolution requirements. An administrative regime similar to the FDIC might be helpful. An alternative strategy would be to develop administrative regimes at the national or domestic level. Hopefully the European Commission will produce some guidelines on this issue.

# Sustainability of EU debts

### 1. Different sovereigns pose different credit risks in the EU

The 2018 edition of the Commission Fiscal Sustainability Report (FSR) points to persisting fiscal sustainability risks. In the short-term, fiscal sustainability risks are identified in Cyprus, in the light of continuing macro-financial vulnerabilities and the sharp increase of its government debt in 2018. Spain, France, Italy and Hungary present some short-term vulnerabilities stemming from their fiscal position. Italy appears particularly exposed to sudden changes in financial market perceptions, notably given its sizeable government financing needs. In the medium-term, high risks are identified in Belgium, Spain, France, Italy, Hungary, Portugal and the United Kingdom, driven by the debt levels, current and perspective, and the sensitivity to adverse shocks. In the long-term, considering the fiscal pressure due to demographic ageing, high risks are identified in Belgium, Spain, Italy, Luxembourg, Hungary and the United Kingdom.

### 1.1. Public debt vulnerabilities remain high in a small set of mainly large European economies

A policy-maker noted they have come a long way since the crisis. The EU has successfully reformed itself, though there is more to achieve. At an aggregate level, public-debt ratios have significantly decreased since 2014; this is also true at country-specific levels. In a significant number of countries, debt has been on a declining path. Compared to other advanced economies, this is a good performance; trends in the US and Japan are far worse than Europe.

There are, though, still risks concentrated in some countries. Unfortunately, some are found in relatively large economies. Current momentum remains favourable, despite the slowdown in growth. Indeed, financial conditions are very supportive, and these countries are encouraged by the European Commission to rebuild their fiscal buffers. It is not just about a short-term fix and fiscal consolidation, but a longer-term perspective to reform economies. There are important trade-offs that attempts are being made to address in terms of ensuring a sustainable debt trajectory, whilst at the same time not weakening economic systems.

An official outlined the high level of sovereign debt in a few countries, with around five close to or over 100%. Given the low interest environment, this is not causing a great deal of stress, but these countries have very thin fiscal buffers. With a decline in growth or a downturn they will be forced into a pro-cyclical fiscal tightening; both uncomfortable and difficult to deliver.

One of the recent worries has been that growth has been well above its potential in Europe. Second, when interest rates and sovereign borrowing costs have been far lower than anticipated, owing to low inflation and an accommodative low monetary policy interest rate environment, these countries have not built fiscal buffers and reduced their debt burdens.

### 1.2. There is no simple metric to define debt sustainability

An official noted that there is no metric that will rule one country sustainable and another unsustainable. It is complex, and the discussion around debt sustainability should be framed about risks and opportunities for countries in favourable times.

Another speaker stressed that their company focuses on four key factors for defining debt sustainability: economic strength; institutional strength; fiscal strength; and susceptibility to event risk. They use a range of indicators to inform the assessment of these factors on a forward-looking basis, including the longer-term challenges that many sovereigns face about health spending and other public service provisions given their demographic profiles; these challenges, in particular, could lead to debt-GDP ratios rising dramatically over the longer term. Together, these four key factors give a sense of how sovereigns compare with each other. Ultimately sovereign ratings reflect an institution's own opinions, incorporating analytical judgment as well as quantitative analysis.

In terms of whether debt is sustainable or not a Central Bank official felt that it all depends. Debt sustainability depends mainly on fiscal policy, including retirement systems as the crucial part. The official warned that economic growth cannot solve the problem, as GDP levels are three times higher than in the 1960s, with public finances not having improved substantially. This increase affects revenues, taxes and expenditure at the same time.

A speaker noted that sustainable public finances are about demographics and pension reform, markets and interest rates and last but not least annual fiscal policy in the context of the EU fiscal framework. Within the EU, national member states maintain their responsibility for fiscal policies. This should always be the starting point for discussing the common fiscal framework.

A Central Bank official questioned whether there is a real need to tie the private sector in its entirety, including banks and non-financial companies, to the sovereign, as is happening at present. From that angle, if stronger policies can be pursued in terms of the diversification of sovereign debt holdings of banks, it would be easy to introduce some concentration risk changes to facilitate better diversification. Getting a capital markets union to work, so that risk is not only shared but there are also financing opportunities which go much further than relying on the domestic market alone, would be a benefit for all.

As long as interest rates are rock-bottom as today, the risk of losing control in the short-term is limited. The worry is what will happen if a recession kicks in, with room for fiscal policy manoeuvre virtually non-existent in these countries. This is a serious risk. A chance can be seen of rebalancing in the system, as there may be a more expansionary fiscal policy in the north, thereby also contributing to a limiting of imbalances in the euro-area. However, it takes a great deal of discipline to avoid expansionary fiscal policy in a recession. In a few countries, this is not possible and would be risky if attempted.

A regulator noted that ESM programme countries have done much to address the situation. It is important to have the right perspective on debt.

Two aspects are important in such an assessment of ESM's operation. Firstly, looking at debt levels is not enough; the prime country here is Greece, and looking only at the debt level of 170-180% does not tell us much. With ESM loans, they have substantially extended maturity, so that for 50% of its debt Greece receives loans for a weighted average maturity of 42 years, at an interest rate of 1% and below. This gives an entirely different perspective on the debt level per se, which is important to note. Greece is an exceptional case, but it can be noted that other euro-area sovereigns have in the past years extended the maturities of their debt structure, leaving room for financing as well as giving a certain stability in terms of interest rate increases. Second, one lesson from the crisis and post-crisis experiences was that it is necessary to take the right direction. A case in point here is what has been seen with Portugal subsequent to the programme, where there had been initial doubts about whether the Portuguese government would stick to the budget, but afterwards the return to confidence has had a tremendous effect.

These two metrics are important and need to come into the picture when looking at the debt situation. EFSF/ESM were set up to provide financial assistance for euro-area countries that could no longer access capital markets at affordable rates. Cyprus, Greece, Ireland, Portugal and Spain obtained loans from the EFSF/ESM at much lower interest rates than those that would theoretically have been offered by the market.

The Chair noted there has been a great deal of development over the last 10 years, with fiscal frameworks being adjusted and added to. The ESM has been created, which is an important institution. At the same time, there is still a tension between governments and investors being held accountable. A Central Bank official had talked about member states being responsible for fiscal policy choices, not only from a policy setting perspective, but a consequential implication. At the heart of it, an issue exists about how to balance market risk and sovereign-debt sustainability. A regulator has given an example of

Greece and extended maturities, but it cannot be forgotten that this came after two sovereign defaults. Apart from institutions, there are fundamental questions about what will happen should another eurozone country find itself in market, credit or fiscal distress.

With this in mind, the discussion can focus on the sovereign side and what needs to change, given that Italian debt-to-GDP is at 130% or higher and showing no signs of coming down. In France, there is little concrete sign of a material downward trend in the debt to-GDP ratio. These risks are out there, and there is less fiscal space in Europe than 15 years ago.

**2. What needs to change or possible ways forward**

The Chair posed the question to the panel of what needs to change, or what may be a possible way forward on sovereign debt.

**2.1. Weakening the sovereign – bank vicious circle by encouraging banks to diversify their sovereign debt holdings**

The Chair noted the idea that diversification on banks' concentration of sovereign-debt holdings would be enough to weaken the links between banks and sovereigns. Some people could see the direct link in terms of the sovereign getting into trouble and having an impact on the capital ratio, and the assets held deteriorating in quality. There are, however, broader macroeconomic links that come via different transmission channels from a sovereign getting into trouble that will necessarily have an impact on the domestic banking sector. Is this sufficient to diversify banks' portfolios or does more need to be done to weaken the link?

A Central Bank official felt the answer is yes, diversification is enough to weaken it, but it is impossible to decouple the banks from the state or the sovereigns. It is possible, though, to do quite a bit to weaken the link, including in the two areas highlighted.

Spill-overs to the banking system can be reduced by incentivising stronger diversification of the banks' exposure to sovereign-bonds. Spill-overs to the national private sector can be reduced if well-functioning banking and capital markets unions offer broader access to financing, thereby also having broader private risk-sharing, so that spill-overs to other sovereigns can be reduced in the context of a comprehensive framework offering financing support for innocent bystanders.

A Central Bank official noted that the negative interplay between sovereigns and financial institutions needs to be addressed. It cannot be fully solved, but not much is being done to solve it. This link needs to be weakened, especially in a eurozone with one currency and a plethora of national policies.

The no-bailout principle will not be credible without further reforms, and this has to do with the interplay between sovereigns and financial institutions. Governments and investors need to be accountable for their actions, which is why the no-bailout principle is so important.

A Central Bank official explained that if there are no clear majorities for having a European finance minister, and no taxation at a European level, then there are still national policies and the credibility of the no-bailout principle is still required. This is undoubted.

**2.2. A stronger "firewall" role for the ESM is welcome**

An official felt that the existence of the ESM demonstrates that the Maastricht no-bail-out clause is not credible. Europe did not have any firewalls, but now has very good firewalls.

A Central Bank official agreed that the ESM plays a critical role in sustainability and combatting crises in the euro-area, which is why it needs to be further strengthened wherever possible.

The ESM is a very important institution, and having a backstop available is important, but there is a chance to protect innocent bystanders from spill-over and contagion. The ESM has the potential to alleviate some of the pressure in the system.

A regulator felt there is a question of the immediate and longer-term policy agenda, and discussions to be have as a follow-up to the euro summit last December about the strengthened role of the ESM. The summit indeed endorsed a stronger role of the ESM as a crisis resolution mechanism. It will operate as the common backstop to the European resolution authority, and its financial instruments have been reviewed to make them more effective. Consideration is now centred on the transposition and implementation. Part of this is relevant for the panel, and other important parts on the completion of the Banking Union and the Capital Markets Union will be dealt with elsewhere. There is an idea of making the instrument toolbox better geared towards protecting the innocent bystander in terms of making the precautionary credit line more useful.

**2.3. The need for debt restructuring: For a case by case approach**

A regulator emphasised the need for clarity on debt sustainability in the future; there is a consequent call for a predictable and transparent framework of debt sustainability analysis. Part of this agenda is the idea of changing the contractual relationships on debt in order to make hold-up problems more manageable in future. This means that the general approach taken about going forward on sovereign debt will remain as it is currently. Some have been asking for automatic debt restructuring in a debt crisis, but this is not the way to go, and so they will remain in a framework of case-by-case situations to be dealt with, with instruments to do this.

A Central Bank official noted that debt restructuring is a key point. Nine years before, the German Central Bank had made a proposal: if there is a country which triggers a certain weak point, and if it is in the bylaws of the sovereign-bond, there is a certain period of time when there is no redemption and no interest payment, which gives the country the possibility of restructuring. It will only be taken up later, so that investors already know that if a certain trigger point is hit then there will be no redemption and no payments on that sovereign-bond. This gives fiscal space for restructuring.

An official noted that, at the macro-level, it comes back to the issue of when it is triggered and what the trigger is. In terms of any country's fiscal policy stance, it is easy to ask whether the fiscal stance is sustainable under certain assumptions. This is the mechanical part of doing projections and passing views on sustainability. The difficult part is what to do if a projection has led to an unsustainable debt. A fiscal adjustment is necessary. A primary balance can be calculated as the primary balance surplus that a country needs to run. The difficult question is whether it is economically or politically feasible in that country. This is what 'case-by-case' means.

Many people in the early 2000s had not believed, even inside the IMF, that Turkey could run a 6.5% primary surplus for three years. Turkey had almost done this and not needed a debt restructuring. This is what is meant by 'case-by-case'. It is not something that can be explained exactly. As to whether debt restructuring is necessary or not, it means a very complicated political discussion. Greece can be talked about in the same way.

A policy-maker noted that in the projection of Irish public debt, it had been supposed to reach 125% of GDP. On that basis, there were important risks to debt sustainability. An automatic system of restructuring would have had disruptive effects. Now Ireland's debt is expected to fall below 60% of GDP and this has been achieved in a few years.

The Chair queried whether it necessarily rules out more clarity on how restructuring takes place, if it is deemed necessary on a case-by-case basis. A policy-maker felt the risk is of self-fulfilling prophecies: if they start talking about it, it is more likely to happen. The Chair disagreed, as there have already been three sovereign defaults in the euro-area.

An official agreed that in the event of debt restructuring it is right to have claims and bond contracts to make restructuring easier. Everything, from collective-action clauses to what is being discussed as single-limb aggregation, is very constructive.

A Central Bank official suggested that it has not always been boring, and it has become standard to think of northern economies as fiscally prudent with solid economies. In the early '80s they had been in a miserable situation, with public development levels at 80% of GDP. The interest rate had been 20%, later falling to 10%, but this was still a heavy burden. It is possible to run a primary surplus for an extended period; it is just necessary to compensate for expenditures.

Debt restructuring for a sovereign is a very bad thing, and part of the problem rather than part of the solution. It cannot be completely excluded from happening, but it would be a better world if at an earlier stage people took stock of the situation and spoke with the ESM. Public debt restructuring only makes up for savings and is not predictive. If market price is in at a sufficiently early stage that this may happen, the expenditure is frontloaded to a large extent, and a self-fulfilling hypothesis is created that there may be default.

A Central Bank official agreed with the case-by-case study. However, the market will still have certain triggers in mind. From a certain point in time, whether or not case-by-case, if there is a selection of sovereign-bonds, they will lose interest and drop certain sovereign-bonds. Therefore, a mechanism is needed not to go to the ESM straight away, but to have time to restructure before using the ESM crisis management system. Market mechanisms need to be considered.

A regulator did not see a debt restructuring coming immediately. There is a need for caution. The experience with Italy in 2018, which led to a drying-up of one of the biggest debt markets in Europe at very short notice, showed there will be trigger points to be conscious of. At the same time, market discipline cannot be relied on. This is a new normal for governmental finance in Europe, and the old pre-crisis regime with no risk differentiation has gone. Risk differentiation will continue across countries. There will be some volatility, which is why safeguards of better fiscal rules and financial instruments of more stabilisation are needed.

### 2.4. Amending fiscal rules is not appropriate

A Central Bank official concluded that the EU fiscal framework is better than its reputation and has contributed positively to the situation not being worse. At the end of the day, it only made a difference where countries perceive that systems were helping toward proper policies. It is a democratic choice to challenge the rules or the markets, and there are implications for this.

A Central Bank official noted that they were a minority to not insist on simpler fiscal rules. There is a good reason for complexity. For rules not to be subject to discretion or Commission and Council assessments, which will politicise them, they have to be tuned so that the outcome is perceived to be fair across countries. This requires sophistication. It is not perfect, nor without reason. The more flexible they are, and the more discret, the larger is the risk of politicisation. The more tuned they are to be seen as reasonable and fair, the more complex they have to be.

### 2.5. An EU macro-stabilisation facility makes sense but requires first that the fiscal rules of the Stability and Growth Pact are implemented in all parts of the EU

The Chair noted that the IMF published work on the central fiscal facility the previous year. The debate has since moved on. The Chair questioned whether the IMF still stands by the principles it set out for the euro-area?

An official confirmed that it does. It is not a unique IMF proposal, but one of a number from the Commission and other bodies. Discussions around the eurozone budget and the next Multiannual Financial Framework are a good direction of travel, but too small for a macro-stabilisation facility.

A Central Bank official noted the absence of any mention of the financial and sovereign debt crisis yet, but it highlights the need for reform, meaning the reform of the governance framework in the European monetary union. Financial stability needs to be safeguarded, in the future as well as in the past.

A deeper economic and fiscal-policy integration would imply a more logical progress to be achieved, but there is a lack of consensus as to how this should be done. There is no apparent majority for transferring powers to the European level, and not many national policymakers are pursuing change in EU treaties. As long there is a lack of consensus, concentration is needed on what is most important.

A policy-maker noted that it is very important to ensure that EU policy-makers have the right instruments for the right objectives. Fiscal rules are meant to ensure sound public finances, but over time they have evolved, and there is concern about stabilisation issues. The key is developing a new stabilisation function at the EU level, even step-by-step, so that there is an ex-ante way of absorbing the effects of shocks and no need for the ESM to deal with illiquidity or a worse crisis.

An official agreed with the need for a stabilisation capacity at the centre to address shocks, and for a simple set of rules. Two issues have not been mentioned. One is that even with a central fiscal-stabilisation facility it is essential to have compliance with the existing fiscal rules. Countries cannot be contributing to a central fund capacity without compliance with these rules. Second, any feasible central fiscal capacity will not relieve national governments of responsibility for national fiscal policy. When countries are running debt 100% plus of GDP, the problem cannot be solved.

A regulator noted that for the longer term there is an important link to be made, which has to do with fiscal rules and trust on the one hand, and on the other the instruments that make the euro-area more robust. There is a call for fiscal rules to be made more effective, and these have been better than mentioned and have helped to contain fiscal behaviour. There is, however, the issue of making them work better to create more trust and better fiscal behaviour.

On the other hand, when it comes to the financing conditions there could be more discussion on stabilisation through a euro-area budget, and more discussion on euro-area safe assets, which would do a great deal to create common financing conditions, and strengthen the euro-area capital market, and therefore the international role of the euro. Trust is needed first, though.

**Conclusion: Fiscal discipline is of the essence**

All 28 EU member states are committed by the paragraphs in the EU Treaty, referred to as the Stability and Growth Pact (SGP), to implement a fiscal policy aiming for the country to stay within the limits on government deficit (3% of GDP) and debt (60% of GDP); and in the case of having a debt level above 60% it should each year have a declining trend.

However, the Stability and Growth Pact regarding debt criteria has effectively not been implemented since the start of the EMU. In 2007, several countries recorded government debt to GDP ratios. Despite the different reforms which took place after the sovereign debt crisis[1], 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 is not unduly delayed. This requires complementary policy action. A monetary union is not workable without economic convergence and fiscal discipline. The enforcement of the Stability and Growth Pact has been too lenient since 2003. EU Fiscal rules need to be enforced more rigorously and should be more binding and effective. 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.

1. 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 of the assessing of national draft budgetary plans (part of the 'Two-Pack') entered into force in May 2013.

# Sovereign-bank loop in the EU

The Chair reminded panellists that the debate would be organised as two rounds of questions: one dedicated to the diagnosis of the problem, i.e. where the industry stands, how this nexus has evolved and the drivers and channels of it; and one dedicated to potential ways to weaken the doom loop further.

**1. The general evolution of the sovereign-bank loop and key challenges**

A Central Bank official described how the relationship between banks and sovereigns was brought to the fore of the economic policy debate by the financial crisis. The regulatory and institutional reforms conducted since then have sought to reduce the probability and impact of a 'doom loop' between banks and sovereign risk, but weakening the threat posed to financial stability by that nexus seems to be 'easier said than done'. Indeed, in the second half of 2018, investors' concerns about this nexus were rekindled by the re-widening of Italian sovereign spreads. This might indicate that the nexus has not been weakened enough and, if this is the case, there is a question as to what additional policy tools should be used.

**1.1. The sovereign debt crisis demonstrated that bank risk and sovereign risk are closely intertwined**

Sovereigns are indeed exposed to banking risk, and banks are exposed to sovereign risk. Therefore, the 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.

An official felt that the situation is simpler than how it is often portrayed. First, banks reduced their sovereign debt holdings until 2006-2007. Banks bought each other's bonds and they were more diversified. However, the banking crisis became the financial crisis in 2008 (Lehman Bankruptcy in September 2008), which became in Europe the sovereign debt crisis (2009 – 2012). Banks saw their sovereigns getting into difficulty and anticipated increases in their future tax liability. Having no interest in being located in a bankrupt jurisdiction, banks rescued their home jurisdictions. They did what others would not: they acted against the supply and demand mechanism and bought sovereign-bonds. This problem involved a link between two weak entities: the banks, which became weak due to the banking crisis and even weaker because they bought state bonds; and the sovereigns, which were weakened due to the impact of the crisis. Logically, either the link between the two entities could be broken, or they could be made stronger. This second solution was clearly preferable. Europe did not try to break the link by imposing an arbitrary rule; it sought to strengthen both banks and sovereigns.

Another official agreed that banks played an indispensable role in the process of shock absorption, citing the example of Italy. When international investors retreated from the Italian market around 2011, within two years the Italian banks had increased their purchase of Italian bonds by €250 billion. Had they not done this, there would have been serious implications for the euro-area. The official added that Eurobonds were the best solution to this problem, but this was not politically possible at the time.

**1.2. There are differences across EU member states, but banks' sovereign exposures are still elevated in many countries**

An official considered that bank holdings of sovereign debt are an obvious and important channel through which the negative feedback loop between bank and sovereign risk can develop. A regulator noted that banks' sovereign exposures in Europe remain somewhat elevated. Given relatively high sovereign-debt levels, the resulting debt sustainability concerns and the low-growth environment, there are obvious risks to banks' balance sheets. The latest figures suggest that EU banks' sovereign exposures have fallen by approximately 10% or €400 billion over the last two years. Approximately half of this reduction concerns the holdings of domestic sovereigns among the individual banks. The median bank sovereign exposure relative to Tier 1 capital ratio in 2018 is approximately 170%, but within this observation there is a very wide distribution from banks with exposures of less than 90% of Tier 1 capital to banks with exposures of more than 250% of Tier 1 capital. Banks should be incentivised to manage sovereign exposure actively. The current prudential framework does not adequately incentivise banks to manage these exposures actively, given that banks can set zero risk weights on sovereign exposures. The lack of concentration limits for these exposures means it is vital for the competent authorities to monitor these exposures consistently and ensure that these vulnerabilities are well managed.

An industry representative considered that the debate about banks' sovereign holdings revolves around the dangers of having 'too many eggs in the same basket'. While the industry representative agreed that this could be a useful perspective, there are other more pressing issues the industry could be working on. The data suggests that European banks have significant domestic public-debt holdings, but the 'usual suspects', i.e. the banks in 'bad countries', are not at the top of this list. Sovereign exposures are essentially a generalised phenomenon. These exposures do not depend on the situation of the sovereign. Additionally, the industry representative stressed the importance of incentives. One consequence of the financial crisis has been a very substantial increase in the equilibrium level of liquidity demanded by economic agents, because economic agents have changed their demand function. The higher level of desired liquidity has impacted what substantiates this demand.

### 1.3. The sovereign-bank nexus extends to Central Banks

The sovereign doom loop also affects Central Banks with large holdings of government bonds purchased as part of Quantitative Easing programs. A regulator described how Central Banks' asset purchases are hold to maturity investments. By definition, they are insulated from day-to-day movements. Moreover, Central Banks have relatively advanced risk-management capabilities for managing exposures. Concentration risk-management is being carried out here. Additionally, Central Banks have exposures to sovereign risk because they accept this collateral in regular policy operations. In that context, Central Banks have very elaborate haircut schemes for sovereign paper of different quality and maturity, and they mark to market on a daily basis. In the banking sector, sovereign exposures can be assigned a zero-risk weight and are not subject to concentration limits. So, there is a big difference between what Central Banks are doing and what the banking sector is doing.

### 1.4. Sovereign debt serves multiple purposes in banks' balance sheets

An industry representative emphasised that the banks' business is not to invest in bonds. Banks invest in bonds to manage their balance sheet (aside from being a cornerstone for liquidity regulation compliance), among other issues. For example, domestic sovereign-bonds are a key component for interest rate risk management because it is the asset class that most closely matches the interest rate sensitivities of banks' domestic liabilities and does not generate additional credit risk. Without this exposure to domestic sovereign debt, banks would be forced to hedge interest rate risk with third parties, generating additional costs and counterparty risks. Second, there now is a scarcity of safe assets. Third, banks, supervisors and regulators have 'too much on their plate'.

Penalising these holdings (via an increase in risk weights or concentration limits), without a viable alternative, could have far-reaching consequences for banks' risk profiles, as well as for sovereign debt markets, cross-border flows and the smooth-functioning of the global economy. The industry representative felt that the debate over sovereign exposure is a way of avoiding a real debate on other policy or fiscal issues. The discussion unduly places a public-policy objective on the private sector.

### 1.5. The sovereign-bank nexus poses an important challenge for the whole monetary Union

A Central Bank official agreed that the sovereign-bank nexus posed an important challenge for the monetary union. The monetary union's unique institutional framework combines a single monetary policy with 19 autonomous fiscal policies. As long as member states are fiscally autonomous, sovereign exposures cannot be assumed to be risk-free. Fiscally, sovereign member states are responsible for their spending and revenue decisions. Ultimately, it is easier for member states to load up debt on the national banking system in times of crisis. Thus, a public-finance problem can be transformed into a problem for the entire banking system. This threat raises the pressure on Central Banks to come to the rescue, but Central Banks are restricted to the actions within their mandates.

### 1.6. Are sovereign exposures risk-free assets for banks?

A regulator felt that sovereign exposures are not risk-free for banks. Any sudden spread-widening can affect profitability and capital ratios. In particular, exposures measured at fair value are now vulnerable. EBA monitoring shows that about 40% of the banks' sovereign exposures are currently measured at fair value. Additionally, longer-maturity bonds are more vulnerable to spread-widening. A substantial majority of banks' exposures are in holdings with maturities longer than five years. On the other hand, extensive fair-value holdings and holdings with long maturities provide the market with disciplined mechanisms that work whenever and wherever needed.

A Central Bank official considered that the discussion on sovereign exposures is often passionate but lacks a technical dimension. While there may not be zero risk, sovereign default is not a high risk. Sovereign default is exceedingly rare in advanced economies; it is very low even for emerging economies. The Central Bank official reiterated the fact that banks' sovereign exposures are countercyclical. Banks want to lend to households and firms, because the return is higher. They invest in sovereigns during periods of crisis because private-sector exposures are too risky. Experience in Europe suggests that sovereign exposure decreases when there are opportunities for lending to households and firms. Empirical analysis suggests that the market's real concern is not total exposure levels but the general state of the economy. The relationship between sovereigns and banks is very complex. This relationship should be discussed in a holistic way and the discussion should include a wider variety of different elements.

## 2. The way forward: different points of view

### 2.1. Fiscal discipline is vital

A Central Bank official reiterated the importance of addressing the root cause of sovereign problems, which could only happen through fiscal discipline. Changing the regulatory treatment of sovereign exposures would be a less optimal solution. An official also agreed on the need for fiscal discipline. Banks should not pay the price for a state's mistakes. It is a 'fantasy' to suggest that the regulatory treatment of sovereign exposure could close the loop between sovereigns and banks. The holding of sovereign-bonds is one channel of transmission to the banks among many others. If a sovereign defaults, the economy will collapse by definition, and the bank's entire loan book will suffer. An industry representative echoes the comments made by other panellists, suggesting that the ultimate cause of these problems was a lack of budget discipline.

### 2.2. There is a need for European safe assets

An official highlighted the European Commission's proposal on sovereign-bond-backed securities in May 2018. While the reception of this idea was somewhat cold, there has been some progress. The European Parliament recently adopted a report on the subject. There were amendments to it, but this at least demonstrates some movement.

An industry representative noted the importance of safe assets, pointing out the unique role played by sovereign-bonds. There can be a debate over who issues these bonds in the context of monetary union and how they are described, but this is the reality of the situation. Either sovereign risk is linked to safe assets or the discussion is going nowhere. The industry representative regretted the fact that there is very little appetite in Europe for a pan-European safe asset. Domestic bias will continue to be an optimal strategy for banks as long as financial fragmentation continues to exist. If limitations on sovereign risk are imposed without addressing this, there could be unknown and serious spill-overs. The industry representative felt that a holistic approach is needed for incentives. At the micro level, public debt is not an issue of counterparty risk. It plays a key role in balance-sheet management, liability management, liquidity management, the structure of the balance sheet and the new regulatory framework. At the macro level, the industry must consider the impact on these elements.

Emphasising his belief that it is not apparent that anything has to be done about sovereign exposures, an official considered that there is no asset safer than government bonds. In the discussion of sovereign risk, it is important to keep in mind that the sovereign is the only body with a taxation power. More fundamentally, the very idea that a sovereign can default is an intellectually problematic one. The sovereign is the source of law. The sovereign can default, but this idea entails the body that is the warrant of the rule of law somehow compromising its own works.

### 2.3. Towards a change in the prudential treatment of sovereign exposures

A Central Bank official felt that the regulatory treatment of sovereigns had been discussed extensively in Europe. It started at the European Systemic Risk Board (ESRB), but the discussion ended up in the Basel Committee, which issued a discussion paper on the subject in September 2017. There is no consensus in Basel regarding the potential regulatory treatment of sovereign exposures. The regulators from advanced economies such as America, Canada and Japan have no appetite for it. This view is shared by regulators from the emerging countries. In Europe, however, there is a split. Some see particular merits in discussing the issue for Banking Union countries. This problem must be solved in order to advance the construction of Europe.

An official considered it positive that there is no support in Europe for 'normal' risk weighting and concentration limits, because this would seriously constrain the banking sector. It is possible to take an approach based on concentration charges, where moderate risk-weights would trigger at certain levels of exposure, but the success of this proposal will depend on the calibration of the instruments. An industry representative suggested that some action will be necessary if the industry cannot 'do the right thing'. As markets react to these issues, transparency is key. Banks should have to demonstrate market discipline, which would mean that banks' access to funding will be influenced by the way they are doing business. Regulators could also make more use of fair value. Connected to this is the need for stress-testing regarding either Pillar 2 or Pillar 2 guidance.

### 2.4. EDIS and the sovereign-bank loop: risk reduction should go hand in hand with risk-sharing

#### *2.4.1. Much has been achieved to strengthen the resilience of EU banks*

A Central Bank official reminded them that the global financial crisis demonstrated how banks with low levels of capital and high levels of risk sometimes have to be rescued by the taxpayer in order to protect depositors, avoid contagion and protect financial stability. Ultimately, the industry has learned from this experience and things have changed significantly. There has been a significant reduction in Non- Performing Loans (NPLs) at many banks in Europe and a significant increase in capital. Due to regulatory and supervisory pressure, there is an increasing consciousness of risk in banks and improved levels of corporate governance. Additionally, the Single Resolution Board (SRB) is starting to ask for binding Minimum Requirement for Own Funds and Eligible Liabilities (MREL) requirements from banks. The situation may not be perfect, but Europe's position has improved considerably since the crisis. The Central Bank official considered that many countries in Europe have done significant work on risk reduction but 'almost nothing' on risk-sharing.

An official felt that Europe has taken several positive actions. The Single Rulebook made the rules clear for all market participants, especially at the business level. Europe's resolution rules strengthened the system considerably and supervision was moved to the European level. Europe put more capital in the banks and increased the banking industry's loss-absorption capacity. The official noted the recent ECB study suggesting that the probability of default among banks had been reduced by one third. The amount of capital in the system has increased by approximately five times. Multiplying these two figures together, there has been a sevenfold increase in capital and liquidity. On the asset side, the level of NPLs has returned to its pre-crisis position. Instead of breaking the link between weak and connected elements, Europe sought to strengthen both banks and sovereigns. The euro-area crisis has been the first item of discussion at G7 and G20 meetings during 2011-2012, but the point has now disappeared from the agenda; there is no longer a systemic crisis. There are some banks with excessive sovereign exposures, but these are not the 'usual suspects'. There is no connection between 'bad banks' and 'bad countries'.

A Central Bank official agreed that strengthened banking regulation contributes positively to crisis resilience. The measures that were adopted have not interrupted the sovereign-bank loop, however. This link can only be broken by changing the regulatory treatment of credit and concentration risk. It is important for discussions to continue at the international level, because an international approach would be the best way to achieve a level playing-field. Timing and transitional periods are important, because the aggregation of cyclical risks should be prevented. An industry representative stressed the necessity of the European deposit-insurance scheme. Part of the industry can attempt to delay the EDIS debate, but Europe will not break the feedback loop between banks and sovereigns without EDIS. Additionally, greater transparency is essential. The real question in this debate is not about whether there should be limits on sovereign exposures but rather whether the industry could function without a safe asset. If the answer to that question is no, Europe must develop a sufficient pool of safe assets and perhaps develop fiscal union.

#### *2.4.2. Completing the Banking Union*

While there is an imbalance between risk reduction and risk-sharing, an official considered that the creation of the

Single Resolution Fund (SRF) was an important element of risk-sharing. In any event, there are two reasons why a European deposit insurance scheme is necessary for the completion of the Banking Union: robustness and consistency. Europe needs robustness, because at least for liquidity it is necessary to have an instrument that can intervene very rapidly. Europe needs consistency, because it is very strange to have rules, supervision and resolution done at a European level but not depositors' protection.

A Central Bank official noted that addressing the sovereign-bank loop is a necessary precondition for a common deposit-insurance scheme. Such a scheme would improve the financial stability of the euro-area as it would reduce the risk of a bank run. However, as long as the sovereign exposures of banks are not subject to capital requirements and large-exposure regime rules, it will remain possible to shift public debt into the national banking system in times of fiscal stress. This means that a common deposit-insurance scheme would indirectly be tantamount to distributing this fiscal risk across the euro-area. An official noted that a number of member states had established a link between EDIS and the regulatory treatment of sovereign exposure, but there is no link between a deposit guarantee scheme and sovereign holdings.

*2.4.3. Incorporating a sovereign risk consideration within EDIS*

An official considered that there is a more logical solution to this problem. If sovereign exposures and EDIS are linked, it is possible to introduce this dimension within EDIS rather than banking regulation. This would mean taking domestic exposure to sovereign-bonds into account when establishing the formula for bank contributions to EDIS, which would obviate the need to change the entire regulatory framework. There would be no mismatch between European rules and the Basel rules, which could be potentially damaging to European banks. However, the European Commission has not yet taken a position on this proposal.

**Conclusion**

A Central Bank official highlighted the one strong point of consensus in the discussion: the need for fiscal discipline. Beyond this, there is considerable variation between panellists' views. There are mixed views on regulatory or prudential treatment, but the majority do not consider it to be the best option available. The representatives of the market suggest that the focus should be on Pillar 2 or Pillar 3 measures. This could help move the debate forward. Additionally, the Central Bank official outlined the troisième voie of including risk indicators related to sovereigns in EDIS. Additionally, there should be a full debate on the important issue of safe assets.

# Benchmark regulation: implementation challenges

## 1. The state of benchmark regulation in Europe

### 1.1. The case for benchmark reform

A Central Bank official explained that benchmark interest rates are important because they are used across a large range of financial market instruments. Benchmark rates impact the assessment of monetary policies and financial stability, given the financial system's overall interconnectedness. Market manipulation and false reporting are not widespread, but they have undermined confidence in the reliability and robustness of existing interbank benchmark rates. An industry representative added that the entire market had been outraged by the misbehaviour of traders in 2012.

This is why Europe has undertaken a fundamental review and reform of benchmark designs and their governance. A regulator suggested that the worst-case scenario would be for the industry to lose access to critical benchmarks. If market participants could not agree on the issue of benchmarks, the FSB had warned that the market would have to manage the situation.

Another regulator explained that EURIBOR is estimated to underpin more than €180 trillion worth of contracts, including approximately €1 trillion of retail mortgages. This demonstrates the diversity in type and duration of instruments covered by benchmark rates. In respect of EONIA, the value of outstanding EONIA-based contracts is established at approximately €450 billion. The vast majority of the euro overnight index swap market, with a notional value of €5.2 trillion, is also linked to EONIA.

While EONIA and EURIBOR have been designated as critical benchmarks, the Central Bank official noted that benchmarks currently do not comply with the new requirements. This prompted the launch of the working group on euro risk-free rates, which is an industry-led group designed to contemplate benchmark rates. ESTER will be produced by the European Central Bank on 2 October 2019 and will gradually replace EONIA as the euro risk-free rate. EONIA will be reformed as ESTER plus a spread, and will continue to be published by EMMI until January 2020.

There is also a taskforce working on benchmarks at IOSCO which is seeking to ensure that all market participants understand the implications of the discontinuation of LIBOR.

### 1.2. Good progress has been made in Europe

A regulator noted that the involvement of public supervisory bodies has been forced by private-market failure. The market manipulation was difficult to spot, and many benchmarks were not subject to any regulation. Public supervisory bodies 'started from scratch' and decided to take a global view when launching the work stream, which can be seen in the work done by Martin Wheatley and IOSCO. The regulator expressed his admiration for the pace at which the major principles had been drafted and established. Within the FSB's Official Sector Steering Group (OSSG), supervisory entities at national, regional and international levels are working closely on benchmarks. The Belgian FSMA has been appointed as the lead supervisor for EURIBOR and EONIA and benefits from advice from a college of EU supervisors, including ESMA.

A regulator emphasised that good progress was being made on critical benchmarks. On EURIBOR, the hybrid methodology represents good progress. In respect of third-country benchmarks, the regulator considers it important to focus not only on equivalence and recognition but also on the possibility of endorsement. Between these three different routes, Europe should be able to achieve something that will enable the industry to move forward. The regulator emphasised that ESMA would continue to be engaged and involved in the subject of benchmark regulation, especially given the recent decision for it to assume direct supervision of critical and third-country benchmarks.

An expert described the circumstances surrounding the creation of EURIBOR and EONIA, noting that the European Money Markets Institute (EMMI) now administrate these rates. EMMI's governance has been strongly reinforced in recent years. EMMI has two clear objectives: to facilitate the transition from a quote-based methodology to a hybrid methodology; and to be authorised as the administrator of EURIBOR and EONIA by the Belgian FSMA. EMMI has published widely on EURIBOR reform and the market supports its proposals. Last year, EMMI's hybrid methodology was successfully tested and the organisation received positive feedback from a large range of stakeholders. In accordance with the Benchmarks Regulation, EMMI will seek authorisation to administrate EURIBOR by the FSMA, which it hopes to gain by the end of the year. EMMI's hybrid methodology will be phased in gradually to ensure a smooth transition, which will have a smaller impact in terms of differentials.

Another industry representative felt there has been tremendous progress on the administration of globally systemic benchmarks over the last eight years. This work has taken place in coordination with the official sector, most notably in respect of the EU Benchmark Regulation (BMR) and the IOSCO principles. The industry is in a much better position in 2019 relative to the situation approximately 10 years ago.

## 2. Considering the risks posed by the introduction of benchmarks and discontinuing existing benchmarks

An industry representative stressed that the challenge for the industry is to keep its flows operating while fundamentally changing the plumbing. Considering the challenge of discontinuing and replacing existing benchmarks, a Central Bank official felt that there could be a divergence between different alternative risk-free rates and also sluggishness in the pace of reform, leading to differences in timing for the availability of new benchmarks. Additionally, in the transition phase multiple benchmarks coexisting simultaneously could produce a high degree of complexity.

An industry representative considered consistency an important issue. Each of the major currencies has developed a slightly different solution. While the Swiss and Americans are considering a secured market rate, Europe, the UK and Japan are considering an unsecured one. There is also a completeness issue. Within LIBOR there is agreement on overnight benchmark rates, but there is no visibility on what the term structure will be for the main currencies in the future. Further divergence could result from the Swiss desire for a backward-looking methodology for compounding in arrears, because other jurisdictions are seeking to keep a forward term structure. This also demonstrates a coordination issue. This Swiss example has prompted a debate on term structure in relation to compounding in arrears. ISDA is considering compounding in arrears for the fall-back language, and the working group on euro risk-free rates is examining a forward rate.

Another industry representative agreed that different parts of the industry have different views on issues such as term and spread adjustments. In addition, many deals made using current rates would remain 'on the books' when risk-free rates become more firmly established. The contracts that underpin those positions currently contain fall-back language which is not designed to contemplate the permanent discontinuation of a rate. Clients and banks will have to examine these contracts carefully. There are different ways to address this issue, but bond markets, derivatives markets and loan markets are taking different approaches to this.

The industry representative suggested that there are legal, regulatory, operational and even capital and liquidity risks associated with the transition to risk-free rates. One plausible scenario is a dual-rate environment across a number of currency sets. This will most likely generate significant liquidity dispersion and create follow-through consequences in terms of the paucity of observable prices for FRTB purposes, funds transfer pricing within organisations, interest-rate risk in banking books and valuation adjustments (XVA). The challenges in benchmarks encompass operational risk, trading risk, credit risk, operational risk, legal risk, reputational risk and, ultimately, conduct risk.

### 2.1. Benchmarks are an integral component of an enormous range of financial activities

An industry representative considered that benchmarks exist to facilitate economic activity in the real economy, which means the industry should reflect on how changes would impact the real economy. It is important to consider how to reform benchmarks in a way that suits the needs of manufacturers, retailers, households and families. It is also sensible to have several different benchmarks, because different financial products have different economic purposes. One benchmark which is appropriate for derivatives transactions may not necessarily meet the needs of a household taking out a mortgage.

### 2.2. Benchmark rates affect the real economy and financial stability

An industry representative stressed that benchmarks affect financial stability. The FCA has fixed the end of its LIBOR support for yearend 2021. Without a coordinated approach between members of the real economy, the financial sector and the official sector, there is a risk for financial instability around the transition.

A member of the audience highlighted the fact that benchmarks have a direct impact on the solvency of insurance companies, which produces a systemic risk. A regulator explained that benchmarks are embedded across the regulatory regime. Insurance is important, but benchmark rates also have implications for capital and banks. The industry must ensure that these benchmarks can be relied on in all fields of the industry, whether that is insurance or any other.

## 3. Implementing BMR: transitional challenges

### 3.1. Setting critical benchmarks in the EU: the future of EURIBOR, EONIA and ESTER

An industry representative praised the approach of European stakeholders to benchmark interest rates in the eurozone. These stakeholders have leveraged a commonsense set of solutions and their approaches are simple to understand. They have committed to a basic and formulaic approach for EONIA, which market participants have bought into, and they have adopted a well-considered hybrid approach to strengthen EURIBOR. Secondly, the European stakeholders tackling this question have been mindful of the real economy. They have acknowledged the need for benchmarks to incorporate credit risk within the context of lending arrangements while establishing an overnight risk-free rate that is appropriate for derivatives contracts. There is a deep empathy towards families and how benchmark reform will impact them. Seeking to avoid unintended consequences for families and the real economy in the transition process is a 'very wise' approach, which will lead to long-term financial stability.

### 3.2. The two-year transition period – is it sufficient?

A regulator described how the Benchmarks Regulation became formally applicable on 1 January 2019. While some of it has already been implemented, certain things are taking longer than originally expected. This explains why the transition period has been extended to yearend 2021 for critical and third-country benchmarks. An industry representative expressed how delighted his institution had been at the two-year extension. The transition is not a 'first-past-the-post' competition, however. The entire market must transition by the deadline. Large institutions will be internally prepared for the change, but they can only be properly prepared if their entire client base is ready. From this perspective, 2021 is an aggressive deadline.

An industry representative stressed the considerable effort made by the public and private sectors to reform IBORs. This work is necessary but not sufficient. The road to reform the IBORs is very long. One of the biggest vulnerabilities of IBORs is their unsustainable reliance on voluntary contributors. While many of the institutions represented at the conference use LIBOR or EURIBOR, perhaps only one or two contribute to them. Over the next two years, the industry must find ways to make these benchmarks less reliant on voluntary contributions or powers of compulsion.

### 3.3. There are transition risks associated with the continuity of contracts and fall-back provisions

A regulator noted that the Benchmarks Regulation requires contracts to include fall-back provisions, which poses a difficult problem. The issue requires coordination between the private and public sectors. In the context of EURIBOR and EONIA, ESMA is currently contributing to the working on a way to address fall-back provisions which properly embed the forthcoming changes while ensuring there is a sensible transition period. In May, the working group on euro risk-free rates will publish its work on fall-back provisions in respect of EONIA, and work will begin on EURIBOR fall-backs once there is greater clarity there.

An industry representative from a benchmark administrator emphasised his organisation's commitment to working with data providers to guarantee that benchmarks continue to have integrity while ensuring contributors feel safe about participating in the process.

Another industry representative noted that, while banks are fixated on loans, deposits and bond issuance, large corporate entities have a very small exposure to these financial products but an extremely large exposure to commercial contracts, which also reference LIBOR and EURIBOR. This economic activity must also be transitioned. The industry should support ICE's ongoing efforts to work with globally active banks to seek to publish certain LIBOR settings after year-end 2021 in order to provide more time to digest the impact of this transition for the entire industry, not merely the largest players.

A regulator explained the transition process from the perspective of the FSMA, noting the importance of providing market participants with accurate information. As the current principal supervisor of EURIBOR and EONIA, the FSMA stands ready to provide explanations where appropriate. First, the process of transition is on track. Second, all market participants must be on board for the transition of EURIBOR. The industry needs a stable and representative panel. In terms of EURIBOR and EONIA, the FSMA is currently the lead supervisor and head of the college of supervisors. Both benchmarks are expected to be reformed to be BMR compliant covered by the BMR licence granted by the FSMA in its capacity as lead supervisor.

The FSMA has a specific work stream for each of the benchmarks due to the differences between them. In terms of EONIA, in September 2018 the working group on euro risk-free rates recommended ESTER as the new risk-free rate for the euro-area to replace EONIA. ESTER will also reflect the wholesale euro unsecured overnight borrowing costs of euro-area banks. The ECB will begin calculating and publishing ESTER in October 2019 based on Money Market Statistical Reporting Regulation (MMSR) information from the 52 largest banks in the euro-area. The FSMA reports to the ECB through the Money Market Statistical Reporting Regulation (MMSR), which may have implications for EONIA. At present, EONIA is used in overnight interest-rate swaps and the valuation of financial instruments. Therefore, one of the main challenges is to ensure the new benchmark can fulfil the same role, which entails giving market participants sufficient time to develop a liquid ESTER derivatives market. To solve this challenge, the working group on euro risk-free rates recommended a modification of EONIA methodology, on which the administrator of EONIA has already consulted. EONIA will become ESTER plus a fixed spread, which will be calculated by the ECB. The main advantage of this work stream is that there will be a constant spread and it will smooth out the perceived fear of valuation transfer and balance-sheet impact, lowering the barriers to transition. The amended EONIA rate will likely be BMR-compliant. From October 2019 to December 2021, which is the new deadline agreed at the political level, EONIA will be recalibrated as ESTER plus a spread. This would be made available by EMMI and would be governed by EMMI's BMR licence. Market participants should use this period to replace EONIA with ESTER gradually.

The work stream for EURIBOR is slightly different. EURIBOR is referenced in a large number of long-term transactions, such as mortgages. In order to make EURIBOR BMR-compliant, EMMI has consulted extensively on a hybrid methodology, anchored to the largest extent possible in transactions and tested by various public stakeholders. This hybrid methodology will be gradually implemented during a phasing-in period, which will smooth the transition from a quote-based to a hybrid methodology. At present, the FSMA expects EMMI's licence application very shortly. Based on the preparatory work done by EMMI, the FSMA currently does not anticipate any problems with this application. The new methodology is expected to be BMR-compliant. The FSMA expects to be able to grant EMMI a licence in the summer after consultation with the EURIBOR college of supervisors.

An expert reiterated that EMMI's major challenges were to facilitate the transition to the new hybrid methodology and to present its request for authorisation to the FSMA. This application will be filed before 13 April. There is still a considerable amount of work to do on benchmarks. For instance, the BMR insists that contracts should contain fall-back rates. In terms of continuity of contracts, EMMI is seeking to ensure a smooth transition. EMMI also wishes to enlarge its panel of panel banks. At one time, supervisors did not have the power to block a bank from leaving the panel, but this tool has now been available for five years. After EMMI has been authorised, it will seek to secure the involvement of some important eurozone banks that are not currently part of its panel.

A member of the audience asked the panellists to give details regarding legacy contracts in terms of new benchmarks and how historical contracts could be translated into new contracts. A regulator explained how the work on benchmark reform, was a partnership between the private sector and public supervisory bodies. Many aspects relating to the continuity of contracts must be addressed at the right level by the right body. This is why there are specific work streams on this subject within the working group on euro risk-free rates. It will also be important to take into account the proposals coming from ISDA and other market participants, although there is no legal basis for doing so at an EU or domestic level. A political agreement on the legislation was made many years ago and it must be implemented on time. ESMA will soon play a bigger role in this process. In terms of trust, credibility and visibility, the most important thing is for the market to see that there are no delays in the process. Taking into account the various deadlines, as described by the other speakers, it appears that this process is on track.

### 3.4. It is vital to ensure that third-country benchmarks are properly managed

An industry representative felt that the industry should not confuse the topic of benchmarks with LIBOR, EURIBOR or EONIA. There are over 100 different IBORs in the world. These rates are very different, and they present a problem of scope. Additionally, it is vital not to confuse volume with risk. Benchmark rates affect hundreds of trillions of euros, but a large majority of that amount is held by 20 firms. These hundreds of trillions of euros do not necessarily mean hundreds of trillions of risks. Another mistake would be to confuse an authorised benchmark with a sustainable benchmark. Some benchmarks are used more frequently, such as LIBOR 12 months in Japanese yen. When an institution asserts itself as an administrator, data providers often do not want to contribute to the rate. In terms of the two-year extension, the industry representative felt that this deadline is difficult but possible for critical benchmarks such as EURIBOR or LIBOR, but it would be impossible to authorise the whole ecosystem of benchmarks.

Another industry representative suggested that problems with third-country benchmarks could have a substantial impact on rates markets, non-deliverable foreign exchange and third-country commodity markets. In a number of markets, particularly those with controlled currencies, NDFs are the typical instrument of choice for corporate treasury hedging activity. For the purposes of BMR, these indices are not centrally administered by Central Banks. The likelihood of regulators or index providers in those markets engaging with the process of recognition in the EU is slim. This suggests that banks and other financial institutions otherwise in scope of BMR should not participate in economic activity in these jurisdictions. However, these markets include Taiwan, India, China and others. Some European corporates' exposure to these markets and currencies is managed entirely legitimately through their desire to dampen FX-related volatility in their day-to-day operations, but this activity is difficult to reconcile with the obligations of the BMR. One solution to this could be a proportionality or relevance test around the nature of the exposure covered by these benchmarks.

A regulator cautioned against underestimating the importance of third-country benchmarks to the workings of the European market. The deadline extension regarding third-country benchmarks will ensure that the European market is sufficiently prepared. ESMA expects the extension to facilitate the availability of third-country benchmarks in the European markets. ESMA is confident that the European Commission will be able to adopt multiple equivalence decisions over the next few years under the Benchmarks Regulation.

# AML-TF supervision and detection

### 1. Recent ML cases in the EU and lessons learned regarding supervisor responsibilities

An official noted that the fight against money laundering and terrorist financing is a priority for EU policymakers. The EU has a solid AML/CFT rule-set in place, but recent high-profile cases raise concerns that rules are not being implemented and enforced efficiently and effectively.

Important initiatives by governments, regulators and financial institutions have strengthened the effectiveness of Europe's AML/CFT regime. Two AML Directives introduced new risk-based approaches to AML/CFT. The ESAs issued nine regulatory technical standards, guidelines and opinions on the risk-based approach and the Council adopted an action plan to strengthen AML/CFT supervision, transforming the European approach.

An industry representative informed them that work done by the Commission and other parts of the EU shows that this is a mainstream issue and a massive global problem. Some 2% to 5% of global GDP is being illicitly moved around, but it is not a problem of resources but of effectiveness. The UK's Financial Intelligence Unit is funded by about €4 million a year, according to EU figures. Assuming all EU countries spend the same and adding Europol's yearly budget gives around €0.25 billion to spend. A 2017 survey of five European countries estimated that industry had about $85.5 billion. That is €74.5 billion for AML. The supervisory challenge is to build an environment where it can be spent well.

A representative of the public sector considered that money laundering erodes the foundation of the Union by hijacking one of its fundamental freedoms: free movement of capital. Money laundering should not only be targeted because it breaks the rules but because it attacks this freedom. AML is not marginal or a by-product of banking system reform but at the core of enhanced supervision. An effective AML policy increases trust in financial institutions, supervisors and of the European project itself. Failure to address it is detrimental to institutions, business and society.

### 1.1. The current effectiveness of information flows between different supervisory bodies

An official recalled that Latvia made headlines in 2018 after the US Treasury issued a notice against its third-largest bank, ABLV Bank, according to the Patriot Act Section 311, labelling it as a foreign financial institution of concern for primary laundering. The language used in the US Treasury notice was strong and accused shareholders and employees of institutionalising money laundering as a pillar of business practices. The bank based its business model on servicing non-resident customers with transactions mostly in dollars. With a large share of shell companies as customers, the bank's business model was difficult to sustain with this in force.

As the bank's liquidity situation deteriorated, counterparties stopped working with it. It took days for the regulator to restrict payments. Within a few-day time, the ECB decided that the bank was failing or likely to fail and liquidated it according to Latvia's insolvency regulations.

This case showed that the ECB cooperates effectively with the SRB and national supervisors on mechanisms for crisis resolution within the Banking Union and even more that there were loopholes in AML supervision. Latvian reforms had already started, but afterwards unprecedented measures were implemented to ensure zero tolerance with AML/CFT issues. Substantial changes to the national legal framework were made and some are still to be amended in order to transform the banking sector. A ban on banks and payment institutions cooperating with shell entities was also introduced.

In less than one year, domestic and EU deposits reached 91%, replacing high-risk foreign clients with shell company features. Although there is a degree of harmonisation at EU level, it is not EU or national institutions that opened this process against ABLV, but a third-country: the US. AML supervision is a national competence. The dialogue between the third-country and Latvia was on a bilateral basis and did not consider the Single Supervisory Mechanism's (SSM) direct supervision of the bank.

The bank had been sanctioned at national level and was in a remediation process. As AML supervisory practices and approaches vary substantially between member states and globally, it can be assumed that the sanctions are not sufficient for other parties. A review of existing cooperation mechanisms for AML in prudential supervisors must determine if they are effective and appropriate. This case is a good study as ABLV is supervised by the SSM, with a business model based on high-risk customers. It is hard to separate AML and conduct risks.

Financial intelligence information is collected at national level in the EU and only exchanged on individual cases. Analysing and gathering information on suspicious transactions is challenging for member states, as is having an adequate level of financial intelligence and being ahead in tackling sophisticated AML schemes. New and emerging technologies can help.

### 1.2. The adequacy of existing tools and indicators

The fourth AML directive introduced a fundamentally new approach and changed expectations from a rule-based to risk approach. It is difficult to be specific at the level of a directive; so the ESAs delivered detailed guidance, via technical standards and guidelines, to establish supervisory expectations and rules for the new risk-based approach to AML/CFT.

An industry representative reminded the audience that a risk-based approach has always been important, although it might have been called another name. Ensuring that the institution makes well-informed decisions based on the risks in front of it has been core regarding credit risk for years. In the area of financial crime it is not an entirely new way to approach risk for organisations.

Such an approach has led to de-risking. In a case study, a country that disliked another's approach imposes a risk-based one, not on a bank but the entire country. Consequently, eight years ago, institutions were pushed to de-risk entire continents, such as Africa or Latin America. The pendulum has swung back, but a risk-based approach can be used for political or other issues.

A regulator noted that the amount of resources dedicated to AML is a political decision, which is derived from what is politically considered as an acceptable level of residual risk in the system. In such a context, a risk-based approach helps to spend money wisely. However, although supervisors and the private sector understand that, no one wants to be faced with such an event although very unlikely, as it is a toxic issue reputationally; such a remaining uncertainty weakens the concept of risk-based approach. Indeed, it is comfortable to use risk-based approaches where the risk distribution is the thickest. Yet, it cannot be ignored that tail events happen. A risk-based approach entails risk to institutions that pursue it, from potential draconian reactions. The pressure on industry and supervisors is such that one has to accept that the subsequent supervisory reaction could even mean a complete shutdown of certain business lines. It is then crucial to avoid any uncertainty in the risk-based approach: uncertainty may happen but not as an element of the risk-based approach.

A regulator mentioned recent events in the north of the EU that resulted in the biggest bank losing half its market cap, and the departure of the management involved, including the CEO and its chairman.

An industry representative referring to nobody wanting to be caught stressed that it should not be a blame game if many people are faced with AML cases, although trying to do the best job. If regulators and law enforcement agencies are involved, or a selection of banks and financial institutions, and they get it wrong, the consequences should be different from when everyone is hiding.

One need is to implement existing rules includes the adopted European level AML framework. When the UK set up the Joint Money Laundering Intelligence Taskforce (JMLIT), it discovered that legislative provision already existed, so it was necessary to understand the circumstances where regulators felt comfortable using it. Indeed, a bank had already obligations in the Data Protection Act to share voluntarily with law enforcement agencies, but that was not thought to be sensible. Eventually consultation with law enforcement agencies and lawyers agreed that it should be subject to an information–sharing agreement. There is no new legislation; it is existing legislation being used in a sensible way.

A Central Bank official advised that free movement of capital in Europe comes with shared responsibility, but the free movement of capital has often been opposed in order to avoid such a responsibility. This is sometimes the first line of defence of the private sector. Beyond regulators and supervisors, the private sector should understand that if not for moral reasons, short-term high profits will eventually be outbalanced by losses, penalties, criminal prosecutions and public disgrace. Know Your Customer, top management and effective internal audit are all crucial.

It is possible to lose track of initiatives. Digitalisation, fintech, cyber things, fostering innovation and capital union are acceptable, but must be balanced with adequate and coordinated supervision. Extending regulatory coverage to all financial sectors and activities, to mitigate the migration to shadow banking risk, makes this possible. Otherwise, such a blind, almost theological, trust in markets will be gone. The fight against money laundering is a public duty which contributes to public good.

Of the figures given earlier, 74% is spent on people, or about €80 billion a year. Motivation is crucial. Public-private partnership can deliver that. Talking to law enforcement agencies, hearing their priorities and responding, does not mean individual feedback on every transaction report. Feedback should give the sense of solving something and fighting crime together, not just compliance. It is not yet right in any country, but a great deal of learning is taking place. It would be wonderful for European supervisors to review the examples and consider how to bring them home, encouraged by the European institutions, so that more of this can be seen in Europe. An industry representative alluded in this respect to the Fintel Alliance, which is a public-private partnership, started by AUSTRAC in Australia. Five Australian banks and an industry partner seconded a member of its staff to AUSTRAC, to learn about receiving information and feeding it back to industry. One challenge is to motivate

Suspicious Activity Reports (SARs) writers, as they receive little feedback and can feel that they write documents that then disappear. Initiatives like JMLIT and Fintel Alliance are encouraging and should be supported to help with resource and information management.

## 2. Main regulatory and supervisory evolutions envisaged by new AML plan

### 2.1. Expected roles of Financial Institutions, the EBA and ESAs and public sector entities

AMLD4 is progress but gives rise to a worrying overlap in group versus host country responsibilities. Cooperation is desirable, but the risk of overlapping responsibilities is that nobody actually handles them.

A participant noted that resources could be better spent. Authorities sometimes misuse a risk-based approach or do not use it appropriately. It could be more effective. Case studies raise the issue of interinstitutional cooperation, which is not costly to improve.

An official noted that cooperation is a problem between countries and for national and EU institutions. Many stakeholders are involved in AML exercises. The previous year demonstrated the scale of the challenge, with the public sector also cooperating in discussions on improving effectiveness. It is easy to say regulations must change but implementation and monitoring for problems is important. The information received by ministries of finance and policymakers from supervisors is critical to targeting higher risks with policy measures. Supervisors' experience shows the importance of cooperation between prudential and AML supervisors.

A Central Bank official noted that AML can be linked to the resolution framework recently created at European level. If a national resolution authority agrees with a proposal to implement a multiple-point-of-entry strategy, European regulation requires total separability, the internalisation of IT systems and treasury activities. The local affiliate should work as an independent separate entity. A multiple-point-of-entry strategy can be granted but if not agreed between the bank and the local authority and between authorities in the euro-area or between non euro-area members and euro-area members, it is cherry-picking by the banking sector, which is to be avoided. This could create loopholes in the system.

An industry representative agreed that it is difficult for national authorities to work together. They find it hard to share, so empowering the private sector naturally arises. GDPR must be complied with but notes can still be compared. The technology exists, and industry is comfortable sharing information provided that legal boundaries exist. Leaving information sharing to national authorities and hoping that fixes the problem is not a quick solution. How junctures are made is less important than stopping criminals.

### 2.2. The consistency of the implementation of AML framework across member states

A Central Bank official confirmed that the rules must be obeyed but many are too quickly designed and changed. However, not applying commonly agreed rules weakens supervisor and regulator credibility. The implementation of FATF standards is a must. It is not optional. The current standards must be implemented in a coherent and unified way at national level, before new ones are in place. Not applying the rules creates room for discretion or case-by-case supervision which must be avoided. To address this, further transparency is needed from regulators and supervisors, together with more scrutiny and accountability for public decision makers.

Many battles were lost in recent years in Europe, so it is important not to lose more public trust in the banking sector. An understanding of the problem's significance is required. Comprehensive standards and harmonised implementation are key.

Europe is as strong as its weakest link. Recent money laundering cases in European banks raise concerns about gaps in the supervisory framework and so action is needed. AMLD4 is based on minimal harmonisation at the member-state level, setting out general principles and technical standards, including supervision guidelines, leaving implementation to member states' discretion. AMLD5 provides for the ECB concluding multilateral MoUs with AML supervisors. It does not detail provisions for cooperation between prudential and AML supervisors to facilitate timely and regular inputs. There is still an emphasis on national supervisors.

The Chair presented a question from the audience proposing that, without an AML regulation and an EU AML agency, the fight remains a game of looking for the next weakest link.

According to a speaker, the suggestion of an EU AML supervisor should be treated with scepticism, as it is hard to see how an EU institution can work with the national FIUs, court systems and police in real time. It would be a disruptive delaying factor due to the difficulty of the different national steps related to prosecution and police work.

Enhanced coordination at EU level is needed to address AML/CFT coherently and pragmatically. The Romanian presidency has significantly advanced the ESAs' review package and concluded with enhanced powers for the EBA. As capital and banking groups are cross-border, so should AML supervision be. Regional or EU-wide Financial Intelligence Units (FIUs) must be implemented. The FIU is risk-based and focused more on terrorist financing than on money laundering but its remit must expand and be followed by feedback to others.

A Central Bank official advised that the basic tools and rules exist but were not implemented by all or identically. Giving more powers to the EBA is good. The creation of a super-institution against money laundering at a regional or European level would be welcome but should not stop the implementation of what already exists. Two more years to build a new institution and elect a board should not be an excuse. The rules exist and should be applied. The guidelines have been agreed. The framework for exchanging information between the ECB and competent authorities was signed in January 2019.

There is no incapacitation caused by a lack of tools but a common will to implement them is needed, with coordination and cooperation between national authorities under the European umbrella. It must occur not only within the EU, because capital does not stop at borders.

An official agreed that discussion about an EU institution is not an excuse not to implement or apply rules or regulations. AML directives have minimal harmonisation. Within the Banking Union, regulations have options and discretion for countries, which creates room for further regulations. Regulators should evaluate sanction worries across member states. It is premature to say that an EU supervisor is needed today. First steps were taken and regulation regarding the EBA adopted. Time is needed to see how it works. Even with existing improvements, something more will be needed. It requires a positive, European approach.

The Chair asked private sector representatives to consider whether the ideal ambition level is to move from directive to regulation or tighten the regulatory framework and institutional setting.

An industry representative noted that it should not mean the lowest common denominator. An example is AMLD5 and AMLD4 before it asked for beneficial ownership registers for every EU country. Government-verified information would be great. Some countries will do that better than others and some will find legal challenge locally. The industry wants the type of beneficial ownership register that does the best job. Total harmonisation might not be in industry's interest but generally, every discrepancy between regulatory regimes is a problem. A regulator agreed, noting that harmonisation should not be tied to the lowest common denominator.

### 2.3. The opportunities offered by new technology

A regulator advised that problems in EU banks were stopped by courageous Estonian colleagues who inspected and requested the closure of the non-resident portfolio. The bank threw out 15,000 customers, a 10% share of the Baltic market of non-resident customers at that time, but no one knows where they went. Technological customer reporting infrastructure at the European level could help banks identify customers who were dumped from elsewhere.

This requires more data recording, data reporting and data assessing. For many regulators and supervisors, either not enough data is being reported and recorded or the capacity to interpret micro-level data is insufficient.

There is scope to use technology more. It is an obvious area for a European institution, as the information is useful across the EU. Technology should also make the Know Your Customer process easier as existing electronic IDs could be used more easily than physical documents. Technology can help spend resources more wisely, so the EU should make that leap.

An official noted that technology is an important part of the debate. Attempts to strengthen systems and existing IT tools already lag. New technologies and methods for data analytics and transaction monitoring are needed. Further cooperation enabled by the JMLIT's proposals introduced into the legal system, is bearing good results with investigators, but the first analytical work is difficult, as shown from the public sector side. New technologies can help.

A speaker insisted on the fact that instead of focusing on a EU AML supervisor, efforts should be made to establish a register and infrastructure about dicey customers and issues where technology can help. Technology should be used in coordination with the FIUs. That could be developed by using AI and machine learning on FIU data. That should be done at the EU level, because there are conflicts with GDPR that can only be addressed there. It is hoped that the issue will be on the EU's agenda during the Finnish presidency.

A Central Bank official noted that financial services can be hesitant to employ new technologies without a seal of approval from a regulator. The feeling of the first mover's disadvantage is not the right way to roll out technology. Contextual transaction monitoring has been successfully implemented. AI deserves consideration. Onboarding and getting to know the customer through electronic IDs, is a low-hanging fruit to consider.

❖

# Non-bank finance risks

## 1. The current regulatory framework and on-going work at the international and EU levels

### 1.1. On-going regulatory work at the international and EU levels

An official noted that the FSB released in January 2017 policy recommendations to address structural vulnerabilities from asset management activities, complementing the IOSCO recommendations on money market funds (MMFs), which have now been rolled out in the main jurisdictions. The FSB observed at the time that asset management is not an area that is unregulated, but that two particular areas – liquidity risk management and leverage within funds - could be a matter for concern. IOSCO was requested to provide more detail for the implementation of the measures proposed by the FSB and subsequently published additional recommendations in 2018 in relation to liquidity risk management. Work on leverage is still underway and due to be finalised by the end of 2019.

With this process there has been a significant increase in awareness and understanding around potential systemic risks both on the industry and policy-maker sides and further guidance has also been provided domestically, particularly regarding liquidity risk. A number of industry participants have stepped up their internal risk management processes. This dialogue has been very healthy, and the ESRB has also made five recommendations to further strengthen the European framework. These include, among others, the improvement of data collection, as well as the availability of liquidity tools to investment managers.

Another official mentioned that IOSCO recommendations to improve liquidity management practices focus more particularly on open-ended investment funds. In the EU, the ESRB recommendations issued in 2018 to address systemic risks related to liquidity mismatches and the use of leverage in investment funds are now in the hands of ESMA and the European Commission.

An industry representative had one concern regarding the current actions of IOSCO on leverage. There is a legitimate objective of IOSCO to facilitate the calculation and monitoring of leverage at a global level. However, the EU is the most advanced region in terms of calculating leverage, due to UCITS and AIFMD requirements and it is important that IOSCO recommendations should be consistent with the calculation methods for leverage currently used in AIFMD reporting. Otherwise, that would generate additional burden without any added value.

In addition, regarding future regulatory actions, the EU should not go beyond what is already being defined at the global level, the industry speaker felt. The FSB has started to assess the measures adopted post-crisis, and the EU should avoid launching any new initiatives at least in terms of Level 1 legislation before this assessment is completed. Finally, updating the guidelines issued in 2010 by CESR, the predecessor of ESMA, on risk measurement in funds would be useful, since there have been changes in the market since then such as the further development of credit and exotic derivatives.

### 1.2. Framework and toolkits implemented in the EU and impacts in terms of risk mitigation

An industry representative emphasized that current EU fund regulations work well in terms of risk mitigation, as demonstrated by assessments published by ESMA in its latest quarterly report on 'Trends, Risks and Vulnerabilities' (February 2019). ESMA has done a specific assessment at

EU-level of alternative investment funds (AIFs) and found no sign of significant liquidity mismatches. On leverage, the maximum gross leverage is around 1.3, or 130%, for the whole scope of AIFs, excluding hedge funds, bearing in mind that this is a gross and not a net (potentially lower) measure of leverage. Additionally, the ESMA statistics show that the maximum gross leverage is stable since 2016. Regarding borrowing, AIFs ultimately have a borrowing that is less than 10% of the NAV, which is interesting as UCITS are capped at 10%. In terms of evolution of liquidity and leverage risks, as it stands today the data shows they are stable in Europe and still relatively low. Additionally, there has been no failure of funds in Europe or no systemic issues related to funds in the recent years, despite market events such as the euro crisis and the Brexit referendum.

Going forward it is expected that the on-going monitoring of the activities of funds from a systemic risk perspective will improve, the industry speaker considered, since this is a requirement of AIFMD. More generally the mitigation of systemic risk is a key objective of AIFMD and there is a requirement to ensure cooperation on this between ESMA, the ESRB and the national competent authorities (NCAs).

A speaker explained that in France, legislative changes have been made to ensure that a comprehensive fund framework is in place. At a regulatory level, different liquidity management tools have been introduced including notice periods and swing pricing, which complement the ability already contained in EU legislation to suspend redemptions. The law was also changed to introduce temporary suspension of redemptions, in the form of redemption gates. Changes in the French law also took into account the impact of gates at the underlying fund level for unit linked products sold by insurers.

The French securities regulator, the AMF, has also improved the monitoring of risks. A first study was published on the French AIF market aiming to improve the understanding of market-wide trends. The AIF market in France includes around 5000 non-UCITS funds representing €700 billion assets under management. The 'others' category accounts for €385 billion comprising many very basic traditional equity, bond and diversified funds that are largely "UCITS like" funds that have opted not to be authorised as UCITS, generally because they do not intend to use the EU passporting system. The size of the highly leveraged hedge fund segment is very limited (0.6% of AIFs). The French market has exposures mainly in euros and the figures are quite consistent with those put out by ESMA.

On liquidity, the AMF found that the percentage of liquidity of AIF funds managed by French asset managers is consistent with the strategy defined by the managers. According to the AIFMD reporting, managers expect that for open ended funds, a large proportion of assets can generally be liquidated within one day. For those funds, daily liquidity is reported at 50%, and reaches 80% for assets that can be liquidated within a week. With private equity funds, which generally are closed-ended, there is only 5% that can be liquidated within a day. For real estate funds, it is 15%. Secondly, the liquidity declared largely covers the liquidity that it is estimated would need to be given back to investors. This means that in normal times managers should be able to meet redemptions, although of course further monitoring is needed.

On leverage, the data is also consistent with the fund strategies. Real estate funds report 150-200% leverage ratios. Money market funds and equity funds report low leverage ratios around 100-120%. For the 'other' AIF category, leverage appears at 130-150%. Supervisory actions are taken in connection with the manager on a case-by-case basis, when erratic or inconsistent leverage is identified.

Following an observation by an official that France has more liquidity management tools available than most other EU member states, as shown by an ESRB report, an industry representative suggested that it would be beneficial if other EU member states would implement these tools also.

**2. Emerging risks in the non-bank finance sector and issues raised by leveraged loan funds**

An industry representative stressed that when scanning for emerging risks it is important to distinguish between systemic and market risks. Systemic risk relates to severe market disruptions that have serious negative consequences for the real economy. By contrast, market risk is present in markets at all times and reflects normal price adjustments. Much of the conversation about emerging risks conflates the two. In addition, it is important to bear in mind that the vast majority of funds are vanilla funds without leverage. In the case of the speaker's institution – a major asset manager - alternative funds, including hedge funds, private equity, real estate, infrastructure funds etc. do not reach 2% of the total.

In terms of emerging risks, the only one which comes to mind is leveraged loan or bank loan funds. It is a small asset class, of around $1 trillion in the US, but it is growing fast. The majority by far of these loans are in the US. This is an asset class with a longer settlement period, typically two weeks or longer, rather than a couple of days. Only some of these funds have liquidity risk. 60% of the funds are CLOs or closed-ended funds that have no liquidity risk. Another 20% are separate account funds dedicated to a given institutional client: these have no liquidity risk as the investor has control over the assets and the ability to redeem as desired. Around 20% are open-ended funds or ETFs, which do have some liquidity risk. A leveraged loan open-ended fund will need a more robust liquidity management than a vanilla bond fund to manage this increased risk, whereas ETFs with in-kind redemptions mitigate such risks. Another aspect is that the EU business and regulatory models do not support the establishment of open-ended AIFs with portfolios of bank loans, preferring closed-ended structures, unlike the US where both exist. Concerning ETFs, the list of firms that offer them even in the USA is fairly small.

When assessing the risks posed by these funds in the US, the lesson is the importance of having robust liquidity management and managing appropriately the percentage of truly illiquid assets they contain. A solution could also be for regulators to reduce the settlement period through regulation, although the industry representative noted that during the market stress at the end of last year and start of this year, industry participants worked together to reduce the settlement period from around 15 days to 8 days on average.

An official emphasized that the growth of corporate leverage financed by non-banks is a relatively new issue at the international level and that there are hardly any tools to address the related issues. The existing policy tools are predominantly administered through banks, including borrower-based tools, but there are no prudential tools to address specifically risk related to corporate debt funding by non-bank lenders. Some EU countries have expanded the set of borrower-based tools and impose loan-to-value ratios (LTVs)[1] on households to all providers of mortgage credit. However, there is nothing like that for corporate borrowing. In the US there is a borrower-based tool, the intra-agency guidance on leveraged lending issued by US regulators, which describes expectations for the sound risk management of leveraged lending activities. However, this only applies to institutions supervised by the Fed.

Another official noted that an evaluation has begun in the EU of the need for borrower-based measures at a corporate level. There may be a situation where corporates are insufficiently capitalised, and are living thinly on the basis of leverage, either from banks or issuance of securities. The problem is that if the economy is going down, these companies will not have a strong enough capital base and this may have disastrous consequences.

### 3. Respective roles of micro- and macroprudential polices in tackling systemic risks

#### 3.1. The possible need for enhancing macroprudential approaches in the non-bank finance sector

An official noted that growth in non-bank finance has been observed, which is very welcome. Complementing a traditionally very bank-based European system with non-bank finance has proven helpful in various countries recently. At the same time, there has been a need to pursue very accommodative monetary policies by Central Banks, despite the risks this creates, underscoring the need to expand the toolkit to counteract a build-up of vulnerabilities in this context. Progress has been made in the mitigation of systemic risks but most countries do not have a developed set of tools in the macroprudential area. There is variation, but the toolkit in most countries in this area is far from complete according to the annual survey performed by the IMF.

Another official did not see an opposition between micro and macroprudential policies. It is important to define an approach where these tools can interact together. A third official agreed that progress has been made in the assessment of risks associated with non-bank finance and views have converged in the last few years. Initially there was concern that risk might be shifting out of the banking sector into less regulated areas without the tools or understanding to properly address these risks but these issues have since been clarified to a great extent.

#### 3.2. Combining micro and macro-prudential approaches in the asset management sector

In the asset management sector the responsibility is first and foremost with the asset manager, a speaker recalled. They know the circumstances in which risks appear, have the information, and therefore are the best placed to act in case of stress. The problem is if the stress is market-wide. There are then questions around what tools are needed, the roles of various stakeholders in the market, and the dialogue needed between micro and macroprudential authorities. The thinking on this is still underway and progress should be possible thanks to the better understanding of these issues that has developed in the market and the greater availability of data and tools. Macroprudential authorities are assessing the risks associated with the development of non-bank financing and the tools available to address them. This is the case in France in the HCSF[2]. Stress tests have been conducted at the national level in France to assess the impacts on the non-bank sector of potential shocks e.g. a commercial real estate shock, and issues potentially raised by interconnections with the banking and insurance sectors.

It was argued that much can be done at the so-called microprudential level, which can meet the goal of what macroprudential is supposed to achieve. The AMF for example has ensured that managers are equipped with the necessary tools for the first level of defence in terms of liquidity management. A number of tools are also available at the authority level. Soft interventions are possible and guidance can be issued. Stronger actions can also be taken, such as gating or the suspension of redemptions for a single fund or a group of funds. Also, the EU fund framework allows leverage to be capped, which can be done where active monitoring shows a build-up of leverage in a given country or market segment. This is one of the ESRB recommendations, and work is ongoing on implementation. Care is needed however about potential market effects of intervention in a volatile and unstable market, which might have unintended consequences.

An industry representative stated that potential risks in non-bank finance are best managed through market-wide data-gathering and monitoring of trends in activities and products, combined with a targeted supervisory focus where risks have been identified. Whilst market surveillance might be called macroprudential, any actual intervention should be micro-prudential - i.e. at the fund level - to be effective. It also needs to be proportionate, given the diversity of funds, and to preserve investor confidence and a continued investment in funds, given their importance for the development of capital markets in the EU. Ensuring that supervisors and fund boards have available the full range of ex-ante and ex-post tools will be most effective in addressing systemic risks.

The IOSCO work on leverage is a perfect expression of the combination of micro and macroprudential approaches, as stage one of the recommended process is a market-wide assessment of leverage levels across all funds with different criteria, followed in stage two by a deep-dive into funds that appear to have high leverage. Leverage, though, is not a perfect expression of risk, and hence stage two should look at VAR, for example stress testing the real mark-to-market potential losses, and having a framework for counterparty risks, or looking at how much liquid assets individual funds have to meet margin calls. That detailed information would help securities regulators to focus on particular fund issues and have fruitful conversations with fund boards about for example, whether the fund board should reduce leverage or suspend redemptions. This illustrates that market-wide data and then focused action is what is required.

One example of a potential macroprudential tool that would be very harmful would be mandatory cash buffers, kept high in good times and drawn down in bad times. This could negatively impact the long-term investment performance for the end investor. Currently, investment fund investors are a mix of retail, high net worth and smaller institutional investors. If the investment performance is reduced by a high mandatory cash buffer, the more sophisticated investors can consider alternative vehicles, but retail investors have fewer alternatives and if they stay invested, receive lower investment returns, which may impact retirement revenue and, ultimately, the fiscal situation in a number of States.

#### 3.3. Data gap issues

An official noted that despite a great deal of progress, significant data gaps remain overall. On leverage, UCITS have a leverage cap, but there is some concern with synthetic leverage on which there is not much data in most jurisdictions. Another official agreed that there are still some gaps, but many improvements have been made with the recent reforms. Supervisors now need to pull all the data together and make it meaningful.

An industry representative emphasized that supervisors are provided with vast amounts of data; both the standard data submitted periodically for each jurisdiction, and also additional data corresponding to occasional requests from supervisors. For example, some countries asked for enhanced liquidity reporting, which shows that they are looking at not just the market level, but fund by fund. With Brexit, daily information on bond funds is also being provided in certain countries. The issue is improving the quality of the data and the processes for providing it. Whilst much has been done, in the future hopefully there will be some form of automated standardised reporting. Asset managers also need better data. Having transparency through omnibus accounts has been proposed, not for individual clients of a bank or a distributor, but to have visibility of the composition of different client types. Each client type behaves slightly differently, and that would help asset managers to make better decisions.

An official noted enormous progress on data. Requests for data on specific areas or where there are issues can now be answered by the ESRB in a few hours. In terms of managing big data, they are completely ahead of the curve.

An industry representative added that progress is also visible on the derivatives side, but at a fund level it is more challenging due to the number of different providers of different sets of data. A qualitative assessment is required to understand the data, as the same data can be used in different ways, with reporting through the securities regulator. There will never be instantaneous fund-level reporting.

An industry representative noted that in the context of liquidity stress testing, there is a need for information from intermediaries on the investors who invest in funds. If funds are not self-distributed, then it is up to the intermediaries to provide the information and asset managers cannot be held responsible if appropriate data is not provided. Another point is that the easiest way of addressing data gaps is to give the supervisors and regulators the raw data at a portfolio level, in order to avoid duplicate calculations, since investment managers already perform their own calculations that may be different from what supervisors want. In some countries, inventories of funds are already being given.

1. Loan-to-value (LTV) ratio is an assessment of lending risk that financial institutions and other lenders examine before approving a mortgage. Typically, assessments with high LTV ratios are higher risk and, therefore, if the mortgage is approved, the loan costs the borrower more. Additionally, a loan with a high LTV ratio may require the borrower to purchase mortgage insurance to offset the risk to the lender.

2. The "Haut Conseil de Stabilité Financière" (HCSF) is the macroprudential authority in France. It is chaired by the Minister of Finance, and brings together the Governor of the Banque de France, the chairman of the ACPR, the prudential regulator, the AMF, the authority of accounting standards and three highly-qualified external economists.

# Insurance comprehensive risk framework

## 1. Approach to the framework

### 1.1. The holistic framework strategy

An official explained that IAIS is close to completing its project. It has developed and consulted on the framework, which has been strongly encouraged by stakeholders and in discussions with the FSB. The approach recognises the specific nature of the insurance business model. IAIS has a different approach to the banking sector and asset management sides, recognising that insurance activities are not inherently seen as systemic, but insurers nevertheless engage in activities and build-up exposures that could be systemic in the collective.

IAIS has ended up with a holistic approach in the sense that it recognises systemic risk can come from collective activities and exposures in the insurance sector, but that does not mean it is completely devoid of an entities element. Recognition is needed that those activities and exposures can be more concentrated in particular entities. Consequently, IAIS needs to continue to monitor and respond to that build-up at the entity level.

Entities-based approaches (EBA) and activities-based approaches (ABA) target similar exposures, but the risks that are propagated differ. EBA is a systemic impact given default effect; the ABA looks more at the collective build-up, which leads to systemic risk. Both sides need to be examined in a holistic way and recognise that both types of propagation can exist. It is also holistic as it is moving away from the previous binary approach, which had prescribed predetermined policy measures applied to a narrow list of a few insurers.

The examination also looks at activities and exposures more generally and applies policy measures in a proportionate way, which are targeted to a broader section of insurers, informed by activities and exposures, rather than starting with the entities themselves. This general direction has been strongly supported in stakeholder comments; a holistic framework that is properly and consistently implemented provides a better approach to systemic risk in the insurance sector than a G-SII (Global-Systemically Important Institution) approach. The IAIS focus is on consistent implementation.

A regulator noted that the holistic framework does not want to simply be a set of policy measures. It wants to be a framework for action and co-ordination between the supervisory authorities to detect any building up of systemic risk as soon as possible and assess whether those threats are being properly addressed. A part of the framework tries to integrate the current supervisory material of IAIS by introducing ongoing policy measures that should mitigate sources of systemic risk. There is also integration of supervisory material by adding a toolkit for supervisors, which has a number of powers of intervention that could be used when necessary and the circumstances require it.

The rest of the framework comprises a monitoring part at the level of the IAIS, which should complement the monitoring of national supervisors. That has the purpose of gathering all the information that is necessary to detect any building up of systemic risk at an individual and sector-wide level as soon as possible.

The other element is how information gathered from this monitoring could be rationalised and interpreted by a joint assessment of national supervisors. In the collective assessment phase national supervisors should make their national assessment a global assessment in order to detect global systemic threats, and also to be confident that those potential systemic threats are known and being addressed properly.

Collective framework ensures consistency of application of the policy measures, but its main purpose is to make all supervisors aware of the level and trend of global systemic risk and to have confidence that national supervisors are taking care of those threats. The final component of the framework is the implementation assessment. There should be an exercise at the IAIS level to check how individual jurisdictions apply the ongoing policy measures and any powers of intervention.

A regulator supported combining or extending the old systemic approach, by including the broader perspective of sector-wide activities and the behaviour of insurance companies. The whole framework will enhance the management of risk of the companies, ICPs and ComFrame.

Proportionality is key. Not every measure is to be extended to every firm, but only if there is a need to address certain firms that engage in certain activities and fulfil certain criteria. What is missing are papers on the application at a different level, which will follow in the second step.

There is a lot of common ground with the European approach, and the global and EU frameworks are covering similar risks, transmission channels and perspectives.

A regulator summarised that the framework is well designed. There is a general recognition of the need to assess the build-up of systemic risk from both the industry and the supervisory community. Following an approach specific to the insurance sector goes against the approaches used in banking. Commonality and consistency are needed between micro and macro supervision, as well as integrated frameworks. One of the distinguishing characteristics when comparing insurance to banking is the need to have a holistic framework which goes beyond individual assessment and has more horizontal view of the activities that may pose a threat to financial sustainability. Proportionality is key, which is also widely recognised. Success depends on implementation and how the supervisors will work together.

### 1.2. Key success factors to benefit from the implementation of the framework

An industry representative stated that the EIOPA paper released in March 2019 is a good framework for discussion on whether a macroprudential framework is needed.

Their company's core business is long-term in nature and its investment strategy tends to be risk-averse, so it considers the insurance industry to have a limited source of systemic risk. Therefore how the framework is implemented is very important. In particular a cost/benefit analysis of the framework is needed before it is implemented. It remains to be demonstrated that the added value outweighs the cost.

The fact there would be an application of proportionality is positive, as the private sector felt that is a critical success factor. Drastic measures such as resolution should only be applied where there is demonstrable evidence that material risks to the global financial system exist.

If macroprudential supervision is needed for insurance, then it should be tailored for insurance. Within that, consideration is needed on leveraging some existing tools. The Solvency II framework already requires the private sector to consider short-term and long-term risks, which provides support for both a micro-prudential and a macro-prudential view.

An industry representative stated that their company has had a good introduction to the holistic framework. One of its most positive aspects is its renewed emphasis on macroprudential surveillance, which the company strongly supports. The representative stressed that the real measure of risk is how an activity is managed, not whether it exists or not.

The success of a holistic framework is the ability to identify, address or mitigate the effects of the next systemic crisis. Annual quantitative data is good as a baseline, but the goal of systemic risk management needs an assessment through a systemic risk transmission channel lens. The two traditional channels of systemic risk that are relevant to the insurance sector are: analysing what makes a party think there is an asset-liquidation risk, and what it could lead to for counterparty exposure.

Critical services to the functioning of capital markets can largely be put aside for the insurance sector.

A regulator felt that the advantages largely outweigh the shortcomings and the costs. Most ongoing policy measures that will be integrated in the supervisory material are not new. More detailed and enhanced policy measures are trying to include good practices in risk management. Appropriate management of liquidity risk, which is one of the most substantial aspects being dealt with, are already – or should be – part of risk management of the companies.

Some National Supervisory Authorities have spent a lot of time doing a gap analysis between the current rules and what should be a regulatory framework that can address systemic risk. It is integrating certain policy measures that have a micro purpose. They are there to reduce the probability of failures of the companies and to protect the policyholders. In doing that, companies should also reduce the probability that these exposures lead to certain externalities in the case of shock. Respective processes should be cost-efficient for the majority of companies.

An industry representative explained that the key is for the emphasis not just to be on annual quantitative data, but rather a forward-looking analysis of the new and emerging risks and trends. Historically insurance was only a small component of most financial crises.

### 1.3. Combining macro and micro, global and domestic and quantitative and qualitative elements

An official explained that this is an integrated framework, every element of which is needed for it to work effectively as a whole.

Supervisory policy measures form the pre-emptive part of the framework, which are requirements on insurers that should help with mitigation. That should be 80% of the framework. If insurers have proper risk management in place, then these activities and exposures should not have the potential to become systemic in the first place. The famous example of AIG was more of a problem of risk management than anything else. This was not an additional cost because these are things that insurers should be doing anyway as part of good risk management. IAIS's global monitoring exercise builds from supervisors' own macroprudential surveillance at a jurisdictional level.

There is then a quantitative IAIS data exercise. Quantitative and qualitative analysis is needed to achieve various objectives. The first is to check that the policy measures have been an effective mitigation. It is also necessary to see whether there are trends or a build-up in potentially systemic activities and exposures. In addition, there is also a forward-looking part, which is where the qualitative aspect is more important. Indeed, an important element of the overall risk framework is to identify the emerging risks that need to be looked at. Thus, a global response to concerns is needed, as systemic risk in the global insurance sector is at a global level and is a global problem. A consistent and collective response to systemic risk is a key success factor.

The current framework has micro-prudential requirements, but some of them automatically give private companies some macroprudential governance, surveillance and supervision. Another Solvency II example is long-term guarantees. There is volatility and a matching adjustment, which in some respects goes to the macroprudential part of Solvency II. A regulator noted that in Europe the 2020 Solvency II review could include some macroprudential elements.

An industry representative believed that those questions are for IAIS and EIOPA, as the proposals refer to bringing both elements together. The question from the private sector is how IAIS and EIOPA envisage that happening. For private companies the consideration is more on how IAIS and EIOPA will leverage the pieces that already exist.

### 1.4. Interaction between Insurance Distribution Directive (IDD) and the framework

A regulator stated that he had not heard of a deep analysis of that. Care is needed to ensure that the outcome is not that the only systemic risk in insurance is conduct risk.

A regulator felt that this is an interesting question because market conduct issues could lead to some kinds of systemic impact. IDD should work by mitigating any market conduct issues in the lack of credibility of the overall insurance system or generalised mis-selling of products. Depending on the size of those phenomena, some issues may need to be addressed at the national level, but possibly also at the global level.

## 2. Envisaged tools

### 2.1. The tools to use for identifying risk and coordinating the response

A regulator explained that the framework is based on monitoring and its quality is key. It is there to detect any build-up of systemic risk, but nobody knows what the source will be of any future crisis that threatens financial stability. The monitoring system should be efficient but also wide in detecting any possible concentration at both market and individual levels of exposures that could lead to systemic risk. It takes into account inward risks, which are risks from the wider economy that could impact insurance, and outward risks that the insurance or financial sector could bring to the economy.

The collective assessment has the purpose of determining a coordinated response, which could be based on different types of tools. The system has the advantage of being flexible in its supervisory intervention. If used properly that is an advantage of the system, because the supervisor will be able to use the right tools for certain situations. The main shortcoming is that it depends on the behaviour of supervisors and companies and is not only a question of the design of the framework.

Regarding costs, it is important not to overburden the companies with data collection. Current data collection is focused on individual companies, but the focus is on integrating that with market-wide data collection. This must be cost-efficient and based on data that supervisors already have at their disposal.

### 2.2. Liquidity risk requires particular attention at both macro and micro levels

An industry representative stated that there is a need to focus on systemic risk transmission channels, liquidity being the principal one that regulators should focus on. In the US, the National Association of Insurance Commissioners (NAIC) has launched a macroprudential initiative, the key component of which is a liquidity risk framework and liquidity stress-testing. They have identified 23 of the most relevant insurers who will be required to do periodical liquidity testing. This is consistent with what all insurers in the US above a certain level have to do with their own risk and solvency assessment (ORSA).

At a micro-prudential level every company should have an ORSA that identifies key liquidity risks and makes sure they have all internal controls in place. If any of those risks materialise, their response should already be identified. The NAIC will have baseline scenarios that insurance companies will be able to demonstrate periodically for whatever area they are focused on across the sector.

### 2.3. Should discussion of capital be included in a macroprudential framework?

A regulator believed the 'elephant in the room' is removing individual specific designations in the whole approach. Everybody who is interested in getting off the list should encourage everybody else to implement the holistic framework as much as possible.

An industry representative felt the starting point for this intervention could be using the right tool to properly identify and address the risk.

Private companies need to start building up capital. If a company is a money-centred bank then they are systemic, and resilience and capital buffers make sense. However, insurers are also trying to address asset liquidation, exposure concentration through limits that they already have in place. Through ORSAs insurers can demonstrate to the regulators if they are sectoral, geographical or even counterparty exposures. Insurers do a lot of work on that, and the industry should be proud of that. Consequently, the added measures being discussed here would be a cost that is not worth the benefit.

The next aspect that private companies will see is the preventative measures in June. The IAIS will come up with improvements to ComFrame, ICPs, and liquidity risk management. Their company is comfortable with that, but the trend that is causing worry comes from accepting the transmission channels of liquidity or asset sales, and then concentration risk. Discussion is needed about the right tools to go with those types of risks.

An official noted that insurance is different from banking. There is recognition that capital is not a good first stop when dealing with systemic risk in the insurance sector, which is different from the G-SII approach and HLA (Higher Loss Absorbency). The G-SII framework is currently still in existence and will only be replaced by a holistic framework once there is credible implementation. A temporary capital add-on in the optional regulatory toolbox is not a recommended regulatory tool, but potentially could be one. Omitting that from the toolbox would signal that temporary capital add-ons were never a solution to systemic concerns, which the IAIS was not prepared to state.

A regulator asked panellists whether discussion of capital should be entirely ruled out when it comes to a macroprudential framework. All panellists agreed that there should be no discussion of capital in that context.

An industry representative noted there is an important role for capital to play in every solvency system. Micro and macro should be integrated because similar risks are often looked at from a macro perspective. Outside the insurance sector, all the work that has been done on derivatives is one of the most important areas where insurance potentially has systemic relevance.

A regulator agreed, but believes it depends on what kind of capital charge is being spoken about. A permanent capital charge could be disregarded but could not be ruled out as being a useful intervention tool.

### 2.4. Next steps and finalisation

An official stated that if everything goes according to plan then the framework will be adopted in November 2019 for implementation in January 2020. If the FSB is comfortable with the proposed holistic framework then it has agreed in November 2019 to suspend the G-SII identification. It will make a final decision on whether to completely remove the G-SII framework in November 2022 based on the experience of the IAIS and its member supervisors' consistent implementation of the framework.

A critical part of the overall success is consistent implementation of the framework. The IAIS has said it will have a robust implementation assessment process over 2020 until November 2022 to encourage the consistent implementation of the framework. Following that there will be an annual cycle of the global monitoring exercise, looked at from quantitative and qualitative perspectives.

Regarding next steps, the IAIS will publish things in the middle of June. The first will be resolved comments on the consultation document that had been released in November last year, but also a new consultation for public comment that will outline a specific drafting of the ICPs and ComFrame to give effect to policy measures being proposed. IAIS also aims to provide an update on other aspects of the framework such as the global monitoring and implementation assessment sides. There will be a comment period until August and then an intensive period in IAIS over September and October to finalise the proposals, discuss them with the FSB, and build the FSB's endorsement of that approach.

A national regulator believed that work is needed on bringing the holistic framework through. Implementation is key, and the next step to take. In Germany, BaFin is committed to contribute to very intensive implementation, but it does not mean that everybody will be ready on the first day. Everybody will take time to adjust to the framework, to assess what has already been implemented and where changes will be necessary. Proportionality is key. The FSB is expecting IAIS to deliver and it is committed to doing that.

# Implementation of EMIR 2.2

### 1. Key elements of EMIR 2.2 and next steps

A Central Bank official explained that EMIR 2.2 aims at ensuring financial stability in the field of central clearing and addresses two main issues. First, EMIR aims to foster the convergence of CCP supervision in order to prevent regulatory arbitrage and mitigate any cross-border spill-over effects from the potential failure of such an entity. The compromise reached with the new regulation allocates responsibilities amongst national competent authorities (NCAs), Central Banks of issue (CBIs) and ESMA, which is granted new powers with the establishment of a new supervisory committee. Second, it creates a proportionate, risk-based approach for third-country CCP supervision with additional requirements for CCPs that are systemically relevant to the EU. The EMIR 2.2 trialogues are now over and the legislative text is finalized. The European Parliament will be voting on the final text around mid-April, to be endorsed by the Council shortly after. The challenge now is to ensure the effective and smooth implementation of the new regulation, and the swift adoption of the technical standards. This should be complete by October 2019.

Another Central Bank official agreed that achieving higher consistency and coordination among EU regulators and on regulatory practices is essential in this area, given the importance of CCPs for the stability of the European financial sector and in view of the increasing interconnectivity of the financial system. Another important element of the EMIR 2.2 legislation is the acknowledgement of fiscal responsibility at the national level. Third-country CCPs will have a centralised supervisory recognition regime, with ESMA at the head of the system and also an increased role for Central Banks of issue (CBIs). For EU-based CCPs, the NCAs will continue to play the most important role, but nevertheless the CBIs and ESMA are strengthened in their roles and activities. Colleges now see more space for their opinions also, and the possibility to deliver ad hoc specific recommendations. The new setup has more transparency also regarding the composition and the workplan of colleges.

### 2. Expected impact of EMIR 2.2 on cross-border EU CCP supervisory processes

A regulator considered that there are only marginal changes for EU CCPs compared to the current EMIR environment. The ultimate supervision responsibility will remain with the NCAs in charge. There is a wider role for colleges, particularly concerning shareholder changes and outsourcing. There is also an obligation for NCAs to ask opinions from ESMA in certain areas, such as authorisation and access requests from trading venues and NCAs can ask ESMA for views in other areas. In terms of governance, the decision-making will remain with the ESMA Board of Supervisors, but there will be a new supervision committee under the Board of Supervisors taking charge both of the EU CCP supervision work, and the third-country supervision work.

A Central Bank official noted that the negotiation of the allocation of responsibilities and decision-making powers between CBIs, securities regulator, ESMA and others had been complex and that there is probably still room for improvement and mutual learning regarding supervisory practices. There is a trade-off between the cost of compliance for regulated entities, and the cost of supervision from the authorities' side, which is increasing. This has already been seen under EMIR 1. There is a learning process from the authorities' side, therefore conclusions on the effectiveness of this new process will need to be drawn in a few years' time.

In addition, whilst the tiering criteria for third-country CCPs are welcome, there is a gap in that all EU CCPs are considered systemically important under EMIR 2.2, the official emphasized. Therefore the same measures are applied to EU CCPs whatever their size, the currencies they deal in, or their shareholding or customer base. It is however difficult to say that all EU CCPs have the same risk profile.

An industry representative regretted that almost nothing will change regarding the supervision of EU CCPs and considered EMIR 2.2 as a missed opportunity in that area. In the end the authorisation and decision-making processes will remain with the NCAs, even if ESMA and the CBIs are consulted on some aspects. The negotiation took place in the very specific context of Brexit, but Europe needs to be globally more ambitious in the promotion of supervisory convergence. Credibility at the international level is important, and if ESMA cannot speak with a united voice and represent the interests of EU member states, this is problematic. Regarding the implementation phase, it is necessary to clarify a number of aspects, notably concerning clearing members, and the Level 2 measures will be helpful in this regard.

Another Central Bank official believed that the fact that changes are limited with the new regulation for EU CCPs is the result of a compromise. There should however be an improvement of cooperation, convergence and consistency in supervision, which will become more apparent after implementation, meaning that the new regulation is more positive than it may appear. Following a question from the audience about whether Central Banks should supervise clearing houses, the official indicated that the ECB has withdrawn its recommendation to modify Article 22, meaning it will no longer ask for a supervisory role on clearing houses, and have only a consultative role.

### 3. Issues to be considered regarding EMIR 2.2 requirements for third-country CCPs

#### 3.1. EMIR 2.2 objectives regarding third-country CCPs and next steps

A regulator felt that that the adoption of EMIR 2.2 in the current legislative period is a positive result, given upcoming changes. While EMIR 1 introduced a very open equivalence system for allowing access to the EU market for third-country CCPs, the potential risks to the EU market from these CCPs are not appropriately reflected. Improvements will be made in EMIR 2.2, particularly regarding systemically important third-country CCPs, the so-called tier 2 CCPs. It is important to emphasize however that EMIR 2.2 provides a proportionate regime, distinguishing between third-country CCPs which are systemically important, and the vast majority of (non-systemic) third-country CCPs which will effectively remain under the same regime as at present. The new regime provides the European authorities with more powers to monitor tier 2 CCPs and to ensure compliance with EU requirements where necessary. This will make it possible to mitigate systemic risks, and will create a level playing field with EU CCPs. Additionally, EMIR 2.2 offers the possibility to consider the relocation of substantially systemic CCPs as a last resort, following potential recommendations from ESMA and the relevant CBI to the Commission.

The regulator stressed that the next steps are for ESMA to provide the Commission with advice for drafting the relevant delegated acts notably in two areas: the tiering criteria needed to determine tier 2 third-country CCPs (those of systemic importance for the EU) and how third-countries may in practice achieve comparable compliance with the EU regulatory framework. There are many on-going bilateral conversations and consultations with stakeholders to get that right. In the EMIR 2.2 delegated acts there is also a need to define the level of visibility that ESMA needs in order to ensure that third-country CCPs meet all necessary requirements. The maximum amount of deference achievable will be looked for. EMIR 1 already had complete reliance on the third-country regulator, but with comparable compliance the individual areas on which deference applies will have to be looked at in greater detail.

A Central Bank official considered that the main change with EMIR 2.2 is that under EMIR 1 there is de facto no supervision at all of third-country CCPs by the EU authorities, only a high-level exchange of information. Now, in view of Brexit and of the expected higher complexity of the financial environment, a recognition and supervisory regime is being implemented, involving ESMA and CBIs in the EU, in a much more effective way than was the case before.

An industry representative emphasized that the whole EMIR 2.2 legislation effectively concerns only a handful of CCPs that will come into tier 2, since the others will continue to apply EMIR 1. The core justification of EMIR 2.2 is that CCPs may have a meaningful impact on financial stability within the EU. However, those same CCPs may have a greater impact on financial stability in their own home jurisdictions. It is therefore unlikely that a third-country CCP would pose such a threat to the EU when it did not pose a similar or greater threat in its own jurisdiction.

Another industry representative noted that EMIR 2.2 provides the EU authorities with a toolbox that should be used in a proportionate way, based on the perceived systemic importance of a third-country CCP to the EU. The toolbox includes direct supervision by ESMA, comparable compliance, etc. Other tools include third-country CCP colleges, Central Bank accounts from CBIs, and ex-ante MoUs (memoranda of understanding). It is important to ensure an equilibrium between ESMA/ECB roles and the home regulator's one. We need effective and predictable decision-making but also some flexibility. Cooperation needs to allow proportionate oversight, predictability and avoid regulatory arbitrage. Only then will we have a robust framework to address financial stability.

The first industry representative noted that the way in which this text will be implemented and executed is key, for the EU, third-country CCPs and markets in general, because a poorly-executed EMIR 2.2 could be very problematic.

#### 3.2. Allocation of supervisory responsibilities and cooperation among supervisors

A Central Bank official noted that the G20, over many years, has recognised that resilient market infrastructures deliver real benefits to global markets both from a financial stability and efficiency perspective. With clearing houses the benefits grow with scale. As a CCP provides services in more currencies and jurisdictions the benefits tend to grow. However, as this happens, an increasing number of regulatory authorities are concerned, with a valid interest in having insight and input into the supervision and resilience of these CCPs. This has been very much reflected in the UK supervisory approach for some years in terms of bilateral supervisory processes or college arrangements. A key part of those arrangements has always been to recognise the ultimate accountability of the home supervisor. The thrust within the EU to strengthen the supervision of third-country CCPs is understandable, but it must be a pragmatic and practical approach and work within both the EU and the third-country in order to support cross-border business.

Some obligations of the agreed EMIR 2.2 text appear to compromise the powers of the home authority and threaten the home authority's discretion, the official believed, and a better understanding is needed as to how it will work in practice. In addition, some of the obligations placed on third-country CCPs go beyond those placed on EU CCPs. For example CBIs within the EU potentially have the ability to place unspecified requirements, in exceptional circumstances, directly on third-country CCPs, which gives CBIs within the EU powers over non-EU CCPs that they do not have over EU CCPs. With EMIR 2.2 third-country authorities are also being asked to commit to assure the enforcement of decisions made by ESMA, which could potentially fetter the legal responsibilities and discretions of the third-country authority and the CCP's own risk management, depending on how this is implemented. A key tool to avoid that and the potentially related conflicts of law is the provision of the CBIs with powers in terms of comparable compliance. This is catered for in the EMIR 2.2 text, but with no detail yet fleshed out on how it will work and it will be important to understand how this can work and address some of the points mentioned previously. When the UK becomes a third-country authority, its authorities will need to assess whether these clauses can work in practice, because if not, the costs and risks will potentially be significant.

A present there are strong working relationships between the UK and EU and Eurozone authorities, the official considered, on which it should be possible to build trust going forward. It is important however that competent authorities like ESMA and the ECB are given the flexibility to implement requirements in a pragmatic way. EU third-country requirements also need to be consistent with international standards.

A regulator believed there is a commitment from all sides to make EMIR 2.2 work. Nobody has an interest in creating an environment where authorities are working against each other. This cooperation needs to be the driving force. ESMA is committed to its new role and responsibilities and to build on existing strong ties to make global CCP supervision work. Part of this will involve formally looking at the existing MoUs and making sure that they are fit for the new regime.

In terms of practical implementation, an industry representative was encouraged by the general tone of cooperation between the EU, the UK and the US. However, there is still a great deal of work to be done. The two key elements are proportionality and cooperation. Proportionality is about striking the right balance for third-country CCPs in terms of supervision between ESMA, the ECB and the home regulator. It is also necessary to prevent duplication and confusion. This involves implementing regulations in a sufficiently harmonised and coordinated way at the international level, as many CCPs deemed systemic are global in nature. Effective coordination is needed between supervisory authorities, with defined responsibilities and powers for the CCPs. The more that can be defined up front the better in order to achieve efficient and effective decision-making in difficult times, however it is a delicate balancing act to also offer the level of flexibility needed to operate in different kinds of environment. Regarding cooperation, there is a longstanding experience of coordination among supervisors in this area. This cooperation should however not be limited to the EU and the UK but should also involve the US and other G20 jurisdictions as well. Cooperation has to deliver four elements which are the objectives of supervisors and also of CCPs: proportional oversight; predictable outcomes; prevention of duplication and of regulatory arbitrage; and a robust framework capable of addressing inherent systemic risks, and enhancing the financial stability of the markets.

Another regulator considered that EMIR 2.2 has landed "in a very odd way" concerning third-country CCPs. They will face a very different regime from EU CCPs, which has led to some strange results, such as ESMA's exclusive responsibility for third-country CCPs, and the fact that ESMA will be funded through fees charged to third-country CCPs. If not applied properly this could result in regulatory conflict. Another regulator clarified that in terms of fees the work that ESMA does regarding EU CCPs, as with any other supervisory convergence work, is paid for via a mixture of EU budget and NCA contributions. Anything where ESMA has direct supervision responsibilities, as applies to third-country CCPs, is directly charged to the relevant supervised entities. This is the same for credit rating agencies (CRAs) and trade repositories, so there is consistency in this approach.

Another industry representative noted that everyone now agrees that effective cooperation and coordination between supervisors across jurisdictions will be crucial. This will be very positive for the supervision of global cross-border CCPs, but it should be applied in other areas as well. A key concern on the part of clearing members is about the preservation of a level playing field for European clearing members in case of relocation of some clearing activities into Europe. Looking at EMIR 2.2, this is not guaranteed at all. It is essential that in the end EU clearing members are not penalised by the new framework compared to their non-EU competitors. If this is the case the only choice would be for them to exit this business, which would have negative consequences for competition and investors in the end.

### 3.3. Recognition of existing arrangements with the US

A regulator regretted that EMIR 2.2 does not sufficiently acknowledge the 2016 agreement between the EU and the US CFTC, which leads to the question of whether there is certainty regarding how comparable compliance will be applied. The fact that US CCPs will be forced to reapply for recognition decisions, with even those granted recently being reopened, with no sense of how they would be reassessed, is a concern for the US. On the positive side however is the timing. The application of EMIR 2.2 to third-country CCPs, especially US ones, will take several years, so there is sufficient time for supervisors to speak to one another and find solutions. There was a pledge by the EU and US authorities when EMIR 2.2 was agreed to ensure that EMIR 2.2 is implemented in such a way that it is effective for both jurisdictions, alongside an expectation that the outcome will lead to greater deference between the two jurisdictions. If this commitment can be kept, it is a result that everyone can agree on. The US has already announced a desire to make changes to its own regime, including in the area of CCPs, which it is hoped will address many of the concerns previously voiced by the EU. Hopefully this will lead to a more cooperative relationship on CCP supervision in particular.

The regulator added that there are many parts of EMIR 2.2 that have generated concern from the US perspective from the start. These include the fact that EMIR 2.2 does not take the same approach as the US does to non-US CCPs, the fact that EMIR 2.2 does not acknowledge the different treatment between exchange rate derivatives, futures products and swap products, and the fact that EMIR 2.2 does not limit itself to the EU-facing business of a CCP, but rather tries to assert EU authority over the global business. Finally, there is a lack of clarity on what constitutes a tier 2 CCP. This will cause third-country authorities anxiety unless it is defined in greater detail.

A Central Bank official felt that the new EMIR 2.2 regulation is very much inspired by the US, and with the new proposals made by the US there can be an evolution towards a more cooperative model, and greater deference in the future.

## 4. Steps taken regarding CCPs to avoid potential cliff-edge risks of a no-deal Brexit

A Central Bank official stressed that the EU and the UK authorities have put measures in place to mitigate the potential cliff-edge effect of a no-deal Brexit. In December, the European Commission temporarily recognised the

UK legislative framework as equivalent to the EU's, on the condition of an appropriate exchange of information between authorities. Since then, an MoU has been signed between the Bank of England and ESMA, and ESMA has recognised UK CCPs to serve the EU market, which is positive. These preparatory measures taken by the authorities should facilitate the transition to Brexit.

Another Central Bank official agreed that the temporary equivalence decision and supporting recognition decisions on UK CCPs and CSDs were key steps to avoid cliff-edge risks. Contractual continuity in cleared markets has been highlighted by the UK authorities as one of the highest risks to financial stability stemming from a cliff-edge Brexit, posing risks to the UK and the EU. This is why in December 2017 the Bank of England announced its recognition process for non-UK CCPs, including a temporary recognition regime to ensure cliff-edge risks can be appropriately dealt with. The Commission's announcement in December 2018, that they had found the UK clearing regime equivalent on a temporary basis was welcomed, as was ESMA's swift action to agree to an MoU and recognise UK CCPs. This deals with a very significant potential cliff-edge risk. Those decisions, however, last only until March 2020. It is important that there should be clarity over what will provide continuity of access after that point. EMIR 2.2 is nearing finalisation, but there are many steps to go before having UK-based CCPs recognised under EMIR 2.2. Finally, from a broader Brexit perspective, there are other areas where material cliff-edge risks, albeit potentially less significant than for cleared derivatives, have not been dealt with, such as uncleared derivatives, trading obligations or data. This could be effectively addressed by further equivalence decisions, and clearing has provided a template that can be used in these areas. It is important though, that these remain technical, outcome-based decisions.

An industry representative agreed that much progress has been made in ensuring temporary recognition for CCPs and that this should be extended to trading, as potential cost increases for on-shore EU investors trading offshore and vice versa would hit EU investors first. Relevant authorities should act on trading equivalence, as it is very simple and in everybody's interests.

A regulator noted that the focus of the public authorities on clearing was justified by the risks involved in derivatives clearing and the need to ensure continuity in this area. This is why it was implemented, with the Commission's equivalence decision and the follow-up from ESMA on MoUs and recognition decisions. The final Brexit scenario will help to create more clarity about how the current temporary equivalence regime moves into the medium/long-term solution of EMIR 2.2.

# CMU AND BANKING UNION PROGRESS

## CMU post-Brexit: status quo, refocus or redesign?

### 1. Objectives of the Capital Markets Union (CMU) and achievements so far

#### 1.1. Rationale for the CMU and main objectives

A regulator stressed that the CMU aims to achieve a better balance between the banking system and the non-banking system, make the financial system more competitive and provide companies and investors with more financing choice and a better return on their savings or investments.

The CMU is often talked about as if it is one system, but in reality it covers a very broad range of different channels of financing and funding varying from venture capital and asset management to derivatives. Although the term CMU was introduced at the outset of the current Commission, the CMU has arguably been in construction for 30 or 40 years since the first attempts to achieve more harmonised rules and regulations for the financial markets.

An official observed that a 'capital markets union' does not mean building a united capital market, but a union of capital markets. This implies achieving a certain level of consistency across the capital markets of different member states, although these are at different stages of development. In addition, there is a vertical dimension in the CMU, since it is composed of different markets such as investment funds, derivatives…., as mentioned by the previous speaker.

The CMU should also play a role in mitigating risk, the official added. The use of CMU for developing risk-sharing across the EU through the private sector is important to consider, because it may provide an additional safeguard against possible stress events. The public sector also has an important role to play in the development of CMU, establishing legislation and putting the right incentives in place. For example, in the Venture Capital (VC) market, public funds represent one fourth of investments and this proportion is increasing. The public sector should consider whether more is needed.

A Central Bank official outlined that entrepreneurs in some parts of the EU are constrained by a lack of finances when there is at the same time an unprecedented savings glut in the EU with savers seeking higher returns. The savings surplus in the Eurozone has been steadily increasing in the last decade to reach almost €450 billion in 2018 and the situation is similar in the EU as a whole. Despite this, member states with savings deficits are only marginally benefitting from capital flows coming from these surplus countries, as a large portion of these funds is being lent to the rest of the world. Monetary policy has been forced to innovate with a refinancing programme dedicated to supporting further access to lending in the Eurozone.

In this context the CMU project proposes a bold vision complementary to the Banking Union, aiming to diversify access to finance, especially for small and medium size enterprises and to increase risk-sharing across the Union.

#### 1.2. Progress made with the implementation of the CMU

A policy-maker noted that the Commission has delivered all the legislative building blocks that it committed to in the initial 2015 CMU action plan and in the mid-term review in 2017. Very large consultations took place in the market prior to this and all the interesting and feasible ideas that emerged at the time were taken into account. Unfortunately the co-legislators have moved quite slowly in the adoption of these proposals and reduced the ambition and / or increased the complexity of some of them. The glass is therefore half full. Some CMU measures have started to produce effects, although it is very difficult to disentangle the causality. If there is the embryo of a CMU, it is for large corporates, because the progress made in capital markets for SMEs is limited for the time being. There is more capital market financing in bonds for large corporates, but it is unclear whether that is related to CMU measures or if it is the result of banks lending less.

It remains to be seen whether the market will "colonise" the new possibilities offered in other areas by the CMU measures adopted. There are also some missed opportunities. The best example is PEPP, which has lost its pan-European characteristics, so it is not the product the market asked for. Authorisation and supervision will be very complex and the resulting cost will be high for these products. Consequently the market for PEPPs is expected to be limited.

A regulator confirmed that progress with the CMU is "diverse". In corporate debt markets, asset management, derivatives and post-trading major steps forward have been made. It could be argued that there is now a "derivatives union", with consistent rules across the EU and elements of central supervision. Securities clearing and settlement has also moved from very national systems to essentially European systems and even international ones. There are however other areas of the capital markets where progress is still very difficult. Equity financing and IPOs are still at very low levels across most of the EU, as well as cross-border funding by the capital markets. The participation of retail investors in capital markets through either equity or investment funds is also very limited.

Another regulator was more optimistic. The progress made over the last 30 years in Europe in terms of development and further integration of capital markets has been quite impressive and further progress should be possible. Changes are quite obvious in many countries such as Spain for example, where there have been huge improvements in terms of products distributed and access to financing for companies.

An industry representative stressed that one key achievement of the CMU is putting capital markets at the top of the agenda and this should continue. The EU institutions need to pursue their efforts not only to complete the financial stability agenda of the CMU, but also to bring down the barriers across member states.

### 2. Issues and challenges facing the CMU

#### 2.1. Political backing by the Member States

The question with the CMU, a regulator suggested, is why it is so difficult to make progress, when all stakeholders at the market and political level seem to be in favour of it. An official disagreed that everyone is in favour of the

CMU, because if every finance minister in the EU in particular was supportive much more would have been achieved regarding PEPP and the ESA review. One issue is that capital markets are more complicated to explain to a minister or to make ministers interested in than with banks or insurance. This is not always due to national objectives but in some cases also a lack of understanding.

Another official was struck by the extensiveness of the CMU 2015 action plan. This is an advantage because having the big picture from the start is always better than combining separate parts, but it is also a disadvantage because efforts have to be spread out over a very wide agenda.

A policy-maker stated that there is a duty to assess the progress made so far without complacency and ask the member states whether they are ready collectively to do what it takes to make the CMU happen, which so far is not obvious. Market participants have not yet had time to implement all the measures adopted, but the CMU suffers from an insufficient level of ambition at the political level. One difficulty with the CMU is that it is very different from the Banking Union in terms of implementation, in the sense that the Banking Union is mainly an institutional construction and could be put in place immediately. Concerning the CMU, the legislations adopted first need to be put in place in order to provide the incentives needed for intermediation to happen and once this has been done, the market needs to take advantage of the new possibilities offered and develop the market.

A Central Bank official observed that there is a certain "fatigue" in Europe about attempts to implement the CMU despite the strong support still shown to the initiative at the highest level e.g. recently by the President of the Bundesbank and the Governor of the Banque de France. Maybe that is because the problem that the CMU was designed to address (i.e. the potential restrictions of bank balance sheets due to additional regulatory requirements implemented after the financial crisis) has somewhat diminished with the loose monetary policy that has been put in place which means that there is sufficient funding available. The own resources of companies have also increased in some countries such as Germany.

A regulator wondered whether the focus of several actions of the CMU on debt financing and supporting bank funding is not an obstacle to the further diversification of funding. A Central Bank official noted that there has been a limited shift of bank funding to capital markets funding already. This needs to be developed, but not necessarily at the cross-border level.

### 2.2. Reducing fragmentation in the EU

A policy-maker stated that most of the reasons why there is no real CMU at present, despite the new EU legislation that has been adopted, are due to frictions between member states caused in particular by different rules and supervisory practices.

Infringement procedures do not seem to be the right way forward because at best the European Court of Justice will rule after 5 years of assessment that the Commission was right and this will not help progress on the ground. The Commission therefore decided to adopt a different approach. People were sent to each of the member states in order to assess with the local authorities and market operators the current barriers to financing and identify solutions to address them in a bilateral non-legislative way. A report was subsequently published, which was quite sensitive because the barriers identified nearly all protect certain parts of the domestic business. This report was then shown to the Economic and Finance Committee (the committee of the European Union in charge of promoting policy coordination among the Member States) and then nothing happened. This exercise will therefore have to be restarted in the next term of the Commission because it is essential.

Besides these issues there are also some objective reasons why capital markets have not developed in certain EU countries, the policy-maker added, mostly related to the limited size and profit potential of these markets. Technology could however offer opportunities to develop smaller markets and connect them to the larger EU financial centres. Other speakers agreed that technology such as blockchain can help in the further integration of capital markets.

An industry representative emphasized that achieving further consistency in the application of rules is essential as it has a major impact on the possibility of doing business across Europe.

A regulator observed that one solution for achieving more consistency in the implementation of EU legislations could be to transform directives into regulations. When looking at MiFID for example, there are many more differences in its implementation across member states than with EMIR. An industry representative suggested that MiFID will need reviewing more broadly in the backdrop of Brexit. Some objectives will need to be readjusted. The impacts so far in terms of transparency are fairly limited and fragmentation in the market needs to be reduced.

A Central Bank official believed that the limits have been reached in terms of the harmonisation of the legal framework across member states, who do not understand why they should change their whole insolvency law just for the CMU. Maybe the concept of the 28th or 29th regime could be reintroduced as an alternative for wholesale markets, as it does not require a harmonisation of all member states' laws and can focus on specific areas.

### 2.3. Impact of Brexit on the CMU

A regulator remarked that it is often said that the UK leaving the EU may have a major negative impact on the CMU given the important role played by the UK in EU capital markets, but Brexit also offers opportunities for the EU27 to further develop its capital markets and financial centres.

An official agreed that Brexit should be an argument in favour of developing capital markets in the EU and this should help to increase the backing of the CMU by finance ministers. However, with the probable departure of the UK, the EU will be losing a major partner, including in the making of rules. It will be a challenge for the remaining 27 member states to outline a appropriate vision for a European CMU going forward and to set the rules needed to develop capital markets in a sufficient way in terms of liquidity, risk taking, etc. Until now the UK has helped a great deal in designing European capital market regulations alongside the Commission.

A policy-maker stated that Brexit will have an impact on the CMU whatever the final Brexit scenario, but many member states do not properly take the Brexit risk into account in their thinking about the CMU. There are a number of things that could have been done better in the CMU in order to better prepare for Brexit. Many believe that the UK and EU are so dependent on each other that they will remain very closely aligned, but that dependence is not a sustainable strategy for the City outside the EU. There will therefore be a common incentive to gradually dis-align, with the UK diversifying the markets where it operates and the EU progressively diversifying its sources of finance, which includes growing a CMU. The EU can also increase its connections with other financial centres, like New York, although this would not be the best course of action for the EU.

### 3. Priorities going forward

#### 3.1. Options for raising political commitment in favour of the CMU

Several speakers emphasized that the CMU would remain a major priority of the EU going forward, but the next steps and priorities of the project need to be carefully and collectively thought out.

An official suggested that political awareness and consensus about the potential benefits of the CMU need increasing. This requires a simpler and more motivating pitch likely to obtain more commitment from political decision-makers in favour of the CMU. It should focus on the ability of the CMU to help finance the growth of EU economies more autonomously. This is preferable to other possible objectives that may be either too broad (such as strengthening the role of the Euro) or too specific or divisive (such as the cross-border development of certain financial markets or increasing retail engagement). Ministers need to be given a long-term perspective that illustrates potential for tangible results. Once a simple and clear target for the development of capital markets in the EU has been agreed, then policy-makers and the market can figure out how it can be achieved. Agreeing on this should be easier than on many other issues, because it does not involve any public money. It is not about achieving full integration.

A Central Bank official believed that one potential obstacle to the CMU is that with the current loose monetary policy there is enough money in the system at present and therefore no real pain that could motivate its achievement. One remaining issue though is the excess savings (above € 400 billion) mentioned by a previous speaker, which are mainly in the Northern part of Europe and at the same time TLTROs (Targeted longer-term refinancing operations[1]) of about the same size need to be issued by the European Central Bank in southern European countries to allow them to refinance their lending operators. The official suggested that the ambition of the CMU could potentially be focused more on bringing money from northern to southern Europe and also on the wholesale area in terms of who is ready to take the risk for the cross-border investment required.

#### 3.2. Enhancing SME financing through the capital markets and encouraging the development of IPOs

A Central Bank stated that as the implementation of the CMU draws closer, structural challenges are becoming more apparent, such as the prevalence of SMEs in the EU and the limited access of these companies to capital markets, which should be given priority in the CMU in order to ensure the effectiveness of the overall project.

The official stressed that improving the financing of SMEs is crucial for new job creation and innovation in the EU. However, SMEs are often family businesses that do not naturally finance themselves from public capital markets. At present only 3000 SMEs are listed in the EU out of a total of approximately 20 million. Different demand side factors in particular, such as the cost of IPOs, corporate governance requirements, fiscal treatment more favourable to loan than equity financing and low interest rates affect the financing of SMEs through the capital markets. Newly adopted European legislation aims to reduce some of these impediments, but many issues remain relevant.

The main solution in sight for accommodating both the objectives of the CMU and SME preferences would consist in capitalising more on synergies with bank financing and on technological progress, the speaker believed. The securitisation of loan portfolios is part of the solution. Credit institutions should also be able to play a role in transferring part of financing to the capital market, as they are well positioned to assess the risks of SMEs for which they already provide financial services. Banks' supply of SME financing can be improved also by using the capital market to secure notes, while lowering the financial risk.

An official commented that it is first important to better understand the financing needs of different types of SMEs. If small enterprises are asked whether they need the CMU the answer will be almost unanimously no, because many of them can get money from a bank. Small enterprises in the EU usually do not want to open their equity to outside investors, which is why comparisons with the US are often not valid.

A policy-maker disagreed that SMEs do not need capital markets. Tech companies in particular need equity to develop. At present when they do not find equity in Europe they go elsewhere. More tech companies are needed in the EU as innovation is a major part of competitiveness in the current world.

The official agreed that the lack of high-tech start-ups in Europe and the movement of larger tech companies to other jurisdictions outside Europe needs addressing. One of the measures to resolve this would be to facilitate access to equity, however that will not prevent the companies that have the opportunity to move to another jurisdiction outside Europe from doing so. Retaining these companies in Europe should be a key public policy objective.

An industry representative stated that it is very important to help companies raise capital in order to support their expansion plans and to help their transition from private to public markets. Some measures have been implemented by the Commission to foster the development of primary markets but many players in the industry believe that a fundamental rethink of the IPO process in Europe is needed in a context where the market remains at a very low level. Evidence shows that some companies prefer raising money on the US market. This can be partly explained by some investor-related factors such as the greater patience of US investors post-IPO, but there are other factors as well.

Two aspects that could be improved concern free float requirements and measures to support secondary market liquidity post-IPO. Free float requirements in Europe tend to be much higher than in the US, which increases constraints for SMEs wanting to transition from the private to the public market. The goal is not to copy the US, but these requirements could be reassessed. In addition free float requirements tend to vary from country to country and from deal to deal, making it far harder to plan for an IPO. The second aspect is that secondary market liquidity post IPO tends to be lower in Europe than in the US, which can partly be explained by different free float requirements, as companies tend to go more often and in smaller sizes to the market in the US than in Europe, particularly in the technology sector.

#### 3.3. Encouraging long-term investment in equities

An industry representative expressed disappointment that PEPP does not have more momentum. The need for long-term capital in Europe is much put forward, yet some EU regulatory regimes seem to promote liquidity at the expense of long-term investment. Insurance has the kind of long-term liabilities that should be invested long-term, yet Solvency II, which is more of a bank type regulatory regime, is forcing insurance companies to go shorter and less risky. Solvency II is due to be reviewed in 2020, which is a great opportunity to address that. Comparisons with the US show that the government debt holdings of European insurance companies are twice the level of the US. It would also be worth assessing national pension regimes to make sure that they are investing sufficiently into assets that are naturally long-term such as equities and longer term projects. However this has been discouraged in many jurisdictions.

Investment funds are another sector where some disincentives need addressing. UCITS is a huge global success, but it is still only half the size of the US equivalent market when GDPs are similar. One issue is that when a product develops, regulators immediately start questioning why; they examine the risks that this entails and seek to add rules. ETFs are an example of this. These are low cost products which are well suited both for institutional and retail clients because they are liquid and index funds allow them to invest in the whole index. Another layer of regulation seems unnecessary for these products, which are already very well-regulated under UCITS and which have not posed any specific risks.

### 3.4. Continuing the integration of EU capital markets

An industry representative stated that a key objective of the CMU is continuing to bring down the barriers across Member States in the capital markets area. Further harmonizing insolvency laws and taxes in particular should be at the top of the agenda, even if it is very ambitious and will take time. Harmonisation within the EU is very important for strengthening the competitiveness of Europe globally because it is necessary to attract more investment flows into Europe, particularly in the perspective of Brexit which was not on the table when the CMU was initially designed.

It is also very important for the next Commission to have a political vision and a plan defining the role that financial markets should play in reducing the dependency of the EU on third-country financial centres and facilitating investment in Europe in order to ensure its competitiveness and growth. The initiative to strengthen the international role of the euro is crucial because it leads into much more strategic thinking about the role that financial markets should play in promoting the euro, positioning Europe vis-à-vis the US and Asia and what financial market structure is needed in this perspective.

Market infrastructures based in the EU can contribute in several ways to strengthening the international role of the euro, for instance by helping to set up, together with the banks that have shifted activities to the EU in the perspective of Brexit, a liquidity pool in the EU for the clearing of interest rate swaps, which would facilitate hedging in the EU. Another example is the trading of debt futures and European equity index futures that has started during Asian hours in December, which helps to facilitate Asian flows coming into the euro and hedge the exposures into the currency. Another area where progress can be made is the improvement of price discovery to the benefit of all market participants.

Another industry representative added that promoting the cross-border distribution of investment products is also necessary. A useful EU legislation has recently been adopted with this objective, but some unintended consequences of MiFID II and PRIIPs that may impact retail investors or the distribution of US index funds for example need reviewing.

## 4. The role of supervision in implementing the CMU

### 4.1. The possible need for more supervisory convergence and cooperation for implementing the CMU

A regulator noted that more integrated and effective supervision, more supervisory convergence and cooperation between supervisory authorities have been considered very important parts of the CMU from the outset, as they contribute to the greater integration and efficiency of European capital markets. More coordination and supervisory convergence are particularly important in areas such as the cross-border provision of services to retail investors, where it is essential to have not only more consistent practices and protocols, but also to promote investor confidence through a sufficient level of supervision throughout Europe. ESMA should play an important role in ensuring that services provided cross-border to non-professional investors are effectively supervised by the relevant home country, but should also encourage home countries to accept help and cooperation from host countries.

Integrated supervision is important but does not necessarily mean more centralised supervision. Member states must continue to have robust supervisory bodies with relevant powers to ensure that Europe continues to have a plurality of markets and financial centres with a critical mass. This will support the development and penetration of capital markets and help to improve the financing of companies of different sizes.

A Central Bank official stated that once the CMU has come into real existence then supervisory practices will follow. The alignment of supervisory practices has two aims. One is to avoid supervisory arbitrage, but there first need to be arbitrage possibilities and cross-border competition. The second consideration is making sure that supervisory practices do not create obstacles for the further creation of a European market.

Supervisory convergence is no longer a problem in the banking sector, because of the supervision of the most significant institutions by the SSM. Banking could serve as a benchmark from that perspective. One lesson from the SSM is that it is not a panacea for everything and the one size fits all approach is not appropriate, because markets and companies are different across member states and these specificities have to be acknowledged in supervisory practices. The risk if practices and standards are harmonised too much is that there is no room for supervisory judgement anymore which will impede the effectiveness of supervision. The Banking Union was created in reaction to the sovereign debt crisis and a regulator wondered whether it would not be better to anticipate a further integration of capital market supervision before a crisis eventually happens in the capital markets. The Central Bank official responded that it is a natural reaction to only solve problems when they arise.

A policy-maker fundamentally disagreed that there is no problem in the capital markets worth fixing at present. That is a view guided by the wish to preserve the prerogatives of domestic supervisors, which has previously hindered the creation of the ESAs. It is common sense that if people want to have the freedom to market throughout Europe there needs to be a referee that ensures that there is sufficient discipline and that risks are under control. Before the euro crisis and the Banking Union a vast majority of member states denied that there would be one day a problem justifying an enhancement of bank supervision at the EU level. A major problem might happen in the capital markets sector in a similar way and then it will be too late to react. If this is not anticipated, the end result could be the worst of all worlds. There may be enough of a single market so that risks can spread easily to other jurisdictions and not enough to be able to control them, which is exactly what happened in the insurance sector where some companies are established in countries where they do not sell a single policy and all the risks are spread over other jurisdictions. If this is the case the home supervisor does not care about the cross-border business and if there is no one in the EU with the ability to stop certain practices and to investigate through serious means and sanctions this makes the system dysfunctional.

An official noted that it is not easy to compare the SSM and the supervision of securities markets, because the SSM does not regulate banking markets, whereas ESMA has a role in regulation and may also be given some direct supervisory powers. Some middle option needs to be found.

### 4.2. The outcome of the ESAs review

A regulator stated that the agreed proposal for the reform of ESAs is an element of progress. The debate had moved between two extreme positions: (1) creating a single securities supervisor in the EU such as the US SEC that would centralise all relevant supervisory functions of EU capital markets and (2) limiting ESMA to a mere association of supervisors driven by its members. The most appropriate stance is a midpoint between the two approaches, the speaker believed.

There are indeed different realities in Europe with countries of different sizes, meaning that there is a variety of situations in terms of how close supervisors are to market participants and also in terms of competences, experiences and tools used. It is essential to strengthen ESMA in the context of the CMU action plan and especially in the light of Brexit. ESMA should be able to play a stronger and more pro-active role regarding breaches of EU law, the establishment of common supervisory priorities and peer reviews. ESMA should also have more independent governance, especially to launch initiatives concerning day-to-day matters. However, ESMA should remain essentially a body that coordinates the competent national authorities and promotes supervisory cooperation and convergence, but the new powers added with the ESA review should allow ESMA to play this role in a more active and stronger way and possibly with more intrusiveness.

An official also welcomed the outcome of the ESAs review, but considered that a 2.0 review would be inevitable sometime in the future. An audit of supervision in the insurance sector revealed issues related to the way cross-border business is supervised. Domestic insurance supervisors at present do not always appropriately consider cross-border business, because in some cases companies conducting cross-border activities are negligible in their home countries. In addition, national rules often focus the role of domestic supervisors on national financial stability issues. Similar approaches would be very detrimental in the capital markets area where the cross-border dimension is very strong and may be difficult to solve in the current regulatory framework. An informal role can be played by the ESAs in this respect vis-à-vis the national competent authorities, but regulations regarding interactions between the competent authorities of member states are quite limited. The ESAs can indeed only obtain information from the national competent authorities and only if they prove they need it. This makes the central supervision of internal models in the insurance sector difficult for example. There was a proposal in the Commission initiative to improve this process, but unfortunately it was not adopted.

# CMU and Banking Union: complementary or antagonistic?

## 1. Complementarities between banks and capital markets

### 1.1. Complementary risk allocation and financing functions

A Central Bank official stated that banks and capital markets are inherently complementary and are necessary for every well-functioning financial system. They fulfil two separate but complementary functions[1]. This is first the case in terms of risk-sharing. The banking sector performs risk-sharing in an inter-temporal smoothing way, providing borrowers and depositors with borrowing and saving opportunities that compensate each other over time. Capital markets have a different risk-sharing function, ensuring diversification and cross-sectoral risk-sharing for investors. The USA has a very large share of cross-state risk-sharing coming from the financial sector. This is much lower across member states in the euro-area, where consumption benefits much less from cross-border payments, dividends and interest rate payments. Improving cross-border financial risk-sharing in the euro-area would also require much higher cross-border holdings of equity claims in particular.

Secondly there are complementarities in terms of financing illustrated by the 'Spare Tyre Theory, which is the idea that if circumstances change borrowers can switch between different funding sources. This is an underlying motivation for the objective of the Capital Markets Union (CMU) to diversify funding sources. Empirical observation in countries with very developed banking and capital markets shows that, in a case of recession, bank lending goes down and corporate bond issuance usually goes up in compensation, at least partly. This means that in such a situation the funding opportunities of firms and households can be smoothed, showing the inherent complementarity of these two funding sources.

An industry representative suggested that the capacity to manage relationships is a major specificity of banks, whereas capital markets are more a matter of product provision and transaction execution. These relationships make banks the natural intermediary between issuers of capital and investors or savers.

Another industry representative added that a long-term relationship is an important element when lending to private households and SMEs. The relationship is taken into account in the credit scoring process underlying bank lending. The companies with longstanding associations with banks usually enjoy lower costs for debt and equity issuance. The effects of traditional banking relations therefore go beyond the pure banking sphere. However it is increasingly challenging for banks to maintain a close relationship with their customers with the increasing digitalisation of the financial sector that drives changes in client expectations.

The different types of enterprises must also be considered when assessing the complementarity between bank and capital market financing. Large corporates already use multiple sources of financing including capital markets, whereas SMEs rely mostly on bank funding. The situation differs for innovative SMEs, who need specific instruments for funding their projects which are often more immaterial and they also need investors who have an

1. Through TLTROs the ECB provides long-term loans to banks and offers them an incentive to increase their lending to businesses and consumers in the euro-area. This helps to return inflation rates to levels below, but close to 2% over the medium-term.

appetite for growth but are ready to take more risks. There can also be complementarity between banks and capital markets in the area of sustainable finance.

A regulator believed there is complementarity between banks and capital markets both for large companies and for SMEs. Italy has a small market for mini-bonds, and research shows that the companies that issued mini-bonds subsequently got a reduction on their bank lending rates of approximately 40 bp. This is because after the issuance of bonds the financing structure of these companies begins to change and they become less dependent on banks, making banks then more prone to lend more at better rates. This can help SMEs who cannot or do not want to issue equity at a certain stage to start testing a diversification of their funding.

An industry representative stated that financing growth is about getting access to liquidity and making smart risk allocations. The connections between banks and capital markets are obvious and both play a role in providing liquidity and allocating risks. Some projects generate cash flows with some level of predictability but others do not and financing instruments need to be provided according to this. The most effective way for the Banking Union (BU) to serve growth is to ensure banks act as the interface between companies and individuals who do not have enough money and need resources, and investors or savers who want to allocate a surplus of resources in exchange for a yield.

An industry representative suggested that the broader perspective of what really drives liquidity should also be considered in this assessment of CMU and BU complementarities. At present the real macro source of liquidity to companies is quantitative easing (QE), which plays a major role in the huge growth of the private equity bubble in particular. Without the huge flows of liquidity coming from Central Banks, the multiples that private equity have been paying over the past two or three years (20-times EBITDA) would not be possible and there would not be so many deals with no real due diligence. If money was priced as it was in the past, this would lead to a very different environment. The big issue is not only how to get CMU and BU to work together, but CMU, BU and monetary policy.

### 1.2. The role of capital markets in helping develop the lending opportunities of banks

A Central Bank official explained that simple, transparent and standardised (STS) securitisation, as defined after the financial crisis, is a highly illustrative case of complementarity between banks and capital markets, although there remains work to be done in Europe to develop securitisation markets. MREL (minimum requirements for own funds and eligible securities) is another illustration of this complementarity. MREL instruments are important for reducing the risk of having 'too big to fail' banks and stabilising the overall prudential architecture of the European banking system. The better the market for those instruments functions in terms of pricing and risk assessment, the better they will work for the banks issuing them.

An industry representative described how in Europe over the last four years banks have been able to grow their balance sheets, with some constraints, at a cost that remained acceptable. But this cost has increased significantly now due to Basel rules, TLAC and MREL, meaning that the expansion of bank assets will be coming to an end in the coming years. However, over 66% of the financing of European households still comes from banks. If banks cannot grow their loan books further due to these new banking regulations, capital markets will have to step in and CMU developments, including those concerning securitisation will need accelerating. The question is not so much about complementarity, but how faster the CMU can move to mitigate the impacts of banking regulations that are already there.

Banks need to evolve from a "buy to hold" approach of loans to an "originate to distribute" one. Major components of this include having a deep investor base to buy securitized papers that banks originate, and the existence of a very liquid market to ensure sufficient price transparency when these products are distributed. Many stakeholders also believe that unless market participants like financial institutions and banks are able to hold these securitised assets at a relatively reasonable economic cost then that liquidity may not happen in the secondary market for these products. Being able to do this would be a positive application of the complementarity between banks and capital markets. Originating assets at market-clearing price (a price at which investors will buy) will impose strong discipline on banks. An often-heard criticism of banks at present is that they are originating assets at a return on equity which is too low. That explains why banking companies in Europe currently trade predominantly below book value.

Another industry representative added that non-performing loans (NPLs) are another area that could benefit from connecting the BU and the CMU. As banks sell their NPLs into the capital markets there is a redistribution of risk and consequently a stronger balance sheet that allows fulfilling objectives on both sides.

There has been significant progress in NPL reduction since the financial crisis. A large proportion of NPLs sold is distributed through junior mezzanine tranches to investors such as hedge funds mainly based in the US and UK. Early in the NPL story private equity investors made very low bids, but over time sophisticated securitisation investors have come into the market and pulled bids up, allowing a meeting of bid and offer in the market. There has also been pressure from regulators to clean up balance sheets. The lessons learned are that the supervisory and regulatory attitude on the banking side can impact flows towards the capital market side. As prudential reforms are implemented in the European banking sector measures that provide an incentive for banks to retain assets on their balance sheets should be avoided as they may hinder flows towards capital markets. This is important to consider when analysing how the BU and the CMU should evolve in the future.

A third industry representative agreed that pushing banks to clean up their balance sheets and sell their NPLs is positive, but care must be taken not to go too far. Measures that are well-intended may have unintended consequences. For banks, cleaning up balance sheets means selling loans together with the relationships with the corporates that borrowed the money. Behind these loans are companies and jobs, and selling loans at a low price to financial investors may not be the best solution for the future operations of the companies concerned.

A Central Bank official however pointed out that a wider European market is needed for NPL assets, instead of single country markets.

## 2. Enhancing the role of banks in the CMU

An official wondered whether the CMU and the BU could, to some extent, be merged to provide a better result. An industry representative responded that whether they should be merged is somewhat moot. The important point is that they are complementary and should be considered together.

An official noted that US banks are integral to many capital market activities, and wondered whether this should not be better recognised in the EU's CMU plan. An industry representative observed that, largely because of their complexity, capital markets have not taken off in Europe. They speak less to the man in the street and generate less political support than banks. The issue is less a matter of merging BU and CMU initiatives and more about understanding, and appropriately reflecting in the CMU, that banks are important actors in the success of this project.

In the USA the development of capital markets went hand-in-hand with the strengthening of the banking industry. The separation between broker dealers and commercial banks was progressively alleviated to give banks a broader role in lending and as capital market actors both for their own account and as intermediaries.

Although building the CMU is an appropriate objective, progress has thus far been limited. The CMU action plan needs reviewing and the priorities of the next Commission in this area defining, but it is equally important to make sure that there are the appropriate market players needed to develop capital market activities in the EU. Banks should be more comprehensively involved in the CMU process. Creating the CMU requires stronger banks, for which the BU is also needed. If a single capital market area is created in the eurozone without strong enough local actors to provide capital, then capital will come from the rest of the world and increase Europe's dependence on other regions.

A regulator agreed that banks are an integral part of the US capital market, particularly in activities such as securitisation and derivatives. They are the greatest investors, but also the greatest issuers in the market. In European markets, banks play a major role in equity and bond issuance. In many cases they are also directly or indirectly the main market makers, so there is perhaps a potential crowding out effect. Accompanying non-financial companies to the market can be a very profitable activity.

A Central Bank official noted the importance of being mindful of transition dynamics from bank financing to more capital markets. In the long-term the complementarities will benefit everybody, but the transition towards a model with more capital market market funding will require adjustments in the financial sector, which needs vigilant monitoring from a prudential perspective. Banks must also reformulate their business models as capital markets grow. Some banks will be able to maintain a strong position in local credit markets, but others will have to invest in the future opportunities offered in the capital markets and develop more fee-based business related to IPOs and other investment banking activities.

## 3. Hindrances to the development of capital markets in the EU

### 3.1. Regulatory obstacles to investment in and research on capital markets

An industry representative outlined that an effective capital market needs four elements: a sufficient number of issuers; liquidity; investors; and research. Europe is fine in the first area, but lacking in the other ones, which are strongly impacted by regulation and supervision. Fixing the weaknesses of MiFID II and Solvency II should be a key priority for the incoming Commission. The coverage of companies by research is strongly reducing following the implementation of MiFID II rules, particularly for SMEs. Measures are also needed to improve liquidity, which is driven by Solvency II and monetary policy. Capital comes from insurance companies, pension funds and retail investors, who must be incentivised to invest in stocks, but there are currently strong disincentives, notably due to Solvency II. Steps are being taken to tackle this problem, but it has taken too long for regulators to realise that the difference between the risk of a government bond and an equity does not necessitate such a difference in capital charges.

A further question is how to relaunch the IPO market. Any company at a certain stage decides between going public with an IPO and staying with private equity. Both have their pros and cons depending on the future prospects of the company and expected premia, but when the multiples offered by private equity are so high the rationale for going public weakens, hence the IPO market dries up, which further deteriorates liquidity.

A major problem in Europe however is the obsession with downside risk. Risk appetite is decreasing as the population on the continent ages. An important question is who in Europe is ready to take risks and how to increase risk appetite.

A regulator agreed that a recalibration is necessary to tackle the unintended consequences of some of the EU regulations. Improving the transparency of the cost of research, which is an objective of MiFID II, is a valid intention, but has had negative effects. It has gone too far because it has affected the economic incentives needed to support such activities. The cost of IPOs is higher in the US than in the EU, which means that revenues are available for intermediaries and it is possible to undercut the cost of research. However, the situation is different in the EU and we could end up having research only on big companies. Information provided through research is nevertheless essential to create interest in companies and attract investors. In Europe, companies that issue €10-20 million on the equity market do not have the liquidity to attract big asset managers and therefore need individual investors, such as high-net-worth individuals who require information to make their investment decisions. This issue needs to be addressed by the incoming Commission.

A second industry representative agreed with the first speaker that a recalibration of Solvency II is needed in particular. The first objective of the CMU was to develop capital markets in Europe to channel massive flows of outstanding savings to productive investments, diversify sources of financing to finance growth, and also to develop access to capital markets for investors. Amendments to Solvency II are needed for that to be possible.

Another issue, a third industry representative mentioned is reconciling the CMU objectives to develop investment in SMEs with investor protection regulations such as MiFID II. It is practically impossible to sell SME equity or mini-bonds to investors while complying with the investor protection and information rules imposed by MiFID II and the related processes. These constraints need reviewing if the objectives of the CMU in terms of investment are to be achieved.

### 3.2. Fragmentation and predictability of the capital market regulatory framework in the EU

An industry representative stated that fragmentation, which is omnipresent in the EU market and its supervision, hinders appropriate liquidity provision and risk allocation in Europe and is therefore a major obstacle to the CMU.

If there is no single authority in charge of implementing regulations at the EU level, responsibility gets diluted. The only way to solve fragmentation is consolidation with an appropriate market model at the EU level. As an example, Euronext contributes to this by consolidating a certain number of markets in Europe (Portugal, France, Netherlands, Belgium, Ireland and the UK). That represents a liquidity pool of €3.9 trillion. A second dimension is a strong focus on SMEs which represent 1000 out of 1300 companies listed on these markets. Capital markets are particularly essential for tech companies, for whom debt financing is often less readily available.

A regulator suggested that a certain level of central supervision is needed in the EU notably for systemic and / or larger capital market institutions. It is too early to implement centralised supervision at EU level, but too late for only local supervision on capital markets.

Another industry representative explained that when banks look at allocating scarce capital they have to consider what returns they will achieve through different activities. Part of the success of capital markets in Europe depends on the ability to operate on a sufficient scale, which is the case in the US where scale is such that it is possible to operate economically and generate return in many market activities. For European banks, how to remove barriers and frictions within the EU and favour cross-border mergers is being discussed. Global banks operating in Europe have a further set of considerations. They look at their ability to operate in Europe with their existing model. Their objective is to achieve this with minimal adaptation and fragmentation for example regarding the amount of internal MREL needed. They also look at structural fragmentation with issues such as IPUs (intermediate parent undertakings) and measures on branching which may further increase costs. This combination of factors affects ROE calculations and ultimately determines the attractiveness of Europe for capital markets compared to other regions.

A Central Bank official added that another fragmentation issue in Europe, beyond that of the supply and demand of funding, concerns the size of average companies. Combining the existing capital market base of small companies into larger industrial clusters should be an objective. Europe does not want to imitate the USA and its Silicon Valley, but something of that type is needed. Existing examples such as German Mittelstand companies clustered in regions, and small companies in Northern Italy clustered around the stock market can be built on.

The second industry representative stressed that the predictability and reliability of the regulatory and supervisory system is another important factor for global firms. The way equivalence arrangements function at present and the possibility of a no deal Brexit could create a perception problem for the EU with a long-term bearing on its attractiveness as a location for capital markets and on capital allocation choices. This could hinder the aspiration to build a broader and more effective capital market in Europe.

1. This was illustrated notably in the work of two academics, Franklin Allen and Douglas Gale "Comparing financial systems" who argue that an optimal financial system relies on both financial markets and financial intermediaries such as banks.

# Bank fragmentation and prospects of further consolidation

### 1. A more integrated EU banking sector would be beneficial both for the real economy as well as for banks' resilience

An industry representative noted that the Banking Union was designed in order to build a private risk-sharing environment needed for the eurozone to absorb shocks, in order to achieve a better allocation of liquidity, capital and resources for cross-border banking groups, and more efficiency in the allocation of resources to unlock growth potential for the eurozone. From a business perspective the Banking Union has created a brand of quality for Europe. It is a cause of happiness that it was created, and that the detail and credibility are being built up day-by-day, by the work of the ECB and the Single Supervisory Mechanism (SSM). The brand will exist more in the Europe of tomorrow, rather than in the Europe of before, and it is making sure that the lessons of the crash have been learned.

An official agreed on the importance of banking integration in the eurozone. This is valuable from the point of view of the industry and is the only way to put in place a meaningful risk-sharing mechanism. This is essential for ensuring the strength of the economic and monetary union project. There is indeed a political limit to public risk-sharing mechanisms; private risk-sharing mechanisms are needed, and it is not clear how these can be put in place without more banking market integration in the eurozone.

A central banker felt that the ECB needs an integrated financial market where capital and liquidity can flow freely, to reap the benefits of the scale and scope of the European market. More needs to be done here, but much has already been achieved.

An industry representative noted that the banking sector should be safe and able to address downturns in the economic cycle. This is the other challenge. The English have a marvellous saying: the proof of the pudding is in the eating. It is in the downturn that the quality of the Banking Union will be shown. The question is whether it will be more solid as a result of fragmentation, or more solid through trust in new institutions.

### 2. A fragmented banking landscape in the European Banking Union despite the implementation of the Banking Union

Whilst much progress has been achieved in terms of the European Banking Union, the banking market remains fragmented across Europe. This fragmentation carries with it a cost for the sector and for individual banks.

#### 2.1. Much progress has been achieved

A central banker noted that the SSM has achieved a great deal. Compared to five years ago, there is now a single rulebook. More than 130 national options and discretions have been harmonised. A single Supervisory Review and Evaluation Process (SREP) has been put in place. A crisis management framework for non-performing loans (NPLs) has been introduced. A Targeting Review of Internal Models (TRIM) project has been launched to harmonise internal models. Many problems in the SSM and ECB's control have been solved.

Regarding market fragmentation, at the start of the SSM 5,516 financial institutions had balance sheets of around €24 trillion. Now there are 4,697 and still a balance sheet of €24 trillion. A consolidation of at least 20% has quietly taken place in the past five years. If this continues smoothly, the eurozone is on the right track.

The Chair noted that an impressive number of – mostly small – banks have disappeared unnoticed, so a consolidation is happening. However, when consolidation is talked about, it means another layer of banks, whereas here when the word comes up it means cases where legacy issues need to be addressed and where consolidation would mean a need to combine or restructure.

### 2.2. A fragmented banking market

An industry representative noted that fragmentation in the EU banking industry has increased since the launch of the Banking Union. In the euro-area the share of cross-border loans to households remains at barely 1%, the interbank market has dried up and cross-border deposits are below 2%. The EU banking system is also less concentrated than that of the US. Fragmentation has a cost for the economy: a non-optimal allocation of savings (which do not circulate within European countries) to the detriment of investment.

An official felt the numbers are not very positive in terms of the degree of market integration achieved. For instance, the proportion of cross-border operations in terms of loans or deposits is 6-8% of the total and has not increased since the inception of the Banking Union. The participation of foreign institutions in domestic jurisdictions is, on average, around 15%, which has also not increased. The number of cross-border mergers between banking institutions remains low and has not increased. Therefore, something is not working as expected. Some progress has been achieved in consolidation, but this does not necessarily imply integration.

An industry representative noted that normally, the signal should come from the authority to move to a more integrated market. There will be some complaints at certain levels, but the process will go on and adjustment will be made. Historical reasons have played a role, but history has to be interpreted. Mergers and acquisitions have not gone as far as they should. It probably falls on the authorities to give the indication.

The Chair summarised that it is possible that fragmentation is hindering free flows, and at the same time there has previously been expressed a feeling that trust is short between members of the Banking Union and beyond. There is talk about a single point of entry resolution approach and a consolidated market that needs to be underpinned, but there will always be some allocation of risk and capital within a group.

### 2.3. Fragmentation has a cost

An industry representative noted that fragmentation and ringfencing comes up time and again at Eurofi meetings, and the same problem is still being grappled with. In terms of what is fragmentation, a former managing director of the IMF once said, 'If people ask me what a giraffe is, I do not know how to define it but, when I see one, I recognise it.' Fragmentation has a cost, and when that cost is paid it is noticed.

There is a sentiment of resignation to the presence of fragmentation. It is perhaps an issue of collective responsibility; not only of the regulators, but of the regulated. At a national level, local banks tell regulators that new regulations need to be interpreted in the light of domestic realities. Everyone is an accomplice in the current status.

The reason that fragmentation is a problem is that it impoverishes the value of the brand of the Banking Union. It also creates problems for banks that have become pan-European and feel under pressure to revert to a more nationally orientated approach. If there is complacency about the reversal of the pan-European model for banks, it should be made more explicit, as it would mean a very radical change of attitude.

### 2.4. Anti-Money Laundering is also a cause of concern

An industry representative noted that it is difficult for investors to understand that behind the brand name there are money laundering stories. It is a common challenge, and a brand that is managed together. The banking sector is more to blame, but it is a joint story. For a few weeks the question that investors have been raising is why this is happening in the Banking Union. The challenge is to maintain the high quality of the brand.

A central banker felt that it is not just a brand name that has been created, but it has been filled with substance. Anti-money laundering (AML) raises concern. The ECB is not directly responsible for AML, but it affects the ECB's credibility with investors. This is an argument for the ECB to focus on tough, fair and intrusive supervision, to protect the ECB and the banking market. No banking market exists without a strong supervisor.

## 3. Explaining fragmentation in the Banking Union

The Chair questioned whether cross-border is therefore helping rather than hindering. At the end of the Asset Quality Review (AQR), it had been suggested that this would be the start of the mergers, but this has not been seen. There are many reasons, including regulatory ones but also inherent business reasons.

### 3.1. Regulation is one of the explanations

An official noted that one could see the causes of fragmentation as an introduction to the remedies that are envisaged. The first focal area is regulation. The single rulebook is not yet complete, despite the progress made at the level of the SSM. Indeed, European banking law includes options and discretions for national authorities leading to different rules across countries. It is also true that the Banking Union is not complete. There is still the absence of a European deposit insurance scheme, which is important.

Another group of impediments relates to the prudential regulatory treatment of international banks. It has been suggested that regulations penalise European banks with international businesses, as they are seen as more systemic and as having been more complacent. Those institutions are subject to stringent capital requirements associated with the complexity and systemic importance due to their interconnectedness.

A number of elements in regulation could be revisited to see whether they are necessary for guaranteeing the solvency of financial institutions. When it comes to issues such as capital charges on complexity, it is not difficult to see banks with international business as normally more complex. The case could be made however that there are benefits from the geographic diversification of exposures, which may not be sufficiently recognised in prudential regulation. This is not part of Pillar I capital requirements, and so is not normally considered in terms of Pillar II in the context of SREP. Moreover, in stress tests, for the adverse scenario, it is assumed that there are parallel shocks affecting all relevant jurisdictions, thereby minimising, by construction, any positive effect of diversification. Benefits associated with the geographic diversification of credit exposures not being recognised in prudential regulation could be investigated at the global level.

Ringfencing by definition can be a cause of fragmentation. It could, to an extent, also be seen as a consequence of a lack of economic or political integration in a context of lacking a fully integrated economic area, without sufficiently powerful risk-sharing mechanisms or a common deposit guarantee scheme, and where financial stability is a competence at a European as well as domestic level. This provides a rationale for domestic authorities to try and keep sufficient room for manoeuvre in order to achieve their own objectives. It may be necessary in order to make progress on economic and political integration and further European integration, to discuss the safeguards that could be introduced at the level of subsidiaries in different jurisdictions. This is complex and includes many economic and political factors that need to be weighed, but fragmentation will not be solved by deciding to waive liquidity or capital requirements at a subsidiary level.

### 3.2. Business case issues are another source of explanation

The Chair noted that more transparency and harmonised rules would unlock the merger or consolidation process, and potentially increase investors' appetites. This has not happened. The Chair wondered if mergers only happen if there is a business case and a clear idea, whether it is more than just working in the same ecosystem, or transparency, and whether a fair value proposition is required.

An official felt that regulation is not the only cause. There is an issue to do with the business case, and whether there is really a business case for more pan-European banks and whether any value is added to banking institutions in Europe by becoming pan-European and starting to invest in other eurozone jurisdictions.

## 4. Possible way forward

The Chair noted that there will imminently be a new European Parliament and Commission, which offers an opportunity to formulate a wish list of ideas to be taken up. The Chair invited the panellists to share their policy priorities for the incoming Commission, to see more cross-border risk-sharing via the banking channel, or more cross-border investments in a broader market.

### 4.1. A need to reconsider the solo approach

The EU prudential framework does not recognize transnational groups at the consolidated level but a sum of separate subsidiaries ("solo approach"). For instance, the Liquidity Covered Ratio (LCR) which is designed to ensure that banks have the necessary assets to face short-term liquidity disruptions, is calculated on a solo basis since liquidity excesses in one subsidiary cannot be used to compensate for possible shortages in other ones. More generally, this solo approach maintains a domestic focus in the way prudential requirements (capital, liquidity, bail-in instruments) are imposed on banking subsidiaries across the eurozone despite the implementation of the Banking Union.

An industry representative noted that there is a need to remove discretion in EU regulations that allow member states to limit exposures of subsidiaries to their holdings, as if they were third-party banks. This is mostly in respect of large exposure limits. There needs to be a change to the existing regulatory framework; whereby capital and liquidity requirements need to be met at both consolidated and solo level. There then needs to be a reconsideration of the amount of loss-absorbing capacity to be requested from banking-group subsidiaries, and the question of the internal Minimum Requirement for own funds and Eligible Liabilities (MREL) for subsidiaries to consider.

There were many changes at the Central Bank level. The Banking Union has come a long way, but there should be a forum of dialogue between the SSM, the Single Resolution Mechanism (SRM) and the ECB on the problems confronting the Banking Union. There are a number of requirements from the SSM and the SRM, and it is necessary to gauge whether there is an integrated capital market to satisfy those requirements without creating problems, which poses a challenge for the ECB in terms of ensuring sufficient liquidity to accommodate all of the issues.

A central banker felt that in terms of dealing, there is a strong dialogue on prudential matters between institutions regarding the SSM, the SRB and the Commission. Much has been achieved, and the SSM is willing to do more whenever it can to generate a more integrated and efficient market. There is a long wishlist, first of all concerning the regulation of derivatives.

### 4.2. The real debate is about trust

A central banker noted that the SSM are supervisors, not a super-ministry for industrial banking policies. The SSM cannot be expected to orchestrate cross-border mergers. It is neither their mandate nor their role and would be an overextension of their authority if they tried. The SSM's role is to make sure that a merger leads to healthy institutions. This is why they will sometimes ask questions in a merger where there is a great deal of bad will-creation for additional capital. A merger has certain restructuring costs that need to be covered and takes a great deal of management concentration away from clients. Here, too, a capital buffer is needed.

'Fit and proper' has different definitions in different countries. In some countries the SSM has a say in mergers, and in others it does not. This makes no sense. If there is trust in the SSM, then it is very difficult to argue against capital and liquidity waivers. The only argument against them is a lack of trust, but what is arguably needed is the completion of the Banking Union, so that the national state is not paying. What is also needed is the completion of the Capital Markets Union. There cannot be a functioning Banking Union without a functioning Capital Markets Union. The harmonisation of insolvency and other laws is therefore required.

An industry representative noted that care is needed when speaking about cross-border, as there is market consolidation, especially in investment banking. What is meant when saying there is no cross-border is in reference to specific operations that M&A bankers prefer. In practice, there is much market-share consolidation in the hands of some European banks, but mainly of non-European banks. This is a crucial question, as there is consolidation and there is a strategic debate behind it. A very senior supervisor once advised, 'If you want to avoid fragmentation, please create branches and transform your subsidiaries into branches.' Supervisors have much discomfort with existing fragmentation. The real debate is not about cross-border operations, but about trust. On trust and distrust of banks, by definition, supervisors do not trust banks, or they are not doing their job. It is normal for banks to challenge supervisors, as it is the only way for them to be sure that they are at the cutting edge of appropriate management.

The new Commission should prioritise consistency. It should try to fix and define the home-host debate, as banks need to know what may happen in the future. Dividends are paid amongst groups and capital is allocated, so discussions cannot keep on happening. The framework and the rules of the game need to be understood. The allocation of MREL, capital, and the capacity to adjust liquidity are extremely important questions in the setting up of a bank. Supervisors are right to ask banks to be clear, but banks need a better understanding of the rules. The Commission should sit down with stakeholders and try to arrange things in such a way as to increase clarity and reduce fragmentation. If mergers are desired, large balance sheets will be required. This means a capital surcharge, or the risk of a capital surcharge. It is difficult to explain to shareholders taking the execution risk of a merger at the same time as paying a capital surcharge. What needs to be in place is an efficient, functioning securitisation system. If assets cannot be shifted outside the balance sheets of European banks, there will be increasing capital surcharges. The level of securitisation in Europe is lower than before the crisis, and hence consistency is needed.

❖

# Addressing ring-fencing issues in the Banking Union

## 1. Opportunities and challenges in the development of Banking Union

Fragmentation remains a difficult issue in Europe; in principle, banks must be able to offer cross-border services with as few impediments as possible to foster competition and facilitate optimum capital allocation. This can, however, not be at the expenses of financial stability at EU and at member states levels.

### 1.1. Fragmentation issues remain and these can trigger negative effects

*1.1.1. Fragmentation issues*

In an ideal effective Banking Union where cross-border groups would be dealt with as groups in both live and death, there would be no distinction between home and host interests, eliminating the possibility of national bias in regulation or supervision. However, the EU's legislative framework does not recognise transnational groups at the consolidated level but only as a sum of separate subsidiaries, principally due to the institutional makeup of Banking Union including the absence of a formalised unconditional and unlimited intra-group support and a formal group insolvency framework. There is no free flows of capital and liquidity within a group as this could considerably weaken some entities in a crisis. However, as a consequence, some liquidity may be trapped if a pan-European banking group runs into financial trouble or, even worse, fails and there are still concerns around the sovereign-bank loop. Consequently, the beneficial effects from banking integration have not reached their full potential, although cross-border groups already take up a large chunk of banking activities in a large number of smaller EU member states. This, together with differentiation in taxes, insolvency regimes, company laws and other national frameworks is fragmenting the banking markets.

*1.1.2. Fragmentation is linked to the unfinished business of the EMU architecture*

An official suggested that fragmentation is fundamentally related to the unfinished construction of EMU architecture. As long as the EMU financial architecture is incomplete, member states will have understandable concerns, which will provide an incentive to engage in ring-fencing. The root causes of fragmentation and distrust are information asymmetry and concerns about effective coordination and burden-sharing in the event of a cross-border banking group collapsing. The official noted that Nordea is a case in point of a truly transnational financial group. Compared to other regions in Europe, the Nordic region has very deep financial integration, despite the fact that Finland is a member of the euro, Denmark and Sweden are EU countries but not part of the euro and Norway is outside the EU but in the EEA.

*1.1.3. The negative impacts of fragmentation*

An official felt that fragmentation in Europe leads to higher capital, liquidity and MREL costs for transnational banking groups without making them safer. Europe lacks an integrated banking market, and society does not receive the benefit of high capital and liquidity. Europe will experience lower growth if it does not have an integrated market. This fragmentation also complicates the implementation of the single monetary policy. Europe must address the notion that institutions are 'global in life but national in death'. An industry representative described how regulators and financial intermediaries have incorrectly resigned themselves to the notion that ring-fencing and fragmentation are facts of life despite the implementation of the SSM and the SRM.

Another official explained how there has been a substantial renationalisation of banking business in the EU following the financial crisis. The level of integration achieved before the crisis was suddenly reversed. Now the European Union is experiencing a period of reintegration despite some diverging signals. This reintegration trend appears to have resumed in convergence and prices while quantity-based integration is declining. In any case, integration does not happen overnight. Many factors must fall into place to achieve more integration in the banking markets; legislation is only one factor.

### 1.2. To foster competition, facilitate optimal capital allocation and enhance stability, banks should be able to offer cross-border services with as few impediments as possible

*1.2.1. The EU economy needs pan-European competitive banks*

An industry representative suggested that the work already completed on the banking sector in Europe has produced much safer banks. Legislation and regulation have led to a reduction of risks, much higher capital and liquidity buffers and the existence of the SSM and SRM. Most of the emphasis has been on making the system safer, however. Not enough has yet been done to make the system more competitive and deliver on the promise of having truly pan-European banks which are able to support the economy. European banks are currently suffering in terms of profitability because the emphasis has been on making them safer but not more competitive. Ring-fencing and the trapping of liquidity and capital has resulted in European banks being less competitive. Europe should be mindful of overdependence on foreign banks and ensure that European banks can continue to play the important role of bank-led financing in Europe. The Banking Union is also important because European companies need to develop beyond their national markets. They need to finance significant developments in the digital transformation, the energy transition and the climate transition. Additionally, Europe should promote the geographical diversification of its banks, so they are no longer over-dependent on single economies. Europe needs strong, truly pan-European and integrated banks.

*1.2.2. Europe needs to decide whether it wants to benefit from pan-European banks*

An industry representative emphasised that Europe needs to decide whether it wants to have pan-European banks. This does not mean national champions but rather banks that operate throughout the continent and manage capital, liquidity and lending policy on a European scale. If Europe wants that, it should seek to open a dialogue with the few pan-European banks currently operating in Europe. It is important to discover what these banks consider to be the minimum requirements for performing these functions. The existing national approach is the precise contradiction of the Banking Union. While other panellists had mentioned several important technical issues, amongst which the solo level application of capital and liquidity requirements, the most important action is to understand what are the minimum requirements for a pan-European bank to continue to operate. If there is a suspicion – which has been flagged by some speakers - that a parent bank would not support its subsidiaries in other countries in the event they were in trouble, there is obviously no possible dialogue and no way to tackle distrust amongst home and host countries.

### 1.3. Building trust in the EU's crisis management framework

An industry representative felt that since the introduction of the SSM and the creation of an integrated mechanism for dealing with banking crises there should not be any arguments for the national approach. The suggestion that host countries can be destabilised by a foreign bank's management of liquidity or capital is grossly overstated. In fact, the evidence suggests that the opposite is true. In Romania, for example, foreign banks consistently supported the real economy during the crisis. In terms of risk reduction and risk-sharing, it is important that there should be guarantees, but these must exist in a cooperative framework and with prior consultation. Another industry representative agreed on the importance of trusting European institutions. Banking Union comes at a substantial cost for banks. For instance, banks are paying a significant cost for the Single Resolution Fund (SRF). This is equivalent to being forced to pay a housing tax on a house one cannot live in.

An official considers it problematic that in case of disagreement national authorities are excluded from the SRB's decision-making process and indicated the SRB's governance framework must be improved. The Chair was struck by the fact that the official was questioning the governance of the SRB. These institutions were conceived in this way. Europe should not blame something and consider it foreign simply because it is a supranational institution. The official replied that it is problematic for authorities to have a seat at the table but not to have a say in the discussion. In addition, irrespective of all the trust you may have in the SRB, it does not currently have the means to force a bank to recapitalise a subsidiary. The Chair felt the need to comment, noting that European countries should not develop a mentality in which everybody is a 'free-rider' on something bigger than themselves. The Chair felt the discussion should not be about small and big countries. Ultimately, the discussion on banks is about whether it is possible to trust someone from another country.

An official suggested that this is not a matter of trust. Rather, if the European Union has agreed something as a whole, it must necessarily use the institutions it has already created. It is problematic for member states to attempt to solve these issues nationally. Once the Union has decided to create institutions, it should make use of them. The European Union relies on trust. The Union has these institutions, and they should carry out their intended functions. Another official considered that trust emerges from the alignment of incentives and interests among different stakeholders. The official described the sudden stop of financing in Central and Eastern Europe, to which the answer was the voluntary Vienna Initiative. The stakeholders discussed the issue together and decided that the industry had to continue to lend; the supervisors allowed this additional lending although the risk was not quantifiable. The Chair emphasised that finance is global and that what Europe seeks is a globally competitive financial sector.

## 2. Addressing the problem of ring-fencing will require a basket of measures

The panellists suggested a variety of different ways to address the issue of ring-fencing, with some noting the importance of having credible guarantees provided by parent companies to euro-area subsidiaries based on European law and enforced by European authorities. Additionally, member states must develop credible liquidation regimes and there must be a balance between risk reduction and risk-sharing measures. Burden-sharing and capital waivers remain for some of the speakers extremely challenging issues.

### 2.1. To solve the home-host dilemma, Europe will need credible, unconditional and unlimited support provided by parent companies to euro-area subsidiaries based on European law and enforced by European authorities

An official expressed dissatisfaction with the word 'ring-fencing'. The real issue in this debate is the level of support that groups are prepared to commit to their subsidiaries and the legal instruments to make this solidarity robust and reliable. The first question here relates to the level of support groups want to give to their subsidiaries. It would not be consistent to implement a framework allowing free flows of capital and liquidity in going concerns without simultaneously addressing the legitimate issues which result from an incomplete framework for managing 'gone concerns' issues. If waivers will form part of the policy in this area, the level of support should be full and unconditional. The second issue is about the legal instruments required to ensure that the support is full and unconditional. If there was agreement on this, the question would become a technical one. The main technical issue is how support mechanisms are perceived. The official suggested that "simple" contractual guarantees (as had also been proposed by COM under the banking package) would be insufficient for this purpose.

An industry representative felt that further regulation on such an issue is probably unnecessary. There should be a pause in regulation to allow the industry to assess what has been done since the crisis and evaluate the benefits. The Chair intervened to enquire whether or not it is possible to offer a guarantee without a legal basis. The industry representative noted that their institution had ensured the stability, capitalisation and management of its Romanian subsidiary here even before these mechanisms existed. The Chair replied by noting that Romania is not part of the Banking Union. The industry representative opined that their institution supported its subsidiaries in a highly responsible way. It would do this even if it were not bound by the mechanisms being worked on in terms of the resolution framework and the process of drawing 'living wills'. Going forward, the solution to this issue will be to allow banks to reap the benefits of Banking Union and remove the regulatory requirements at the solo and consolidated level. Capital and liquidity must be allocated in the most effective way possible, because that is how groups manage their subsidiary banks. An official considered that the industry has a range of issues to tackle. Guarantees are not the silver bullet, but they do align incentives. This puts a substantial amount of pressure on a parent. In the case of the 'sudden stop thing', both sides had problems: nobody knew what was happening with the parent groups, and nobody knew what was happening with the subsidiaries. The industry is in a much better situation now. It is possible to know much more, and the European institutions can help.

An official noted that the extensive discussion on the proposal involving simple guarantees has ultimately not resulted in political agreement. Noting the example of Theresa May, who recently had her Brexit deal rejected three times, the official felt it unwise to restart the same discussion the next day on the same basis. Trust is also very important. If there is a discussion at the level of the EU Council and a majority of countries say that they are not comfortable with the proposals, other parties should not immediately blame these countries. This is not conducive to creating the necessary trust to have this discussion. Simple guarantees will not do it; EDIS will not do it; a single supervisor does not do it. The sceptical countries need legal certainty. If a group expresses full and unconditional support for a subsidiary, there must be a legal instrument to make it valid. As of today, Europe simply does not have this.

### 2.2. Member States must develop credible liquidation regimes

An official felt there are many things missing in Banking Union. There is no single 'silver bullet': Europe needs a basket of measures. Further risk reduction will need to be carried out by banks. There is still work to do on, for example, loss-absorbing capacity and the concentration of sovereign risk. This cannot be avoided; it must be tackled. On the official side, countries must develop credible liquidation regimes for cross-border financial groups. This is especially needed for banks, and it is the task of justice ministers. Europe needs to align the interests of finance ministers and justice ministers. Additionally, Europe will not develop cross-border banking without deposit insurance. It is too costly for banks to invest in local deposit insurance.

### 2.3. Europe must maintain a balance between risk-reduction and risk-sharing measures

*2.3.1. More integration means less risk*

An official considered that Banking Union contributed greatly to fostering the EU-wide application of strengthened regulation and supervision. However, the crucial factor of trust is not enshrined in legislation. Markets and market players make objective assessments of risks and opportunities. Risks will not disappear when they are shared. Risk reduction in the European banking sector must continue in a way that is transparent to the market and to all market players. This includes further reducing the levels of the NPLs, addressing exposures to sovereign risks and making more progress on risk diversification. Where risks are further reduced, there is an opportunity to advance with financial integration in Europe. In any case, Europe should note that financial integration does not stop with traditional banking. New technologies and the use of the new technologies by banks will probably also hasten financial integration in Europe.

*2.3.2. Providing objective measurements of the processes of risk reduction and risk-sharing*

An industry representative considered it necessary to provide objective measurements of the processes of risk reduction and risk-sharing. Before Banking Union, there was a very different situation. Now, the introduction of the SSM is a major measure of risk reduction. This is quite clearly measurable. Additionally, the reduction of non-performing loans and the new liquidity requirements are also measurable. It is essential to move from perceptions and impressions to quantifications of what has been achieved in terms of risk reduction before saying that the problem of trust is a fait accompli.

*2.3.3. Increased solidarity must go 'hand in hand' with increased solidity*

An official described how in 2012 the industry was able to combat financial fragmentation through the ECB. In this case, however, Europe must find a structural solution. Europe is reducing non-performing loans in banks, but this task is not yet complete. In order to make real progress, risk-sharing must go 'hand in hand' with risk reduction. There is plenty of 'unfinished business' in the Banking Union from the perspective of the private sector. The official noted the importance of considering this issue also from the broader macroeconomic perspective. First, financial fragmentation hampers the transmission mechanism of monetary policy, which means the effectiveness of monetary policy is reduced. Second, there is an imbalanced policy mix in the euro-area. The 'good times' of fiscal policy were not used for building buffers or pursuing economic reforms. Europe is facing a period of uncertainty and an economic slowdown at least for some time. The countries with fiscal space should use it for investment and countries with much less fiscal space should continue to build buffers. The official stressed the importance of meaningful coordination. In the current context, the industry needs a better and more optimal policy mix between fiscal and monetary policy.

### 2.4. Addressing the challenging issues of burden-sharing and capital waivers

The Chair highlighted the question of whether legally binding guarantees would be sufficient or whether other instruments are needed. An official suggested that the most pressing problem today is the lack of appropriate instruments. In a situation with capital waivers and therefore burden-sharing, the official's concern is about not being at the table or not having a say. Burden-sharing is difficult, and this difficulty should not be underestimated. There are two principal issues here: liquidity and capital. Regarding liquidity, to the extent that groups have a pool of collateral, they can move it. If a group wants to move liquidity and it does not have the collateral, however, there is a problem. For capital, burden-sharing is difficult. A banking group would not want to die with a subsidiary because the host country was taxing the banking system without limit. It would be understandable for some banking groups to say that full solidarity is not that easy because they do not want to die with their subsidiaries. Additionally, it is important to consider the 'single point of entry' resolution. The core idea of single point of entry resolution is the prepositioning of capital and MREL within subsidiaries so that losses can be upstreamed. Most resolution plans foresee an SPE. It is impossible to remove the prepositioning part of this.

An industry representative agreed that burden-sharing is difficult. However, there should be a forum for discussing this, and it must be within the European institutions. If there are countries that belong to the European Union and do not belong to the monetary union, they should have more say in the discussion about banking. The industry representative felt that Europe should 'bring the outs in' as it would have clear benefits and promote further consolidation of the sector. The Chair noted that this is a big task, reminding the participants of the fact that, after the UK leaves the European Union, all countries other than Denmark are committed to joining the eurozone.

The Chair agreed on the difficulty of burden-sharing. However, member states share a single market and a currency. Europe's banks have capital because they benefit from a space without borders, which is the real single market. Europe must do everything in its power to ensure that the benefits from the single market for goods are also reflected in the single market for financial services. Europe always compares its banking system with the US banking system. Europe should seek to build something as strong as the US banking system, but Europe cannot continue to compare itself with the US and regret its lack of organisation.

# EU resolution approach for SSM banks

The Banking Union (BU) remains fragmented and incomplete, which weakens the global competitiveness of European banks and raises the risk of dysfunction in the event of a future shock. Banking markets are still fissured along national borders. There is little progress in cross-border lending, especially in retail markets, i.e. lending to households and firms. Ring-fencing is still an issue in the BU, although the single supervision authority and single resolution authority unite all of the national competent authorities. Indeed, Member States do not sufficiently trust the institutional set-up of the BU. They believe that capital and liquidity will be trapped in individual Member States if a pan-European banking group fails. It is therefore essential to address host countries' concern over the crisis-management framework.

The Chair invited panellists to discuss forthcoming priorities for progressing with a common, transparent and predictable resolution regime. The second half of the discussion focussed on the European deposit insurance scheme (EDIS). Where does Europe stand? What can EDIS contribute to the completion of the Banking Union (BU)? What are the main stumbling blocks? Why does it seem that progress is stalling?

## 1. Priorities for progressing with a common, transparent and predictable resolution scheme

Increasing confidence between home and host countries around burden-sharing is urgently required. In this perspective, there are several outstanding issues around resolution to be addressed, such as the need to define a common application of 'public interest criteria', a lack of appropriate mechanisms for resolving mid-sized banks and a need to establish a common banking liquidation framework while maintaining the precautionary recapitalisation instrument.

### 1.1. Increasing confidence between home and host countries around burden-sharing remains a key priority

*1.1.1. It is necessary for parent banks to issue credible cross-border guarantees for their subsidiaries*

A regulator noted the difficulties concerned with burden-sharing, expressing his belief that Europe should continue working on guarantees provided by the parent company of transnational groups to their subsidiaries located in the euro-area in order to strengthen trust between home and host countries. Indeed, there must be guarantees and reassurances before the 'fatal weekend' when burden-sharing becomes necessary, which means that these positions must be strengthened ex ante to inspire confidence in burden-sharing and provide Europe with flexibility. Credible cross-border guarantees are suitable for this purpose. These must be based on European law and enforced by European authorities. This will increase confidence between home and host authorities. However, it is difficult to progress in this area because different banking groups want to take different approaches.

*1.1.2. MREL is a cornerstone of the EU resolution regime for significant institutions and groups*

A Central Bank official felt this issue depends on many of the structures currently being built. For example, large transnational banks are dominant in the Croatian market. When Croatia becomes part of the BU, it will be necessary to have a coherent and consistent framework for these banks to hold a sufficient amount of MREL. There is little alternative to a robust and transparent MREL framework, which is achieved to the largest extent possible in the new Banking Package. By the end of 2024, both the Single Resolution Fund (SRF) and the agreed resolution strategies should become fully credible and operational for all, or the vast majority, of the significant banks and groups in the BU. Second, the SSM and SRB must have a predictable and consistent policy to manage 'failing or likely to fail' banks. If there is a substantial number of exceptions, every bank or national authority will claim a particular specificity, and this will cause multiple fragmentation.

### 1.2. There is a need to define a common application of the 'public interest criteria'

A common application of the "public interest assessment" by the Single Resolution Board, the European Commission and national resolution authorities would make more predictable the resolvability of failing banks, whatever their size. As evidenced by recent liquidation cases, whether the resolution of a bank deemed failing or likely to fail is in the public interest or whether a bank should be liquidated in the absence of public interest has been assessed differently at the EU and at a national level based on the current legal framework. 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 a national level, enabling divergent courses of action to be pursued along national lines. In recent cases, ailing banks which have been turned down by the SRB were subsequently found to be of public interest by national authorities. Ultimately, the right to decide lies with whoever is prepared to foot the bill.

A regulator observed that the current resolution framework suits large banks well, but there are questions about mid-sized deposit-funded banks. In these cases, there are different definitions of public interest at the European level and the national level. In addition, the differences between different national approaches to public interest cannot be completely explained by the specifics of local markets. This fragmentation undermines the credibility of Europe's resolution framework. Moreover, it is not predictable for external stakeholders. Therefore, Europe should immediately seek a common definition of public interest. As long as EDIS has not been established and is not fully effective, the regulator felt that this topic was essentially a question of burden-sharing. It is essential for national public interests and the European public interest to converge quickly. As an immediate transitional measure until EDIS is fully established, Europe could seek stronger involvement from national resolution authorities in the SRB's decision-making process.

### 1.3. The EU must determine the appropriate mechanisms for resolving mid-sized banks

*1.3.1. The BRRD's approach to resolution does not take account of a bank's size or business case*

An official disagreed with the remarks made by the regulator, highlighting that liquidation is the default option in the regulation. If Europe wants to have different resolution approaches for large, medium-sized and small banks, the regulation must be changed because the current EU framework, respecting the principle of proportionality, is applicable to all kind of banks. Second, the Single Resolution Board (SRB) has a single policy for assessing the public interest, so for banks under the remit of the SRB only one resolution policy is applied. The only two Institutions that can challenge its decision are the European Commission and the European Council, not a national resolution authority. Third, the governance of the SRM is completely different from that of the Single Supervisory Mechanism (SSM). Decisions on resolution or on approving resolution plans lie with the executive section (if a national authority participates and the members do not reach a consensus, only the permanent board members vote). An industry representative stressed the importance of taking into account the reality of the relationship between the SRB and national resolution authorities. With regards to the two failed Venetian banks in 2017, the SRB assessed that they banks were neither systemically relevant nor providers of critical functions, so they concluded that there was not public interest in their resolution.

*1.3.2. The BRRD rules seem inadequate for mid-sized banks in the EU*

A Central Bank official reiterated the importance of trusting and valuing the work that is already complete. If the system is not working, Europe must conduct some fine-tuning. One of the primary objectives of BU is to provide visibility and financial stability. The current system does not guarantee financial stability from the point of view of different member states. Banks still 'die nationally'. If this principle is applied to a medium-sized bank which does not comply with the European interpretation of public interest, an insolvency process will be required. However, this will be completely chaotic, because Europe has not created instruments for insolvency within the BU and the common legislative framework. In other words, this means that, while supervisory and resolution decisions are mostly taken at the European level, the ensuing consequences still lie with taxpayers at the national level, with potentially serious impacts on national budgets. As the ultimate guarantor of financial stability remains national, but with limited tools to act, this 'accountability conundrum' needs to be solved.

Solutions need to be found for the orderly exit of traditional medium-sized deposit-taking banks without disrupting financial stability. Whereas MREL and bail-in requirements form a cornerstone of the common EU resolution regime for larger banks, the 8% bail-in within the BRRD is absolutely inadequate for medium-sized banks whose business model relies on retail and SME clients. Thus, there is a systemic dimension to these non-systemic or non-relevant banks at an European level. Additionally, the role of national DGSs must be clarified. A Central Bank official considered it essential to determine the correct solution for deposit-taking banks before considering harmonisation. Additionally, financial stability is a key objective. Otherwise citizens will not recognise the BU as anything but an instrument for the consolidation of banks. It is prudent to refrain from supporting greater harmonisation of insolvency regimes until Europe understands what it is trying to do. The Central Bank official clarified that their main objection is not with the concept of a bail-in but rather with the 8% BRRD bail-in, which demands an excessive amount of MREL. In addition recent calls to form a sort of European FDIC, merging the Single Resolution Fund and EDIS into one single entity, merit our attention in this regard in the medium-term, provided that the legal framework is fixed and that financial stability – both at the European as well as at the national level – is enshrined as the first and fundamental objective of any intervention.

### 1.4. Europe must establish a banking liquidation framework

*1.4.1. Making the liquidation regimes across the Union more consistent and predictable*

There is still considerable fragmentation between national regimes, which means there is a need for greater harmonisation. A regulator suggested that it would be useful to reform the liquidation framework for banks. Liquidation regimes across the Union are not sufficiently consistent and predictable. This framework will need to hold during the 'fatal weekend'. This process involves the reaction function, commitment and engagement and it must have a sound basis in European legislation. The early intervention of the authorities should create confidence and the process should be enforceable, whether in resolution or liquidation. Liquidation will be essential here, because resolution will need to be built on the 'no creditor worse off' basis.

*1.4.2. EU legislators should create a single insolvency regime instead of harmonising incrementally*

An industry representative emphasised the importance of learning lessons from recent cases of resolution, even if Europe's system was fully aligned with international principles on the subject. Ultimately, national insolvency regimes should be harmonised. Europe must have a single resolution framework, but it is important not to discuss harmonisation for decades and achieve nothing. A common insolvency regime would provide clarity for investors, customers and the public regarding how bank failures will be treated. The ideas floated by the SRB and the Commission indicate the right direction. There should be a single insolvency regime for banks with a single administrative authority. Arguably, the SRB is the ideal institution for this role. This will require the involvement of judiciary authorities, because it is a deeply legal issue. There will need to be a set of liquidation powers, a resolution toolkit and a bridge bank. There will also need to be clear and consistent creditor hierarchies in order to ensure that the resolution framework and insolvency regime are consistent. Finally, Europe should define common triggers for the activation of insolvency. The Commission has called for a study about this issue, which will feed into a legislative proposal.

*1.4.3. There is potentially added value in using a 28th regime for Europe's liquidation framework*

The Chair described how, in a previous panel, a panellist had proposed involving justice ministries in this process. However, each justice ministry believes that its version of insolvency law is better than the 26 others in the Union. The Chair wondered whether Europe could consider a 28th regime where issuance is possible. A Central Bank official agreed that this is possible, adding that harmonising insolvency regimes is something for the very long-term. If a big bank operates in multiple regimes inside the BU with a clear regime and a responsibility for covering deposits, all of its stakeholders should have the same level of guarantee. The Central Bank official felt that harmonising the different insolvency regimes of member states cannot work. This is the reason why a 28th regime seems a viable option. In addition, Europe must undertake further work in relation to the medium-sized deposit-taking banks notably because the existing regulations around the BRRD and state aid create a nightmare. An official disagreed, noting that the issues raised by the Central Bank official were about the application of burden-sharing. The Central Bank official emphasised that he had not asked for state intervention. The official considered that this was behind the desire for a different approach from the BRRD. The Central Bank official clarified that the problem is not the bail-in but rather the rigid bail-in rules of 8% and 5%.

### 1.5. It is necessary to maintain a precautionary recapitalisation instrument

In relation to divergence in national liquidation procedure, the Chair noted that a member of the audience had suggested that the simplest way to solve divergence in liquidation practices is for the European Commission to announce the withdrawal of approval of precautionary recapitalisation. An official answered that without precautionary recapitalisation a bank will be forced into resolution or liquidation and the lack of harmonisation of the insolvency laws will not be solved. In liquidation without the state aid allowed by DG Competition, the shareholders and creators of a bank should bear the losses of the liquidation. This question comes back to market discipline, but such a withdrawal of the precautionary recapitalisation instrument will not solve the lack of harmonisation in insolvency proceedings. This type of measure could be possible if flexibility is added to a different part of the EU resolution framework, for instance a flexible liquidation regime for handling medium-sized banks. However, Europe must seek a compromise to secure additional flexibility. It cannot be withdrawn without compensation.

## 2. Still many stumbling blocks to achieving an agreement on EDIS

While views on EDIS still diverge considerably, a possible way forward to accommodate the differing opinions appears achievable. Without EDIS, the credibility of the SSM and SRM is at stake, but EDIS will not 'miraculously' solve the issues within the BU and it has the potential to threaten the existence of member states' institutional protection schemes (IPS). However, EDIS should not be considered as a novelty since a political commitment was achieved as early as 2012, inspired by the US system. Ultimately, Europe should progress gradually and cautiously towards EDIS.

### 2.1. Without EDIS, the credibility of the SSM and SRM is at stake

A Central Bank official considered that not creating EDIS could create morally hazardous incentives for national authorities. National regulators may be incentivised to use tools designed for systemic institutions to handle less systemic institutions in order to protect their own DGSs. There are also other moral hazards and possible arbitrage around EDIS. For example, Croatian banks could offer German savers a slightly higher interest rate while guaranteeing deposits up to €100,000. If savers know they are insured and that the DGS is well funded, this kind of arbitrage becomes possible.

Additionally, EDIS will solve the problems concerning liquidity and capital ring-fencing issues in transnational banks. In many cases, EDIS will lead to the branchification of larger transnational banking groups, because it is unnecessary to have a subsidiary if it is possible to have a branch. In the absence of EDIS, full responsibility for depositor and client protection, as well as protection of public funds in thousands of small and medium-sized banks, will remain at the national level while key decisions on issues such as licence withdrawal and public interest are made at the EU level. However, the Central Bank official highlighted the importance of ensuring that legacy issues are not mutualised, stressing that this would have to be solved before EDIS is possible. The SSM and the SRB should create an environment in which all countries agree that it is now time for EDIS. Before this, the banking market should be cleaned up. The Central Bank official expressed frustration that the people advocating EDIS are also attempting to make the SSM less efficient. There must be the will on all sides to do this. Everything will be much easier with a good insurance system and properly capitalised banks. The Central Bank official noted that Croatia closed 42 out of 62 banks over 16 years and experienced no banking crisis because there was enough capital and enough money in the deposit-guarantee-scheme. It is possible to clean up the market gradually with the right expertise.

An industry representative agreed with the Central Bank official's remarks, noting that the issue of EDIS is about consistency, credibility, and the logic of the BU. If BU is about ensuring the fungibility of money, EDIS is necessary because one euro should be equally protected regardless of where it is located. As a compromise, there could be different speeds of implementation, but there is no intermediate solution which can break the 'doom loop' between sovereigns and banks. The industry representative stressed the importance of having the same rules with centralised supervision and resolution. If the costs of EDIS are borne locally, decisions taken at the European level could create serious political issues. The absence of EDIS generates doubts about European states' ability to compromise on the BU and hampers the development of cross-border deposit markets. EDIS would support the single market, enhance financial stability and enable more lending in the economy, because more deposits would flow. However, a badly designed EDIS would be a 'nightmare'. Europe needs solidarity, and there is no solidarity implied within EDIS. EDIS must be designed so there is no systematic and consistent flow from the north to the south or from the east to the west, which could be avoided by adjusting contributions using risk parameters.

### 2.2. EDIS will not 'miraculously' solve the issues with the BU and could threaten IPS regimes

An industry representative questioned two of the main arguments for EDIS: It supposedly breaks the sovereign-bank loop and its absence causes restrictions on the free flow of capital and liquidity. EDIS will not miraculously eliminate these problems. Additionally, the industry representative brought forward several arguments against EDIS. First, alternative measures such as those being applied in Italy would no longer be possible. Second, the target volume of 0.5% for concentrated markets like France would be lost. Third, 50% of all credit institutions in the EU are part of an IPS, the existence of which would be threatened under EDIS. Bearing all this in mind, the industry representative stressed the need for Europe to explore alternative solutions. If the industry sets aside the Commission's 'dogmatic' proposal for a fully mutualised EDIS, there are several alternatives allowing for the retention of national DGSs as a first line of defence, while also making possible the creation of an additional European layer. Regarding resolution and EDIS, the industry representative questioned that there are direct links. After bailing-in the debt of the institutions that need to be resolved, will Europe reach a level where deposits also need to be bailed in? The industry representative doubts this, suggesting that the conservative MREL and TLAC requirements in place will be sufficient. A regulator agreed that an evolutionary approach could be a solution, expressing doubt that EDIS would threaten IPS regimes.

### 2.3. EDIS should not be considered as a novelty since political agreement was achieved in 2012

A Central Bank official considered that not implementing EDIS is problematic because it is a compromise package and not something envisaged to be dependent on NPLs, sovereign exposures and insolvency harmonisation. EDIS was a package agreed when Europe was in a serious crisis (2012) and inspired by the FDIC. Europe must think back to this time and not consider EDIS as a novelty. The reason for the discussions on waivers and alternative measures is because the progress being made on the BU has stopped.

### 2.4. Europe should progress gradually and cautiously towards EDIS

A regulator considered that every member state has carried out risk reduction, which means that Europe should progress gradually and cautiously towards EDIS. Domestic exposure to sovereign-bonds is an important problem to address, and this will require 'creative' solutions. It is not sufficient to discuss solutions exclusively in terms of prohibitions or disincentives for investment on sovereign-bonds. On the contrary, Europe should consider the incentives for buying sovereign-bonds carefully, because to some extent all banks will hold sovereign exposures. Europe should not penalise sovereign-bond holdings per se; rather, Europe should create positive incentives for well diversified sovereign-bond portfolios.

The Chair noted that the debate between risk reduction and risk-sharing had been raised and queried whether this is a false dichotomy. An industry representative suggested that Europe could be halfway to EDIS if attitudes toward risk reduction and risk-sharing were different. If further risk reduction is impossible, there is always the possibility of changing the risk premiums in EDIS. The industry representative agreed that diversification could be achieved through a safe asset or synthetic risk-weighting. It is healthy for banks not to be excessively concentrated on one sovereign, but they do need some sovereign exposure.

# DEVELOPING EU CAPITAL MARKETS

## Developing and connecting securities ecosystems

### 1. Developing securities ecosystems at the domestic and EU levels

#### 1.1. Balance between domestic and cross-border development

A regulator noted that the capital market union (CMU) initiative has two main objectives. First, developing capital markets in the EU. Capital markets are small in many European countries, which reduces their attractiveness and capacity to fund the economy. Second, further integrating and connecting domestic capital markets, as the differing legal systems and corporate structures that exist at present across the EU mean they are largely national. This will provide additional opportunities to savers and issuers such as SMEs and also help to improve risk mitigation across the EU.

Further developing and integrating EU capital markets is challenging because the right balance and sequence needs to be found between local and pan-European development in order to achieve positive impacts. There is always the risk that a pan-European market-opening measure may weaken existing domestic capital markets but at the same time it is necessary to connect local markets, once they have started developing, in order to achieve sufficient development at the EU level.

An industry representative agreed that building the CMU is valid, but SME equity financing must be built first on a national basis with the development of local capital-market ecosystems. Once they are functioning, a cross-border layer across the EU can be added to bring extra benefits. Post-trade must also be addressed, as the present market structure does not support cross-border listings for SMEs. It is costly to handle the extra friction that a company incorporated in a given EU country experiences when listing in another one. The CMU must be stepped up by the incoming Commission, taking into account existing best practices across Europe.

Another regulator noted that securities ecosystems include companies, investors, infrastructures and intermediaries, and emphasized that there is still a great deal of friction in the matching of financing supply and demand among them. An ecosystem is usually domestic, but there should also be the objective to develop a European ecosystem as a local ecosystem.

#### 1.2. Capitalizing on best practices at the EU level

An industry representative stressed that effective capital-market ecosystems for SMEs already exist, particularly in the Nordic region, showing that the CMU objectives in terms of developing local capital markets are achievable. Finland, Sweden and Denmark have a little more than 1,000 companies listed, of which 600 are small-caps; 350 small-caps are on the junior market, which is an MTF (multi-lateral trading facility) with its own rulebook and half of the 600 companies on the regulated market are also small-caps. This SME market in this region survived the financial crisis and is still successful despite tough regulations such as MiFID II and the Market Abuse Regulation (MAR).

The Nordic region is the only one, when looking at the EU and US, to have had a net increase in the number of listed companies since the latest crisis. The junior market is also growing quickly. This example shows how effective capital-market ecosystems can develop with different regulations and a proportionate regulatory regime and currently there is an initiative underway with the US to promote these practices. The US market indeed no longer encourages SMEs to go public. Recent initial public offerings (IPOs) such as Facebook, Lyft and Uber concern huge companies funded by venture capital and private equity until they went public.

The industry speaker underlined that within the Nordic region, development has been particularly strong in Sweden over the past 10 years and even before the financial crisis. Best practices from Sweden are now being used in Finland and Denmark, where progress has been more difficult.

Another industry representative agreed that the net increase in the number of public companies on the Nordics market is remarkable given the opposing global trend. Around 75,000 companies were listed globally in 2000; by 2017, there were fewer than 35,000. This must be addressed by public-policy decision-makers. A question however is to identify which issuers can best drive SME issuance forward.

### 2. Priorities going forward

#### 2.1. Refocusing the CMU on a smaller set of investor and SME-related objectives

An industry representative was struck by the diminishing confidence in CMU progress and comments made by speakers in another session of the Eurofi seminar, that SMEs do not need capital markets because there is sufficient bank funding. The EU regulation recently proposed by the Commission regarding SME growth markets however mentions the need to reduce dependence on bank lending and facilitate the raising of capital as major objectives. These sceptical comments show that it is time to re-evaluate how this can be done. Having thousands of listed companies in Europe is difficult to achieve in the short-term, but the objective of developing capital markets and better balancing capital market and bank financing for stability reasons needs to be pursued, possibly with a different action plan.

The CMU agenda must be reset to emphasise two main lines of action, the industry speaker suggested: investor protection and a proper understanding and development of ecosystems. SME markets and the main blue-chip markets are not different, they are part of the same ecosystem and the same rules should apply.

Another industry representative considered that a great deal has been done to design and implement the CMU over the last five years with an action plan containing 33 different measures covering all possible areas identified at the time. Most of the corresponding legislative texts have been delivered, although some are still to be implemented. Continuing the momentum requires a focus of the CMU on a smaller set of priorities.

The speaker suggested three main priorities going forward. First is a focus on SMEs. SME markets have done well in some parts of the EU, but overall Europe is not as good at growing companies as the US. The causes of that need to be rectified, whether it is proportionality or a lack of strong local markets across the EU. The US JOBS Act[1] can possibly provide inspiration also. Second is looking at the pools of capital that exist in Europe and those that need developing. The current CMU action plan focuses mainly on growing existing pools of capital with measures related to securitisation and Solvency II. Going forward the objective should exist of developing new pools of capital, for example with the further development of pension funds. The Pan-European Personal Pension (PEPP) project was an attempt to do that and more should be done in that space. Pensions are indeed the area where there is the biggest gap with the US in terms of savings, with private-pension savings in Europe of about a quarter of the US. Within Europe, the gap is even bigger, as private pension funds in the smallest member state are 200 times smaller than in the biggest. That equates to trillions of euros to invest. It will not change overnight but must be improved. The UK has made a start so it is relatively ahead in Europe. Over the last five years, it has moved to auto-enrolment into private pension systems, with 7 million new pension savers investing £10 billion more than would otherwise have been. It is not enough but it is a good start to build on. The third aspect is the global dimension of capital markets. The UK has hundreds of European companies listed and raising funds there, but connections are also needed to global markets, where much of the growth and investment will come from over the coming years.

A regulator agreed that developing pension funds and life-insurance in Europe will lessen fiscal burdens and create investment capacity. Only few countries in Europe have prefunded systems and they are mostly where the most active capital markets are: northern Europe, the Netherlands and the UK. Going from pay-as-you-go to more prefunded systems would improve fiscal sustainability and help to foster the development of capital markets for everyone's benefit, including a broader ownership among European citizens of European corporates.

Another regulator noted that building effective securities ecosystems is complex, as it requires a combination of individual measures relating to the four core categories of market participants: savers, intermediaries, infrastructure and issuers. Measures must create potential for all four.

Developing securities ecosystems first requires increasing the diversity of investors and participants, the regulator suggested. Greater diversity helps to increase market volumes and cover the costs of building the ecosystem and also provides more stability with a broader variety of investors. That means increasing retail-investor participation and also attracting cross-border participants and foreign investors with different characteristics, skills and expertise.

A second area is addressing barriers to cross-border investment, which stem from differing fiscal and legal requirements across member states that increase the costs of these transactions. This explains the low participation of investors in cross-border capital markets in the EU rather than geographical distance. Tax is a fundamental barrier, as income on securities is taxed twice at present in many cases, in the country of the security's issuance and in that of the investor. This makes little sense in a single European market, especially when compared to the single taxation in goods markets. Post-trade barriers are a second issue that impacts long-term investment because these barriers affect securities during the whole period that they are held. The third type of barrier is securities account structures. Eight to 10 EU countries have account structure requirements, such as mandatory segregated accounts, which in effect prohibit direct investment by other countries' retail investors. Slovenia is an example. Eliminating these barriers requires in particular a high degree of standardisation and interoperability at the level of infrastructure.

An industry representative added that investors see the EU as fragmented, which creates the perception that EU equity markets are relatively illiquid and lack a centralised regulatory regime for capital formation. Capital formation should be a key focus of the CMU going forward to build a stronger ecosystem.

### 2.2. Tackling the unintended consequences of EU securities regulation for SMEs

An industry representative suggested that introducing more proportionality for SMEs in all EU capital market legislations i.e. MiFID II, EMIR and MAR should be a key priority for the next steps of the CMU (CMU 2.0). Another industry representative however considered that investor protection should not differ between main markets and SME markets. Differentiating rules destroys confidence and can be dangerous. There is only one ecosystem and problems need to be addressed as a whole.

A regulator considered that growing regulation at the EU level still leaves many differences in the implementation at local level, as well as creating unintended consequences of regulation.

Regulation is often seen only as a cost, but if it is appropriately defined and implemented it is an asset and compliance must be seen as an investment. Some aspects such as investor or issuer education to convince participants to go to the market can be dealt with without regulation, but developing SME capital markets and efficient market infrastructure needs an appropriate European regulatory framework.

Some mistakes have been made in developing securities regulation over the last 20 years, the regulator felt, including extending the scope of the new market-abuse regulation (MAR) with insufficient care. This regulation is about market abuse, insider trading and market manipulation, and also provides a framework for price-sensitive information and disclosure obligations. Having the same disclosure obligations for smaller and bigger companies does not make sense and needs to be reviewed.

The new Prospectus Regulation coming into force is another example. It seems a mistake to add a simplified version of the prospectus to the existing layer of hundreds or thousands of pages, especially for SMEs. This should be replaced with more palatable information requirements, especially for retail investors, considering that many SME issuances mainly target retail investors and do not correspond to the needs of most institutional investors or asset managers who require larger issuances and more liquidity.

A third issue is the unintended consequences of MiFID II for research. Some countries have seen a decrease in research, others such as Italy have developed automated research based on numbers and less analysis. Those rules must be rethought and better calibrated.

In addition to tackling these problems, regulation should be used to better match investments with the appropriate investors and ensure a sufficient level of diversification. For example, more sophisticated investors are needed for less liquid and longer-term, riskier securities or for crowdfunding, not necessarily professional investors but ones with revenues exceeding €70,000 and net assets above €100,000. The European Long-term Investment Fund (ELTIF) is a way of facilitating this match as it is open to retail investors, with interesting compulsory diversification rules. With ELTIFs, retail investors can go for illiquid, longer-term securities or infrastructure, which helps to develop long-term investment.

Recreating a stakeholder group at the Commission-level that existed in the past would also be useful in this perspective because member states' National Competent Authorities cannot deal with all issues.

### 2.3. A programme of research to support CMU work going forward

An industry representative suggested that research on capital market development in the EU is needed to support the CMU work, gathering evidence and driving the thinking about the next steps. That should be an objective for the incoming Commission, with industry playing a role. The low-hanging fruit have already been picked, so finding new ideas will be more challenging. There are many pieces of research on different components of the CMU but little on the future steps of the whole initiative. The main reasons for the limited progress in the development of capital markets in the EU are also still largely unknown.

Another industry representative agreed that studies and research should be used to develop a CMU 2.0, which is a good idea, possibly underpinned by big data analyses. One possible area of study would be to evaluate the amount of equity that has been extracted from public markets by mergers and acquisitions and the activity of private-equity and venture-capital firms' over the last few years and the impacts and underlying reasons of this.

## 3. Essential drivers of the development of EU capital market ecosystems

Detailed comments were made on two major drivers of the development of EU capital markets.

### 3.1. Developing retail participation

A regulator emphasized the importance of retail investor participation because even if they are only a small part of the market they are the "canary in the coalmine". If the canary dies, there is a problem. If the canary sings loudly and is buoyant, this usually means that other market participants are happy and developing well. If SMEs do not go to the market, the same reasoning applies.

An investor representative considered that developed local securities and equity ecosystems need a robust local base of individual investors. An appropriate investor base is also needed to develop IPOs in Europe. It is key to the CMU project's success for two reasons. The first reason concerns liquidity in equity markets: academic research, such as that from Edhec Business School, shows that individual investors are mainly contrarian, in contrast to institutional investors, who are mostly momentum-investors. Even a small base of individual investors helps.

The second reason to nurture a local base of individual investors and share ownership is that retail investors have a relatively bigger role in the small and midcap markets than in the overall markets. Euronext statistics show that the share of retail investors in the primary market for IPOs and secondary market for small and midcaps is 20% compared to 10% overall.

The investor representative also emphasized that employee share ownership is a powerful way to develop retail investment. Following a proposal by Better Finance, the Commission added an action on employee share-ownership to the initial list of 33 CMU objectives defined in 2015. A pilot project conducted in 2014 by the Commission concluded that there was a need to promote awareness of employee share-ownership, especially in countries where it does not exist. If employee share-ownership in the EU reached the level of the US, it would be multiplied by 6 which would add $2 trillion of market capitalisation and unlisted SMEs' share ownership would multiply by 100 (from $13 billion to $1,300 billion). This can be a key driver of EU capital markets. UK studies also show that a majority of people exposed to employee-share-ownership open brokerage accounts and buy other shares.

### 3.2. Developing the IPO market in the EU

An industry representative considered that developing the IPO market is a major opportunity for the EU and also for global capital markets because a robust, healthy IPO market, particularly for SMEs, is a key building block for a strong EU securities ecosystem.

IPOs have a positive social impact. IPO issuers are job creators, and companies that raise capital, particularly SMEs, contribute to underlying economic growth. Studies show that 90% of companies see economic revenue and employment growth after going public, so it is critical from a public-policy perspective. It is even more important when considering that over two-thirds of the EU's workforce is employed by SMEs.

IPOs are also an attractive asset class of investment. They have outperformed benchmarks by 500 to 700 basis points through multiple cycles on a global basis and provided institutional and retail investors and issuing companies' employees with significant premium or alpha investment performance.

There are several challenges to address regarding this market in the EU. IPO volumes are down some 70-80% over the last 10 to 15 years due to regulatory costs and complexity. European issuers are also looking outside the EU, as shown by Spotify, which is a missed opportunity for the EU.

The EU should consider creating an IPO and capital-formation taskforce to study existing practices at the global level, assess their impact and make recommendations. There is potential for cross-border regulatory collaboration between the EU and other jurisdictions on this. Examples of innovation or progressive reform around the world relating to IPO issuance include the US JOBS Act, which focuses on emerging growth companies. The success of IPOs in the Nordics is another example that should be expanded at the EU level. There are also on-going IPO initiatives in the UK and Hong Kong that are worth assessing.

1. The Jumpstart Our Business Start-ups (JOBS) Act is a U.S. piece of legislation that was signed into law by President Barack Obama on April 5, 2012, that allays some SEC regulations on small businesses. It specifically targets "emerging growth companies" which are defined as issuers with "total annual gross revenues" of less than $1 billion during their most recently completed fiscal year and includes measures to facilitate capital raising by these companies notably via IPOs and crowdfunding.

# Is the EU securities market structure adequate?

## 1. The evolution of the EU trading/post-trading market structure

### 1.1. Progress made in the post-trading area

An official explained that much progress has been made over the last few years in the eurozone in the integration of securities markets with the building of the necessary infrastructure. TARGET2 allows the exchange of large value payments in Central Bank money in real time in the euro-area. TARGET2-Securities (T2S) provides in addition the capacity for the securities market of the whole eurozone to settle transactions in Central Bank money. T2S was conceived as a single market initiative providing a unique multi-currency Central Bank money settlement platform. It settles euro and Danish Krone transactions at present, but can be extended to other currencies, showing that integration in the securities market can go beyond the euro-area to deliver a single market for the EU.

Further infrastructure projects are being developed in the eurozone. The new generation of RTGS[1] (Real Time Gross Settlement System) supported by enhanced technology such as ISO 20022-type messages, is being built to harmonise the different types of exchanges that exist for Central Bank money and liquidity. This will allow all Central Bank money liquidity to be managed centrally and will ensure that banks get access to sufficient liquidity to be able to handle large value payments in TARGET2 for securities, money market and repo transactions, as well as retail payments. TIPS (TARGET Instant Payment Settlement) is another new service that allows instant payment in the euro-area and will be eventually extended to the EU.

A policy-maker stated that much progress has been made in the harmonisation and efficiency of post-trading in the EU, which is relevant for the capital markets union (CMU). Each country had its own procedures and requirements until recently, which hindered the cross-border settlement of securities transactions. The Central Securities Depository regulation (CSDR) and T2S have brought significant improvements. Investors can now more easily buy securities in other member states. CSDR allows the establishment of regulated links between CSDs in order to facilitate cross-border transactions. Harmonised rules and the removal of national barriers make settlement processes more efficient. That has created cost cutting opportunities and helped reduce settlement failures.

Competition among service providers has also increased in the trading and post-trading spaces, extending choice for securities issuers, market participants and investors. At the operational level, T2S provides market participants with opportunities to pool liquidity and collateral at EU level and contributes to financial stability by allowing settlement in Central Bank money. EMIR increases derivative market resilience and improves transparency thanks to transaction reporting requirements. In addition, the Securities Financing Transactions Regulation (SFTR) will bring more transparency to securities financing markets.

Further improvements were proposed in the European Post-trade Forum's (EPTF) report published a year ago, which was followed by a public consultation. The main output of this consultation was a request to focus first on the implementation of ongoing initiatives before starting new ones and to carefully consider any further adaptation of the EU post-trade legislation before initiating it, which is the way forward adopted by the Commission.

The co-legislators have also recently agreed to some simplifications of the EMIR requirements (EMIR Refit) making them more proportionate, while maintaining a careful balance with financial stability requirements. EMIR 2.2, which will strengthen the supervision of non-EU CCPs has also been adopted and some more limited measures have been voted regarding the supervision of EU CCPs. The implementation of new rules is underway in other areas. The CSDR settlement discipline regime will apply from 2020, with new reporting requirements and SFTR will be implemented in April 2020. The evaluation with the industry of the changes these different initiatives will bring in the market and the identification of possible additional needs are critical to ensure further innovation and competition in the post-trade market, the policy-maker emphasized.

An industry representative welcomed the progress made in the wholesale market particularly in developing a liquid and harmonized collateral market, as collateral is strategic. The ECB initiative to harmonise and create a CSD in this area is positive. A Central Bank official agreed that collateral management is an area for action at the wholesale level but is not so pressing as CMU.

### 1.2. Progress made in the trading area

An industry representative noted that the implementation of MiFID II has significantly decreased unregulated trading in securities markets. That increases transparency for investors and also improves the access that supervisors have to the data needed to evaluate whether objectives have been achieved. Competition has also significantly expanded in the trading area with a reduction of barriers to entry. There are now 500-plus execution venues in equity and non-equity instruments in Europe under the new MiFID II regime.

A policy-maker considered it too soon to determine whether all MiFID II objectives have been achieved, although the first stages of implementation have been satisfactory. Liquidity did not dry up in the first months, contrary to predictions, and market structure has strengthened. Many loopholes have been closed and this will continue, as with systematic internalisers in the investment firm regime. Closing all possible loopholes and keeping track of new ones is challenging however, because the market takes advantage of any opportunity to make a profit. That is not a reason for not pursuing the development of competition, which is essential for increasing market competitiveness. MiFID I already helped to increase competition in the market and MiFID II continues this objective, but in a more sustainable way.

### 1.3. Brexit implications

A policy-maker stressed that Brexit also has implications for the EU securities market structure. The two conditional equivalence provisions that the Commission has decided to grant to the UK are in this area. One is for CSDs in order to address the specific situation of the Irish CSD. The other is for EMIR to address the challenge posed by the concentration of centrally cleared derivative markets in the City.

Answering a question from the audience about the absence of a temporary recognition of equivalence for UK-based trading venues, related to the shared trading obligation, the speaker explained that the priority in the EU had been given to mitigating the systemic implications of Brexit and not to eliminate all costs related to Brexit and the fragmentation it will lead to. Brexit will have many undesirable consequences and increase costs and frictions for private operators, although the consequences in the financial sector are much lower than in many other industries such as car manufacturing. Benefits from the Union cannot be retained when leaving the EU. For the time being, the Commission does not intend to provide any equivalence regarding shared trading obligations or derivative trading obligations, but going forward this might be addressed in the future framework to be possibly negotiated with the UK.

## 2. Issues still in need of addressing

### 2.1. Remaining fragmentation and high cross-border costs in the post-trading area

An industry representative suggested that the adequacy of the EU's market structure should be measured against its capacity to support the CMU and make Europe an appealing venue for investing. The persistent complexity of European capital markets clearly shows that more work is needed to make them fit for purpose in order to achieve these objectives going forward. Reviewing the achievements of T2S, for example, shows that a layer of harmonisation was added to a layer of unharmonized settlement, with multiple CSDs still operating in the market. Adding this layer of infrastructure with T2S has not led to significant cost reduction.

Comparing European and US markets is useful in this perspective. The US solution does not provide a model to follow for the EU, as it is not necessarily the most appropriate, but it is an interesting point of comparison. US and European markets have similar transaction volumes, with about 350 million transactions in the US and 450 million in Europe in 2016. Whilst the volume in Europe is higher, the US has a greater level of netting. There is a difference in orders of magnitude in terms of value. In 2016, the latest year for which information is public, the value of US transactions was $111 trillion compared to €1.1 trillion in Europe. Calculations also show that assets held by US CSDs amount to $48 trillion, whereas in Europe, it is only €1 trillion of assets.

Looking at the different components of market structure, the US has one legal system, Europe, 27. Utility structures support post-trade activity in the US, whereas Europe has a mixture of utility and commercial entities. Securities infrastructures are predominantly horizontal in the US, but Europe has a mixture of horizontal and vertical ones. The US has two regulators, the EU more than 40. All this illustrates the complexity in the European market that must be dealt with, creating costs. The extra-costs are difficult to calculate due to the intricacies of the various fee schedules, but transaction post trading costs in Europe are still higher than in the US. When T2S started, settling a trade in the US cost 18 euro cents whereas European CSDs would typically charge between 40 and 50 euro cents for domestic DvP settlements (and higher fees for cross-border settlements within the EU). T2S and the implementation of harmonized rules are helping to reduce costs, although not to US levels yet.

Another industry representative considered that post-trade efficiency and resilience has generally improved but agreed that further progress is still needed. After a couple of years, the weakness of cross-CSD settlements in T2S demonstrates that T2S alone will not deliver the single market for securities Europe needs. In addition there are difficulties to passport CSD services and to overcome national licensing.

Inefficiencies in European retail post trading processes are also apparent for investors and mean that European securities markets remain domestic. Clients prefer purchasing US stocks rather than those of another EU country. Part of the explanation is that it is easier and less costly to purchase stocks on Nasdaq and NYSE than on another European exchange. This is an issue for SMEs, because they need retail investors. The EU market is fragmented particularly on fiscal and legal rules, indicating a possible political preference for retail investors who are also voters to purchase local stocks. Although a push has been called for with the CMU to further integrate EU capital markets in order to improve the financing the economy, it is likely that the retail market in particular will remain fragmented if no more is done.

An official stated that the EU securities market is adequate in many respects and improving significantly, but not fully. The cross-border dimension is key to the development of national capital markets in the context of the CMU. However there are still major differences between the rules applying to different domestic securities markets, such as bankruptcy procedures and business registries, creating fragmentation. These are some relatively "hidden" issues that still need addressing in the CMU.

### 2.2. Price formation issues and the complexity of MiFID II requirements

An industry representative stated that the efforts made to increase the choice of execution venues and to increase competition in the trading area have been successful, but further work is needed to ensure the quality of markets, which is equally important. The speaker raised the issue of reference prices that are used by most of the execution venues that have developed with MiFID. This evolution is problematic because these venues do not take part in the price discovery process, which might affect price quality in the longer term and reduce transparency for investors. Everyone is in favour of transparency and price discovery, but not all players are ready to contribute to them. Price quality must be ensured as prices are important benchmarks, as well as vital indications for securities traders and investors. Access to price information is also important for investors.

Improving the price discovery process involves tackling two main components. The first is ensuring that the flow of transactions is not disincentivised to take part in the discovery process. Issues regarding the tick size regime for example were tackled via the investment firm review but this needs to be monitored over time. The second one is ensuring sufficient liquidity provision. That issue was tackled in the context of discussions about the capital requirements of liquidity providers in particular.

A policy-maker added that the provision of fair price discovery information is only possible with an effective transparency regime. The present transparency regime in MiFID II is however too complicated and requires more proportionality and simplicity, which is not easily achieved in the EU where compromises between different stakeholders tend to increase complexity. The policy-maker also felt that MiFID II investor protection requirements are overly complex, involving a great deal of paperwork. Created with the best intentions these rules have significant unintended consequences and have become an obstacle to more retail investment in the capital markets. In addition requirements still differ across investment product categories creating regulatory arbitrage issues. This complexity ultimately undermines effective investment protection and means that the framework is not sufficiently conducive to developing investment in capital markets.

### 2.3. Barriers to the development of SME markets

An industry representative emphasized that the SME listing market has mostly disappeared in the EU. There are practically no more IPOs, especially for SMEs and private equity has taken over as the main source of funding for these companies. SMEs prefer private equity funding because there are less constraints in terms of transparency and governance and private equity funds, which are highly leveraged, benefit from the current low interest rate environment and the liquidity coming from Central Banks. The result is a reduction of investment supply for retail investors, because they cannot access the private equity market. Although there are economic explanations for these difficult market conditions, the time has come to find appropriate solutions.

An official also noted that requirements related to financial stability are costly for smaller transactions that do not require that level of reporting. The threshold is maybe too high. A Central Bank official mentioned that prospectus requirements have been refined and a new securitisation framework adopted to support SME financing in particular, but agreed that more needs to be done to facilitate the issuance of securities by smaller issuers.

## 3. Priorities going forward

### 3.1. Defining a future vision for EU capital markets

An industry representative considered that there needs to be a discussion about the future evolution of EU capital markets and how to find the right balance between openness to global flows and financial stability. This topic tends to be overshadowed by Brexit discussions but is very relevant for the EU. The initiative about the international role of the euro launched by the Commission at the end of 2018 is important in this regard since one of the aspects is to define how the development of European capital markets can contribute to reinforcing the role of the euro. These two elements are mutually reinforcing. This requires defining a future vision for European capital markets, which the speaker thought should be less about developing competition in Europe and more about improving the competitiveness of European markets on the global scene.

A policy-maker saw no opposition between competition and competitiveness. There might be some short-term benefits in reducing competition but this is not true in the longer term. Markets benefit from more competition, which must continue to be fostered by EU frameworks. There is however a balancing act with financial stability and stability will always be given priority. There are calls e.g. to develop open access for derivatives, but this must be assessed carefully, as too much open access may connect players in a way that threatens financial stability.

An official suggested that the euro-area capital market should be developed as a domestic market, together with the community of market infrastructure service providers operating in the area. There should be a public consultation of the ECB in the coming weeks to evaluate if it is possible to capitalise on T2S and the CSDs present in the euro-area to develop a domestic euro-denominated debt instrument that could help address some of the questions raised by the CMU in terms of access to capital markets.

### 3.2. Implementing the measures already agreed

Several speakers concurred that delivering the measures already agreed and assessing their impact is crucial before launching any further initiatives.

An industry speaker explained that market participants need time to adapt to such a significant revamp of the regulatory framework and noted that transparency has already increased in the securities transaction value chain and that markets are more stable than in the past. Another industry representative observed that the barriers listed by the EPTF group are one example of work that needs to be finished as quickly as possible, What should be fixed in the post-trading marketplace and the order of priority has repeatedly been considered by market participants and the work of the EPTF group is the latest iteration of this. Some of the issues it identified were already included in the 2001 Giovannini Report and have still not been addressed.

A Central Bank official agreed that reforms and initiatives require time to "sink in". Many business models have not yet adapted to MiFID, EMIR, CSDR and T2S. More harmonisation is expected. The settlement discipline regime may lead to some improvements, such as the fees paid for not adhering to it fostering harmonisation.

An official considered that further rationalisation of the EU market infrastructure is necessary to tackle the cross-border cost issues identified in the EU. The problem is that there is not yet a real single market in the EU. The ECB is contributing to this rationalisation with the development of some platforms such as T2S. A question is whether further consolidation of EU market infrastructure is to be encouraged and if the ECB could play a greater role in some areas notably in settlement and collateral.

Another official emphasized the importance of continuing the supervisory integration process. The process launched with the ESAs review did not achieve all expected outcomes in the end and should be pursued, notably regarding certain issues such as AML that constrain cross-border activities.

### 3.3. Further developing and integrating retail capital markets in the EU

An industry representative considered that a political push on the CMU particularly in the retail area and for harmonising the remaining fiscal and legal issues across member states is needed because otherwise fragmentation will persist and many on-going CMU initiatives will not be effective. Improving MiFID II rules on research is also necessary. Without these improvements there will be no development of retail cross-border capital markets.

An official agreed that a political push is relevant, particularly in the retail area, but this requires tackling difficult harmonisation topics. Some of these are best approached in a depoliticised way, such as business registry issues for example. Addressing these questions in a proportional and simple way is also essential.

The official also noted that maybe too much attention has been paid to the wholesale part of the market so far. This has enabled cross-border wholesale markets to develop in the EU and the functioning of these markets has improved. Further integration has also been achieved in the core infrastructure of the market with T2S in particular. But the development of capital markets in Europe also depends "on the last mile" and the development and further harmonisation of local infrastructures. Without these, there will be no development of local markets or no cross-border markets. It is crucial to continue to work with different small markets across the EU and their different components and identify the improvements that might be needed in the legislation impacting retail investors in particular in order to improve pricing and proportionality.

The retail payment market is also relevant to the securities market, the official believed, as it supports small cross-border transactions and trading and can also help to educate customers in cross-border dealing. If cross-border payments for goods develop, then it will seem more natural to buy shares cross-border.

A Central Bank official agreed with the importance of local markets and the "last mile". The CMU is about bringing issuers to the market and making it simpler for SMEs to access funding and for investors to purchase securities. This means reviewing prospectus law, crowdfunding and other things. This is the next frontier to be tackled in the CMU.

Another official agreed that the development of local and retail markets is important but these need to be connected to the broader European market and economy as well, which is why the development of capital markets at the eurozone and EU levels is necessary. Much progress has been made in this respect, but there is still some way to go. Platforms developed by the ECB are playing a role in terms of harmonisation. When T2S was developed for example, work was done on the harmonisation of certain legal and fiscal rules (e.g. tax withholding mechanisms) in order to support the implementation of the platform and ensure that it could play a sufficient role in further integrating securities markets in Europe.

### 3.4. Leveraging new technologies

An official suggested that further thought should be given to how new technologies such as fintech or DLT can contribute to solving some integration issues in the EU market e.g. some fiscal issues. A taskforce is looking at that in the market and has delivered a report also on two other aspects: corporate events and shareholder transparency.

A Central Bank official agreed that it is crucial not to forget tokenization, DLT and the platforms based on these new technologies in this debate. Payments were the first area of application of these technologies, but they will extend further in the future, and notably into securities trading, clearing and settlement. At present regulatory oversight is not ready to handle situations where securities are directly issued on a blockchain or a platform that does not need to be licensed under MiFID. An official suggested that technology neutrality should be respected in that perspective.

1. The Real-Time Gross Settlement (RTGS) service is the infrastructure that holds accounts for banks, financial market infrastructures and other institutions. The balances in these accounts can be used to move money in real time between these account holders, this delivers final and risk-free settlement.

# Integration and competitiveness of the EU fund market

## 1. Competitiveness issues in the EU asset management sector

### 1.1. Balancing competitiveness objectives and investor needs

A public representative considered that there remain challenges ahead to integrating the European fund markets and ensuring that the European fund industry is sufficiently competitive. Market statistics show that there are many more funds being offered and sold in Europe than in the US, and they are also smaller and hence more expensive. The market is still rather fragmented; 70% of all assets under management are held by investment funds registered for sale only in their domestic market, and only 37% of UCITS and 3% of the alternative investment funds (AIFs) are registered for sale in more than three member states. It is therefore still largely a domestic business. Further progress is needed to achieve a single market for funds, which would support improved capital allocation and also better risk allocation within the EU. In the US about 75% of shocks are absorbed by private risk-sharing due to more integrated capital markets, whereas that proportion in Europe is only 20%. The efficiency of the underlying cross-border securities trading and post-trading processes also needs improving. Cross-border post-trade order execution costs are 10 times higher in Europe than in the US, which also increases the costs of the EU fund business.

An industry representative considered that the EU fund industry has many positive features. UCITS provides a strong framework for asset management activities and is a successful brand both in the EU and other regions. The diversity in the number of asset managers and funds in Europe shows the dynamism of the industry and also provides investors with choice. Another industry speaker agreed that the positive features of funds and the benefits they provide investors with must not be forgotten in this discussion. They indeed allow savers to pool their assets and prepare financial needs for the future, and provide retail and professional customers with investor rights.

In addition the statistics showing a high number of funds in Europe are somewhat biased, the first industry speaker felt. There are indeed many funds that are managed either for one institutional investor or high net worth individual who wants to have a more specific or tailored fund (e.g. separate account funds) or for a limited number of institutional investors such as so-called special funds in Germany. In France, there are also many employee investment schemes usually dedicated to a given company that use fund vehicles. One potential issue is that Europe does not have many flagship funds. There is probably room for some mergers. Economies of scale can also be made using pooling systems which may help to have parallel management for different funds that have comparable investment strategies, but it is important not to create barriers to entry to the industry in doing so.

A regulator agreed that although the size of funds is a factor of competitiveness, it is also important to maintain diversity and that includes having both active and passive funds. That is important for competition and investor choice but also for financial stability reasons. According to prudential regulators, if funds are all tracking the same indices or investing in the same products there can be herd behaviour, which could facilitate the propagation of some risks.

### 1.2. Potential implications of Brexit for the EU fund sector

An industry representative considered that much will hinge upon the future arrangements between the UK and the EU, but if the UK is no longer in the single market there will no longer be the possibility for UK funds to passport into the EU or vice versa. Equivalence determinations will be a major issue going forward for both EU and UK regulators, particularly in the event of a hard Brexit where any divergence between jurisdictions is likely to raise the bar of competition between the UK and the EU. A hard Brexit is most concerning, as after any transition period or temporary authorisation mechanisms, EU-domiciled funds will have a significant advantage in obtaining regulatory approvals in a timely manner, as well as marketing to EU investors and also in respect of cost of regulatory compliance compared to UK-domiciled funds looking to gain access to EU investors. UK-domiciled funds marketing to UK investors would have similar advantages compared to EU-domiciled funds looking to gain access to the UK.

These relative advantages however, come at a cost and a risk to all investors, whether in the EU or the UK, and who today, thanks to the passport system, benefit from a wide range of investment products and strategies managed by the best in class managers in any jurisdiction. Those benefits will inevitably be reduced as a result of increased regulatory burdens from having to deal with multiple regimes. It remains critical that regulators in the EU and the UK work together to ensure that the best possible products are available to all investors. For that to happen, and to prevent more fragmentation after any transitional Brexit arrangements are over, it will be essential for the delegation model of portfolio management to be maintained. It should not matter whether substance is provided in the EU, the UK or anywhere else, so long as it is easily accessible for proper supervision. If the current business model changes following a hard Brexit, there will be no winners but extra costs and worse performance for end-investors.

Another industry representative agreed that Brexit will have negative short-term implications because with it, the single market is being rolled back and the UK is a key player in the market. However, business will adapt. It will be more costly to have a split of liquidity pools and operations built on both sides of the Channel, but investment firms are putting the necessary arrangements in place. For asset managers, the challenge ahead with Brexit is being able to continue providing investors with access to the best portfolio management talent in every circumstance, wherever they are. There has to be flexibility but also a proper framework in place for supervisory cooperation for that to be possible, while answering the understandable concerns of EU regulators.

## 2. Addressing fragmentation issues in the EU fund sector

### 2.1. Inconsistency of fund rules across regulations and EU jurisdictions

A regulator explained that although much has already been done to improve and harmonise the EU regulatory fund framework. There could still be simplification. Rules applying to management companies and funds - UCITS, AIFMD and more targeted fund rules - differ to a certain extent, which has an impact on management costs and also makes the comparison between different types of investment vehicles more difficult for investors. As an asset manager always manages various types of funds, more consistent regulation across fund categories may be worth considering in order to simplify internal control, risk management, etc. An official noted that there are good reasons why rules applying to management companies and funds differ across regulations.

An industry representative agreed that there are negative impacts on the fund sector from the current differences across regulations. In addition to the UCITS and AIFMD directives, broader capital market legislations apply to investment funds in the EU: i.e. EMIR for derivatives, MiFID for distribution and SFTR for repo and securities lending, amongst others.

A first problem is that despite this high level of regulation there are still discussions, as part of shadow banking assessments, about whether regulation of asset management is sufficient. But in addition to this, a major issue is that these rules are not completely aligned. Remuneration and reporting obligations are not totally convergent. With reporting, once the setup is made the preference is to maintain it instead of changing, but if there is a change then it should move towards convergence. IT processes are heavy to change and it is important to have stability in this field.

Different member states also interpret the same rules differently. For example, leverage under AIFMD is not computed in exactly the same manner in all EU countries. That should be addressed as part of the review of AIFMD. There should be a clear view on leverage calculation, which should be consistent between AIFMD and UCITS and also with the upcoming IOSCO principles. The industry indeed wishes IOSCO to take stock of the strong experience the EU has on the topic, especially with UCITS, notably taking hedging into consideration.

Another industry representative concurred that some details still need adjusting despite all the iterations of UCITS and AIFMD. The truth however is that the present framework works reasonably well at the EU and international levels and has helped Europe to acquire a leading role in this sector. Fundamental reviews of UCITS, AIFMD and other rules impacting the fund industry are not needed. There are always issues, but supervisory convergence in the context of ESMA can deal with most of them, the speaker believed.

### 2.2. Cross-border distribution issues within the EU

A public representative mentioned that a legislative proposal was recently passed that should help to facilitate the cross-border distribution of funds in the EU and wondered whether, beyond the marketing obstacles addressed by this legislative text, European citizens are also hesitant to invest in non-domestic funds. A regulator agreed that cross-border distribution barriers are an important issue as they create fragmentation in the fund sector. The new legislation should facilitate cross-border marketing to a larger extent, with less cost for asset managers. Answering the question of the previous speaker, the regulator did not believe there is a strong domestic bias in fund investment, however, the way fund distribution channels are organised plays a role in this. Banks favour the distribution of products linked to their group, which is a problem both at the domestic and cross-border level because it reduces choice for investors and also increases domestic bias.

A regulator was positive about the current developments in the EU fund regulatory framework. New rules have just been implemented and need to be tested. The passport is a reality in Europe. Other regions envy the European UCITS framework; elsewhere e.g. in Asia memoranda of understanding are the main tools for exchange of information between supervisors. However, some issues need further assessment. In Belgium, multiple types of funds are distributed through different distribution channels and the number of foreign EU funds offered to Belgian retail investors has more than doubled since the financial crisis. For every Belgian fund, five foreign EU funds are now being offered to the public. However when looking at volumes invested, the proportion between Belgian and foreign EU funds is more the opposite. That is not due to domestic barriers, because the rules are fully in line with all ESMA requirements, or to taxation, since the same rules apply. It may be due to the way in which the freedom to provide services works across the EU, because administrative notification of EU funds on a cross-border basis is very easily done by email. The result is that many funds are potentially available in each country but only few of them are actively marketed.

An industry representative hoped that the costs associated with cross-border fund distribution can be addressed in the future with the new package recently adopted. A regulator noted that new digital and fintech technologies could also help to improve distribution and reduce fund management costs. New platforms based on these technologies could allow asset managers to issue funds, reach investors directly and also maintain a record of transactions, thus cutting costs.

## 3. Improving investor education and protection

### 3.1. Investor education

A regulator noted that there are differences in terms of retail investor education and financial literacy that contribute to explain the difference in size of market-based finance in Europe vis-à-vis the US. This is important to consider at a moment when the EU and domestic authorities are pushing to develop capital markets in the EU with investment funds playing a significant role in this objective. When investors lose money on their investments, part of the problem can come from mis-selling but another cause is usually insufficient investor education. Some investors believe that investing in capital markets should always bring gains and others do not understand all the implications of the products they buy.

An industry representative considered that when comparing the EU and the US key differences are the importance of defined-contribution 401K pension plans and the equity culture that they have helped to develop. That culture cannot be easily created in Europe merely with additional regulation and CMU. It is nevertheless a positive objective, and progress can be achieved, but this issue does not come under EU competence. Action is needed at member state level to improve pension regimes and to get people to save more. The key issue is getting people to understand that they have to increase long-term savings and put money in equity finance for their futures. Education plays an important role in this, but it is mainly a member state responsibility.

### 3.2. Investor protection

An industry representative considered that where the EU can play a role regarding retail investors is in the improvement of investor protection and investor disclosures, which would help to further develop the EU fund sector. Asset management is a long-term business and trust is needed. The desire is to engage investors for a long time and encourage them to invest for their future needs. Investors should, however, not be over-protected. The worst protection is when people do not make any changes because they think it is too risky to do so or if they are put off making investments in the first place.

A major problem with EU regulation, perceived by investors, is that it is silo-based. There are many different regulations applying to investment products that investors might consider relatively similar i.e. UCITS, AIFMD, MiFID and IDD. Consumers do not care about the legal form of products and many do not understand the difference between a fund and life insurance. They want to buy a certain product with a certain risk profile at a certain cost, and to understand those basic elements. The regulation should make sure that these disclosures are clearer for investors and more aligned across different products. That was the objective of PRIIPS, which is a great initiative encouraged by the fund industry and aiming to provide customers with the necessary information for them to be able to understand and compare the costs, risks and objectives of different investment products. Unfortunately it was a collective failure in the end. There must be another attempt, and it is good that the Commission has mandated a review of the delegated acts of PRIIPS. The EU has to get investor disclosures right so that they are encouraged to save. Some parts of MiFID II also need considering because it creates a great deal of red tape and administrative burdens, with pages of documents where people have to tick boxes. People are being scared away from investment.

Improving disclosures and distribution rules is the role of the EU, whereas member states need to fix the appropriate level of taxation, improve investor education and improve their pension systems. In that respect, PEPP is a great idea, but many member states have indicated that they will not provide the same tax advantage as for domestic products, which is a concern.

A regulator agreed that ensuring a level playing field across different types of investment products is essential and that it is difficult to achieve with different product and distribution frameworks. What is needed is a common and comprehensive approach covering products that most retail investors consider similar in terms of investment features, such as UCITS, many life insurance products and some structured products. Confidence is linked to quality and clarity of information, as well as the possibility to buy and invest in simple products. However the distribution, marketing, tax rules and information provided are all different across these different product categories. The ban of excessively complex products for retail customers could also be considered at the EU level. There has been a successful experience in Belgium with regard to complex structured products (a voluntary standstill on the distribution of particularly complex structured products).

An industry representative stressed that cost disclosure rules need to be improved so that investors can understand exactly what is covered and compare costs. The way that transaction costs are defined under PRIIPS is problematic in particular. Transaction costs[1] are part of the costs that funds need to disclose. They include explicit costs, which are the costs of trading underlying investments in a fund (i.e. broker commissions, research costs, taxes and exchange fees, securities lending costs) and also implicit costs, which are calculated as the difference between the price at which an asset is valued immediately before an order (the arrival price) and the price at which it is actually traded, therefore taking into account different factors including market impact[2]. Implicit costs[3] however are typically something that is already dealt with under the MiFID II best execution obligation and it is therefore surprising to see it as part of the transaction cost that needs to be disclosed under PRIIPs. It is hoped that this can be changed with the review of the delegated acts. The best way to tackle this would be to withdraw the market impact element and put that in the best execution analysis. Otherwise this will make calculations very complicated for a very limited effect since it is a question of basis points, which is not very significant in the total cost for investors. In addition, transaction costs are not meaningful by themselves if not linked to the turnover and the performance of the fund. Frequent transactions and arbitrage are necessary to obtain sufficient performance in an actively managed fund, which is less the case for funds pursuing a buy and hold or a passive strategy.

Distribution costs also depend too much at present on the way distribution channels are organised, the industry speaker felt. For example, so-called inducements are part of the distribution cost for integrated distribution networks, but they are not in other cases.

A policy-maker accepted that some aspects of EU legislation applying to funds need to be reconsidered, and PRIIPS is the main issue. Retail investment is a priority for the capital markets union agenda. There were the best of intentions with PRIIPS, but following the legislative process and different consultations the proposal did not end up exactly in the right place. It aimed to provide more transparency, more disclosures and clear, short factsheets in order to break the silos between products and create some comparability. Some parts of it, such as the KIDs (key information document), are considered to be useful, but changes can be considered. Some tweaks are already being made in the PRIIPS delegated acts but a more thorough review will be needed in the next few years, taking into account all of the issues raised. The exemption from UCITS has been extended so that when they come under the PRIIPS framework they can already use the adjusted rules after the update of the delegated act.

Moving towards a more comprehensive framework is a direction being envisaged by the Commission, looking at how MiFID, PRIIPS, IDD and other regulations interact and overlap. The question is how to put in place a more sensible and simpler framework for retail investors. AIFMD will also be looked at with care. A study by KPMG was commissioned, so there is some preliminary information on what is and is not working. Overall, the result is that AIFMD has created a harmonised market, though there are minor differences depending on the transposition and the extent to which national law applies. For instance, half of the survey participants said that there are differences in the way the rules are applied but asked for there to not be changes because those differences are small enough to handle. The market will be consulted when it comes to the review.

1. Transactions costs are defined as the total of explicit and implicit costs minus any swing pricing that may occur. Swing pricing is a mechanism used to protect long-term investors in a fund from having the value of their investment eroded by the costs involved in managing short-term fund inflows and outflows – especially during times of extreme market volatility. If a fund experiences unusually high inflows or outflows, the buying or selling price will be systematically adjusted up or down to absorb the impact of higher-than-usual transaction costs.

2. A difference between the price at which an order to trade is given and the price at which it is executed can result from a number of reasons including: (i) Trade impact: Instructing a large trade can have the effect of moving the security's price up (if buying) or down (if selling). Managing this impact is a key skill for asset managers and their trading desks. (ii) Opportunity cost - Sometimes it is not possible to execute a large trade in one go. Executing a trade in stages can create gains or losses depending on how the market price of the security moves. (iii) Delay impact - If a transaction is delayed, for whatever reason – even by a minute or so – market movements in the meantime can contribute to the arrival cost. Powerful trading systems that minimise latency (the delay between a trading request and response) are vital.

3. Implicit costs can be positive or negative and vary depending on the liquidity of the financial instrument.

# ETFs: possible need for specific rules

### 1. Growth of the ETF market and comparisons between the EU and the US

An industry representative noted that there has been a rapid growth of the ETF market in Europe with 1575 funds registered at present, although the market is smaller than in the US. At the end of 2017 there were €630 billion of assets under management in ETF funds in the EU compared to just below €97 billion in 2008, corresponding to an average yearly growth of +23% over the last 10 years. Growth however somewhat stalled in 2018. Development in the EU has been mainly due to institutional clients who hold 80% of the market and usually want bespoke references, which is quite different from what is sold in the retail market. Retail clients who represent the other 20% are looking for simple products providing diversification and transparency. A regulator stressed that the ETF market has developed significantly since the financial crisis with the continuous launch of new products offering different exposures.

Another industry representative added that the global footprint of the market is over $5 trillion invested in ETFs, with more than $3 trillion in the US, where the retail proportion is stronger than in the EU. The US market is larger for a few reasons. First, independent advisors play a bigger role. In addition many US retail investors used to invest in individual securities and consider ETFs as a less risky and more diversified product, so moving towards ETFs was a natural evolution for them after the dot.com bubble. There is an 80/20 rule. 20% of the funds hold 80% of the assets, and they are broad-based, diversified, and relatively unsophisticated products. The cost advantage of ETF products is structural, in that it is driven by their broad accessibility in terms of distribution.

### 2. Current framework and on-going regulatory work at the EU and global levels

#### 2.1. Main characteristics of ETF products and present regulatory framework in the EU

ETFs bring effective investment solutions for institutional and retail investors, being relatively cheap in terms of management and distribution costs, transparent, and an easy way to get exposure to specific asset classes or indexes. A Central Bank official noted that these benefits that ETFs can bring to investors and the economy are widely recognised. The ETF is a distinctive and unique product that combines features of open ended investment funds with access to secondary market liquidity. ETFs also use specific mechanisms such as APs (authorized participants)[1] and the arbitrage mechanism. The regulatory community is seeking to better understand the dynamics behind the growth of the sector, and also identify any potential risks posed by ETFs and how to mitigate them. A regulator added that ETFs raise other specific issues in terms of price formation and use different redemption mechanisms.

An industry representative explained that on the investment management side, ETFs are subject to product regulations such as UCITS in the EU or the '40 Act in the US. The majority of EU ETFs are UCITS and less than 2% are AIFs. There is sufficient flexibility in these regulations to adapt to the specific features of ETFs. On the capital market side, ETFs are subject to capital market regulations such as MiFID. Rules applying to single securities may not fit as neatly with the characteristics of ETF markets, although there has been an evolution over time to improve this. Another aspect is that there is more and more demand outside Europe for products structured under UCITS because of the safeguards the framework provides. This could help to develop the global footprint of ETF products structured under UCITS, potentially enhancing liquidity and bringing down trading costs. An industry representative emphasized that the ETF market is relatively recent but there is 26 years' experience which has seen many market events and changes made in the market ecosystem. Some changes have been made post-crisis, as the crisis showed for example that one could not internalise some of the derivative and securities lending structures previously used that could inherently increase some of the risks in the product sets.

Answering a question from the audience about whether the UCITS label is adapted for ETFs with a shareholding that is mainly institutional, another industry representative felt that UCITS is an appropriate label for these products, appreciated by institutional investors. UCITS is very protective, particularly for retail investors but also for institutional ones. There is no adverse effect to using the UCITS label for ETFs and it is adapted to most of them except commodity ETFs, which represent about 7% of ETF assets in the EU, compared to 2% in the US.

### 2.2. Ongoing regulatory work at the international level

A regulator explained that a range of international organisations including the FSB, the BIS, IOSCO and the IMF have been assessing the possible implications and risks of the strong development of the ETF market. IOSCO in particular has fostered a dialogue between national supervisors and the industry and this has shown that the ETF standards published six years ago are still relevant and necessary to implement. These standards cover a wide range of topics: disclosure on portfolios, cost, risk, strategy, structuring issues, and conflicts of interest. The first principle, which is one of the most important ones, is disclosure aiming to help investors differentiate proper ETFs from other non-CIS (collective investment schemes) ETPs (exchange traded products) i.e. non-fund ETPs. There are also principles relating to the risks of ETFs using complex investment strategies and also to conflicts of interest. Potential conflicts of interest between different ETF stakeholders – management companies, APs, liquidity providers, index sponsors, and others – are an area that retail investors are less aware of. It was positive to be able to find a consensual approach within IOSCO on these principles as that will facilitate their consistent implementation at the regional or national level. This is an added value for the investor community, especially retail investors. These principles apply at a worldwide level, which does not mean that additional regional requirements cannot consider for example the difference in levels of maturity between professional and retail investors. Additionally, in February 2018 specific comments were published on ETFs in the context of a broader IOSCO report on liquidity risk management for open-ended collective investment schemes (CIS) emphasising notably the importance of day-to-day liquidity management.

A Central Bank official noted that a significant portion of the European ETF sector is located in Ireland. The Central Bank of Ireland issued a discussion paper in 2017 aiming to better understand how ETFs will react and function in different market conditions, favourable ones and more difficult ones. No broad-ranging conclusions have yet been reached, but a set of considerations have been fuelled into the on-going IOSCO work on ETFs.

### 2.3. Potential issues raised by authorized participants (APs) and the current market structure

A Central Bank official felt that more international regulatory consistency and convergence would be highly desirable regarding APs, as well as further discussion amongst stakeholders to gain a better understanding of different risks these mechanisms may pose in different parts of the world.

A first issue is having a clearer picture as to which APs are active in respect of which funds. This is important in itself, but also to understand whether there is potential for concentration risk and if it needs to be disclosed. This overlaps with the potential for counterparty risk and whether the same entities are concerned. There may also be overlaps with the providers themselves. Greater transparency is needed around these activities in the market, as so much is dependent for ETFs on the functioning of the AP mechanism. Some of the information emerging also suggests a significant degree of concentration in terms of the ETF providers themselves, and further clarity on the possible implications of this would be helpful as well.

The possibility that the AP mechanism does not function in times of stress has been addressed in, for example, ESMA's guidelines on this topic. Work should be done to better understand how the idea of "direct recourse" in the context of a stress situation would work in practice. It is outlined in guidance, but more work is needed on how an investor would be able to have access to liquidity in a stress situation.

The ESRB has also produced an interesting piece of work on the functioning of the AP mechanism and on liquidity in this space and what it means in terms of herd behaviour potential, volatility, correlated movements, and potential for hard stops. This does not mean that there is a need for intervention, but it is important to understand these mechanisms.

## 3. Potential development of the retail ETF market in the EU

### 3.1. Improvements needed in financial education

An industry representative emphasized that the plain vanilla, broadly-diversified, lower-cost ETFs are one of the best products for long-term asset allocation of both institutional and retail clients. Lower costs are due to the larger distribution footprint in particular. ETFs fit well with some evolutions observed since the financial crisis in the US, with many financial services firms having shifted to a top-down asset allocation approach, rather than allowing individual wealth managers to develop their own allocation plans. Another encouraging evolution is that retail investors are starting to act more like institutional ones. They are taking a longer-term view of their investments and are more cost-conscious, considering the full cost of an investment product. Ideally they should be very much aware of access and exit costs from a product set in particular.

In countries with more of a bank distribution footprint and a domination of bank products, as is the case in most EU countries, ETFs can help savers move towards capital market exposure, but encouraging that move will require further education about the long-term benefits of equity market participation. A challenge also is the provision of retail investors with appropriate tools for their long-term wealth management.

A regulator noted that in Belgium there is a strong agenda on financial education as part of the legal mandate of the market and conduct supervisory authority (FSMA). There is a dedicated financial education website - Wikifin,- providing objective and independent information to financial consumers. ETFs are relatively easy to understand, but investing in ETFs is not only about costs and paying lower fees.

### 3.2. Developing the distribution footprint of ETFs

An industry representative felt that for retail investors, distribution footprint is very important and how they can get access to these products. It can be directly, although that is fairly marginal representing about 10% in the US or through a wealth management advisor. A regulator noted that the mainly bank-dominated distribution in the EU means that many people do not have access to ETF products.

A regulator agreed that a major characteristic in Europe is that ETFs are distributed in a bank-driven landscape. However, the products distributed in the Netherlands, Germany or France are not the same due to the distribution model developing quite differently – and not for tax reasons or gold-plating. This is why a compromise was needed for inducements at the implementation of MiFID, with different rules, e.g. in the UK, Sweden and the Netherlands, versus Germany and France. For ETFs there are some impediments in terms of distribution. Non-EU ETFs for instance are not proposed to retail investors, as they qualify as AIF products, which are as a rule not offered to retail investors.

### 3.3. Possible need for more specific ETF rules in the EU

An industry representative felt that several questions regarding retail investment in ETFs still need addressing, such as: how clear is cost information? How accessible are the best products from a liquidity standpoint? How robust are the markets in terms of liquidity of the underlying assets and also of bid and offer? The speaker favoured a very simple and clear framework for retail investors, notably for ETFs, helping them to understand the main features and risks of the products they need to be aware of. Favouring trading in lit venues also helps retail investors in the long-run, providing them with more clarity about trading costs and bringing those costs down. Sufficient clarity is also needed on the actual liquidity conditions. Institutional investors have access to a better toolset in this regard for the moment.

Answering a question about whether more specific ETF requirements would foster more retail market development and better risk mitigation, an industry representative suggested three possible improvements that could complete UCITS requirements and support the retail distribution of ETFs. A first suggestion would be to propose a UCITS ETF label, which could lead trading venues to separate UCITS ETFs from other, less safe, ETPs (exchange traded products). That could be an effective way of attracting more retail clients. A second element would be to improve transparency on ETF products. This could be done at two different levels. First, it would be useful to identify the degree of discretion used in the management of ETFs, in order to differentiate ETFs that track an index very clearly, those that use active management according to predefined rules, without discretion, and finally those that are managed with a high degree of discretion. There are three possible levels there, but only a limited number of ETFs at present are managed in a totally discretionary way. Second, transparency would help to better manage potential conflicts of interest. The starting point with conflicts of interest is to identify them, for example those related to the role of APs, then to provide transparency on them on an on-going basis if needed. This could be done possibly through disclosure to investors. A third suggestion would be to put in place circuit-breakers, but with different protections from those used for listed securities, i.e. to limit the difference with the tracked index rather than an excessive price movement of the ETF itself.

A Central Bank official agreed with the relevance of improving ETF nomenclature and disclosures, although the active/passive distinction may not be the most helpful distinction. The IOSCO principles move in that direction, and are the seed for different jurisdictions calling for the labelling of products. The fact that there is a discussion about the role of index providers and whether there is potential for conflicts of interest in that area is also welcome.

A regulator felt that to tackle ETFs, which are relatively new products, supervisors need to think "outside the box". There needs to be a level playing field across different products that may be perceived as similar by retail investors and these products need to be treated in an objective way by regulators in terms of the risk they pose. This is not easy with ETFs, because the discussion is mostly focused on their competitive advantages and benefits in terms of low management fees and distribution costs compared to other investment products, rather than on their potential risks. A more comprehensive approach is needed to ensure that consumers understand the product and that all costs are disclosed. Management fees do not reflect all costs incurred by the investor, for example the embedded bid-ask spread costs need to be clarified. Additionally, all types of ETFs do not have low costs. The so-called classic ETFs that track an index do, but this is not necessarily the case for the more complex ones. This latter point, which involves trying to have a complete overview of the risk return consideration of the investment strategy and other features of all types of ETFs. is the most difficult aspect of the debate, the regulator felt.

Another regulator added that whilst ETFs may be passive in their management, engagement of investors must be active. The responsibility of shareholders to be engaged in ownership and the corporate control market is crucial.

### Conclusion

As a summary, a speaker stressed that the ETF market is rapidly growing and has experienced impressive evolution with different types of products, index-related or more active. More transparency could be beneficial on certain features of the ETF product, notably for retail investors, and the creation of a UCITS ETF market could be useful in this regard. In terms of trading, the type of protection needed may be different from regular traded securities, with a focus on the capacity to ensure the tracking of the index rather than avoiding excessive price movements. ETFs have become a major investment option, due to their lower costs, but some questions need answering as to whether the information provided on the products is clear enough, how robust the markets are, and whether there is sufficient liquidity.

Benefit must be gained from the on-going work at IOSCO on risks, returns and other features, in order to establish appropriate principles for ETFs. Further transparency may be needed on conflicts of interest and the role of APs in particular. In terms of vehicle, UCITS seems to be the best vehicle for ETFs, with most of the firms using them in the EU, because investors know they are protected in the UCITS environment. The UCITS brand also helps to develop a global footprint for these products.

The UCITS ETF label needs to be built on, with a simple and clear framework for ETFs linked to lit markets. The potential risks posed by ETFs need to be further assessed among stakeholders, but any further regulatory action should be carefully considered. A final point is active corporate governance engagement which needs to be preserved in a perfect world, despite the passive index-related nature of ETF products.

---

1. Authorized participants (AP) are one of the major parties at the centre of the creation and redemption process for exchange-traded funds (ETF). They provide a large portion of liquidity in the ETF market by obtaining the underlying assets required to create a fund. When there is a shortage of shares in the market, the authorized participant creates more. Conversely, the authorized participant will reduce shares in circulation when supply falls short or demand. This can be done with the creation and redemption mechanism that keeps share prices aligned with its underlying net asset value (NAV).

# Future for securitization in the EU?

### 1. Securitisation framework status in the EU

An official outlined that they are particularly interested by this discussion around the securitisation framework in the EU because, there was hard-fought battles around the concept of simple, transparent securitisations, notably at the Basel Committee, which were met by scepticism in the US. In the European framework securitisation is a key issue linking the Banking Union and the capital markets union. It is one of the focuses of public policy. Many public authorities, including ACPR and the Banque de France, are trying to push forward for having a more integrated capital market.

A policy-maker stated that securitisation is a very useful tool, especially after the financial crisis. It strengthens a bank's ability to lend, provides additional funding sources for companies, and increases private risk-sharing. This tends to be forgotten because of the mistakes of the past and forgotten even more in Europe because it has taken longer in Europe for securitisation to bounce back after the crisis.

Securitisation is one of the key building blocks of the capital markets union project. The framework was published at the end of 2017 after relatively long negotiations with the European Parliament and European Council and entered into application on 1 January 2019. It aims to address the key deficiencies in the past and to revive the market in three key ways: to establish a clear and consistent legal framework for all securitisation to ensure clarity and transparency, to zoom in on the Simple, Transparent and Standardised securitisation (STS), and to help the new asset class by giving it preferential prudential treatment.

The European Commission is in the midst of finalising many technical standards with the ESAs, which have taken far more time than envisaged. The implementation date has been passed and most of the standards have not been adopted, aside from one on third-party verifiers. Lots of comments had been received from the market and ESAs that the Commission wanted to carefully address. In the area of disclosure, the market was re-consulted and something more appropriate was produced. There were also inevitable bottlenecks within the European Commission.

The Commission and the ESAs are working as quickly as possible to get the rest of the Level 2 measures on stream. The notification requirement is very important and is being prioritised. Other than the disclosure templates generally the Commission does not intend to depart from what the ESAs have provided. There may be legal drafting comments but there are already some drafts that the ESAs have provided, and they can already give an indication to the market as to where these standards will end up. The Commission needs to send it to the European Council and the European Parliament, and a new European Parliament legislature will delay things further into the second half of the year. The third-party verifier act has already been sent. Others will not be reviewed due to the end of the current legislature, so the objection period will not start until the new European Parliament takes effect in July.

#### 1.1. A persisting stigma: securitisation had almost become a bad word after the crisis

An official asked whether a definition and endorsement of STS is needed, as it could potentially be an open door for arbitrage. That had been championed at the international level. Securitisation has almost become a bad word after the financial crisis due to the role it played in that. The STS was a way to try to fight through the stigma.

A policy-maker does not know whether it is a fair assessment to say that European legislators and regulators are not in favour of securitisation. That was why the legislation was proposed. It is true that negotiations took a long time and possibly ended up more restrictive than initially planned, but the intention was to revive the market. The STS label has preferential prudential treatment. It is not clear whether liquidity ratio issues are about STS itself or the larger securitisation population.

There was an intention to revive the market and create a label that gives investors more assurance that there is quality. There were more criteria than the European Commission had started with, but the intention of those criteria was to add safety to that product. It could not be stated that the market is not picking up because of the heaviness of those criteria or the constraints of the framework; the market is not picking up because the detailed standards are not there. People do not have confidence to issue based on drafts that ESAs have sent to the Commission and do not have any certainty that those drafts and templates will be adopted by the Commission and become law.

An industry representative noted that the private securitisation market in the USA is much bigger than the European one. In Europe it is about 1 trillion, which is an outstanding amount, and before STS. In the US the public securitisation market represents more than $7 trillion. The success of securitisation in the US has been the confidence in solving the stigma issue. That confidence is given by the government sponsored entities (GSEs). Banks are trying to develop that in Europe but are limiting themselves to a very small part of the market as long as mortgage backed securisation is not adressed.

#### 1.2. Recent securitisation frameworks impede EU financing mechanisms from benefiting from this essential tool

An industry representative agreed that STS was meant to fight that stigma. The stigma is more in the minds of the supervisors and regulators than of market participants. STS is a very burdensome process to issue. All banks need to issue securitised products, so every effort is made. In exchange for that, banks would have expected the supervisors, regulators and Commission to recognise the value of the product they have built themselves, by defining specific, positive capital charges for the main buyers of those products.

Natural buyers of those products need to be identified. In the US the natural buyers are insurance companies and banks. A lot of banks have excess liquidities but no access to a lot of corporate clients, and through securitisation they can have some corporate exposure of very good quality. If the capital treatment and the liquidity treatment is what it currently is then they will not buy it because it does not make any economic sense. Currently there is no reason for a private bank to buy a securitisation tranche. An investing bank will invest 100 and it will be recorded as only 70% high quality HQLA, but if they bought the same issuer a covered bond it is going to be 93%. These inconsistencies have to be cured.

The legal framework is extremely constraining. If a product is of high quality, then the bearers should be given all the advantages that are going along with that quality. If a bank holds a securitised product on its balance sheet, it is extremely punitive to its liquidity coverage ratio. STS is qualified as HQLA Level 2b, with a haircut of 25 to 35%. The haircut of a covered bond is only 7%, and covered bonds are qualified as HQLA Level 1 or Level 2a. Treatment of capital is extremely punitive. The capital charge for the senior tranches range from 7-15%, which is completely inconsistent as a senior tranche is very, very low risk.

Securitisation has always been of central importance for banks. To a large extent banks are disappointed by the STS regime and the way it is going, as it ultimately shows that the European authorities as a whole are not really in favour of securitisation and do not wish to develop it that much. In terms of funding, the same result can be obtained with covered bonds, and because there is a double recourse one gets even better rates and a lower cost of funding.

However, covered bonds are not bringing any advantage in terms of the balance sheet; the assets are kept on the balance sheet, which is a big burden due to taxes such as the Single Resolution Fund contribution, which is extremely heavy in Europe. There are many other systemic banking or diverse taxes, so limiting the balance sheet is important. Capital requirements are even more important. It is clear that if a bank only issues a covered bond then it does not change capital requirements, but if the loans are sold through securitisation then there is relief on the capital requirements. Private banks are extremely in favour of securitisation. The concept of STS was brilliant, but the results are extremely disappointing due to the huge number of STS qualifying criteria and detrimental treatment for regulated buyers.

### 1.3. Impacts of the regulatory process and legal framework on the market

An industry representative stated that in the first quarter of 2019 in the EU27 the supply of securitisation is down 87% year on year. If the UK is included along with all cross-border transactions the overall decline is 40% year on year. The first number predominantly focuses on STS securitisation; it is down 87.5%, so the market is waiting, partly due to regulatory uncertainty. That is expected, as the regulatory framework and implementation documents are extremely complex. The industry was surprised by a lack of a proper transition period, as it had always asked and argued for grandfathering and transitioning over a longer, prolonged period of time. That was not done, and the industry was not granted a more extended transition, causing the market to tank.

However, the covered bond supply is up 39% year on year. In the first three months of the year the industry has seen almost half of the entire supply of last year come to market, which is as a result of a regulatory framework which is favourable, lenient and easy to implement. The negative is that there is no proper comparison between the two products. Banks use the same collateral and achieve many of the results of funding in a similar way, in many countries with a very similar legal framework.

For private banks, regulation is the number one reason for the decline in the market and for the delay. There will inevitably be a pick-up in the market in the second quarter, because many issuers cannot wait. The result is that there is a high degree of uncertainty; private banks do not know whether the deal is STS or not because the entire framework is not in place. There are concerns about the reporting requirements and how to integrate them into due diligence, and with how to use the STS verification report. Another crucial issue is how to implement the very complex regulations, and who private banks need to turn to for advice about the interpretation. One of the regular issues on the market is that private banks are always referred to the Level 1, which is often very difficult to interpret.

A policy-maker stated that the European Commission has recently seen some STS issuance. That is surprising because the Level 2 standards are not there; some people are basing it on the drafts that the ESAs have submitted, which is encouraging. That shows that there is interest, and hopefully there will be more adoption when all the rules are in place in the second half of 2019. If this discussion was had in Q1 2020 then everyone would be better informed to make a judgement call.

An industry representative agreed. Deals have been delayed due to a lack of framework. There is a large discrepancy and no realignment of regulatory capital treatment. If an insurance company buys a 30-year mortgage pool it would receive 3% capital. If it bought a three-year mortgage backed security, it would get 3.5% capital. If it bought a leveraged loan portfolio it would get 28% capital. If it bought a AAA leveraged loan portfolio then its capital would be about 75%.

## 2. Existing approaches for regulation securitisation

### 2.1. Globally fragmented securitisation markets

An official agreed that the insurance framework is clearly not harmonised globally. On the banking side it is a treatment for securitisation provided by the Basel Committee, and normally applied by US banks. The US is against STS as they feel it is too lenient, and that Europeans are having a lax approach to the holding by banks. LCR is also a Basel standard, so securitisation in the US is thriving.

An industry representative stated that three weeks ago their company undertook a global comparison of the major jurisdictions in the world in terms of the securitisation framework. The conclusion was that there is no uniformity and that it is actually fracturing the market. The market is becoming regionalised and segmented, as opposed to unified and global. A key difference between Europe and the US is risk retention. There are many countries in the world which do not apply risk retention. That is a cost to the issuer, and in many cases, it may not be really necessary.

Liquidity treatment differs across the world. Europe has one of the better treatments, but there is a large discrepancy between the liquidity treatment of STS, RMBS and covered bonds. It is 70% versus 15%, and a 7% haircut versus a 35% haircut. There are large differences in the capital treatment of securitisation across insurance companies. In the US the treatment is exactly the same as corporate bonds. In Europe the numbers are quite dramatic; it is not possible to transfer risk from the banks to the insurance companies, especially mezzanine risk.

There is also an issue with STS and STC[1]. Europe is the only jurisdiction which has STS in a much more developed way. As of April 1, the Japanese regulation introduced a Basel-type of STC, but it does not automatically recognise European STS into Japanese TSC treatment. As a result of that there are discrepancies among the lack of mutual recognition, which consequently means the regulations are not coherent. Europe is in some of the worst positions because it will end up buying its own product and will increase the concentration within the system.

EU banks will not be able to transfer risk abroad or more towards the insurance companies. This is not atypical, because it is the same story with the covered bond market. 50% of covered bonds are bought by the banks, they use as collateral for ECB operations. The ECB holds 270 billion of covered bonds. More systemic risk for the covered bond system is created, and the restriction on the securitisation system also prevents transferring the risk out of the banking system. There are many issues that need to be tackled but putting layers and layers of requirements will not help. STS has 102 criteria, and it is doubtful that many more can be added.

### 2.2. Strengths and weaknesses in EU and US markets

An industry representative believed the elephant in the room is the large housing loan securitisation market. That is the only one where private banks can find depth and breadth since this is where they can build zero risk securities; the famous European risk-free bond. Such a risk-free security should be the senior tranche of a mortgage backed security sponsored by a government entity. Yet, every time that is stated to somebody from the authorities in Europe, they will say they do not want any government or public entity to be mixed with that and committed to anything. That is more evidence that Europe does not want securitisation.

A policy-maker stated that the discussion of government sponsored entities is for the next European Commission because everything being discussed is primary legislation. It cannot be changed by the ESAs in regulatory standards. It is not for these regulatory standards that are being developed, but something may need to be done in the next Commission when the securitisation regulation needs to be reviewed. The US model is an interesting idea but relies on several things, including a harmonised mortgage credit market that Europe may not have to the same extent. Guarantees by state and by budget are also unknown as to whether there is willingness in Europe to put that on the table.

### 2.3. Covered bonds versus securitisation

A policy-maker stated that the difference is that covered bonds are dual recourse. There is 'full skin in the game', which should be reflected in the prudential treatment.

An industry representative stated that by nature covered bonds have less risk than a securitised product, but the difference between the quality of a covered bond and the quality of a senior tranche of a properly securitised product should not be that big. It should be very limited; although covered bonds are less risky due to double recourse.

However an industry representative queried whether the dual recourse in covered bonds will effectively work since they have not found practical evidence on this as it has never been tested. Conversely, securitisation has been tested in rough times. Dual recourse means that the holder or investor who first claims the collateral then becomes senior unsecured pari-passu creditor of the bank. Dual recourse therefore depends on the bank foreclosure and bankruptcy regime, and what kind of recovery there will be. It is unknown how long that would take. There is no proper evidence or legal guidance of how would be handled multiple maturity covered bonds that are outstanding when a bank goes bankrupt; they may end up repaying the shorter maturities and losing money completely.

Another aspect is the existence of conditional pass-throughs, which are covered bonds which extend immediately upon insolvency of the bank. A conditional pass-through is good, because if the bank goes insolvent the bond is extended for up to 20 or 30 years as long as the maturities are there. That means that the investors would recover their money, but this same point is held against RMBS because RMBS is a pass-through security and therefore banks are being told that they cannot look into a pass-through on a weighted average basis, but on legal final maturity, which banks are still waiting for the RTSs to be able to calculate.

The covered bond market is necessary as it is a very good funding tool. It diversifies the investor base and brings longer maturity funding for the banks. However, it would make sense for all the new jurisdictions which introduce covered bonds to impose them, such as not being able to encumber more than 6-8% of assets. In this respect, one of the points that could be examined in the future is why there was a parallel existence of covered bonds and RMB in Australia and the UK.

Securitisation would allow risk transfer away from the banking system. Banks needed to transfer risk, but a covered bond does not allow that. Raising capital is also expensive. Non-banks rely on RMBS, and if there was issuance of RMBS in the UK this year most of it came from them. The two products should not be juxtaposed, but there are elements which have to be realigned. The two products should ultimately be allowed to function and support the banking system and the economy.

### 2.4. Ways forward

An industry representative suggested that in the short-term the technical standards be finalised in such a way that maximum flexibility is introduced, as the Level 1 framework is very rigid and demanding. The Commission needs to talk to the SSM about securitisation and the real, significant risk transfer they allow. At the moment the SSM is not completely sure that there is a significant risk transfer associated with securitisation as private banks practise it. If the significant risk transferred is not recognised to the issuers, then they have no incentive to issue at all.

An official summarised that everybody is waiting for finalisation of the standards. Level 1 needs to be examined but is a problem for the next European Commission. Most importantly, buyers need to be looked at, as they could be the regulated field of insurance.

1. Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) jointly produced a paper in December 2014 on Simple, Transparent and Comparable (STC) securitisations.

❖

# Investment firm prudential regime

### 1. What are the main features of the regime?

A regulator explained the new prudential regime of investment firms has now been agreed. The legal text has been finalised and it will soon be published. The discussion will address the issue of what the key elements of the agreement are, the challenges of implementation, and the key outstanding issues going forward.

The EBA had been asked by the Commission to prepare a report in advance of the legislative proposal. Most of the recommendations, if not all, have been taken on board and are reflected in the system. There will be about 30 mandates coming from the legislation, so the implementation will be a significant challenge. Focus is needed on the agreement and what participants think the key achievements of the legislative process are, and what added value new legislation will bring to the investment-firm space in Europe.

A policy-maker believed it is fitting that a regulator should chair the session because the Commission's proposal took inspiration from the EBA documents. There are around 6,000 investment firms in the EU. The vast majority of them are small and tailored to some services. A minority are very large and provide a broad range of services. They are systemically important, because those firms manage 80% of the assets. When the Commission launched the call for evidence in 2014 the overwhelming reply from market participants was wariness about compliance costs and proportionality. As a result of the EBA's advice a Commission proposal has been made that has generated a fruitful discussion in the European Council and European Parliament and arrived at three results which simplify the mechanism substantially and reduce the costs of compliance without reducing its effectiveness.

The first result is that now there is a much more appropriate and proportionate regime for the non-systemic investment firms. This is centred on a set of risk metrics called K-factors, which determine capital requirements.

The second result is that the largest, class 1 firms whose size and activities make them systemic remain subject to the bank prudential supervision.

The third result is that clearer and stronger rules have been introduced for the provision of investment services to EU clients from third countries. This has been done by improving the MiFID equivalence regime.

### 1.1. Key issues and challenges

An official stated that the final compromise is a balanced one. There are two broad areas of concern which deserve further monitoring in the implementation of the text that has been agreed. The first concern regards a level playing field in financial stability issues. Small investment firms deserve some proportionality because the banking framework is not formally suited to those firms, but the initial proposal created a very large class of investment firms that could be treated in a way that is not fully consistent with what is thought to be the right objective in terms of financial stability.

Progress made in the discussion is the creation of the 'class 1 minus' class, which enlarges the set of investment firms that will be subject to prudential requirements comparable to those faced by banks. This addresses the level playing field issue and is also necessary from a financial stability viewpoint, as the class 1 category was initially empty as it was defined.

Regarding the prudential side of the text, the two things that need to be monitored are the possible side effects of the decision to introduce a new definition of 'credit institution' by making very large investment firms credit institutions. This could have a number of side effects, such as access to euro-system financing, access to the Single Resolution Fund, and consistency with the provisions of the Financial Conglomerates Directive. All of these concerns have been discussed and could be addressed at a technical level, but close monitoring is needed.

The aspect of concern that the official's organisation has in terms of implementation is the prudential regime itself, particularly the treatment of market risk. Since capital requirements are set according to the volume of certain services and businesses (K factors) rather than risks, the definition of a prudential requirement are in the hands of market participants; that could create bad incentives, so very close monitoring is needed.

Regarding the other aspect of the text, enhancing the equivalence regime of the MIFIR Regulation is a necessity due to the current context. Good progress has been made in this respect, as the equivalence decision will be taken based on a more granular assessment. The concern the official's organisation could have with the equivalence regime is that it is an equivalence that is decided at the level of the country, so EU authorities do not have any power to enforce the rules. This is part of the very idea of equivalence, but if there are third-country firms that are based in a country that the Commission has deemed equivalent and that behave well on the EU market, then inadequate tools are available to actually enforce rules that provide sufficient protection for EU consumers.

Article 49 provides ESMA with additional powers, which is very useful, but it is an area that needs to be closely monitored, as it is believed the Commission will not decide to question equivalence based on the misbehaviour of a few players if it has rightfully decided that the third-country's legal framework is correct. Close monitoring is needed as a result of this.

An industry representative stated that the industry has welcomed the European Commission's proposal, based on the EBA report, to design an appropriate prudential regime for investment firms. The overarching principle that should apply is that the same activities entailing the same risks should be subject to the same regulatory framework. It is positive that the equivalence assessment for third-country investment firms that seek to provide investment services in the EU has been strengthened in the legislative process.

Yet, the industry does not know how the equivalence assessments will be carried out as no third-country investment firms have benefitted from them to this date (the MiFID II/ MiFIR regime only entered into force on 3 January 2018), and also because the context has changed due to the UK's decision to leave the EU.

A harmonised supervisory framework of investment firms across for investment firms across the continent is key according to the industry representative, to prevent any sort of regulatory arbitrage and ensure that the level playing field is guaranteed with EU-based firms. The strengthened role of ESMA in this regard is also welcomed, to ensure that sound and robust standards are applied in a consistent way amongst investment firms.

A policy-maker felt there are two points worth highlighting. The European Commission did not propose the class 1 minus, but debate at the European Council and European Parliament showed that there was a majority around that idea and the Commission did not oppose it.

Regarding equivalence, it is clear that it requires some monitoring when it is given to countries that are close, whose size is significant and that have many activities and interactions with the European Commission. The Commission was used to an equivalence regime in the past for small islands in the Atlantic and now things may change. It is clear that the Commission, which is responsible for equivalence, will have to play its role until the end.

### 1.2. Implementation of standards

A regulator explained that the EBA is going to gather approximately 30 mandates and is planning to publish a road map of them. Clarity on the implementation issues will be given as soon as possible. The question of how equivalence will actually be assessed is something to be seen once the legislation enters into force and is applied, as it can only be assessed once put it into practice. The lead on that will be the technical assessment by ESMA in consultation with the EBA, and the European Commission will have the final say.

### 1.3. By promoting proportionality, fair competition and financial stability the IFR is expected to contribute to the CMU project

The panel received a question from the audience on whether the EBA advice and the legislators are bank-biased in setting prudential requirements for investment firms, and how they view that, especially in light of the wider CMU objectives.

A policy-maker explained that the starting point is that there is an excessive bank bias. The notion of a level playing field had been put into question by the overwhelming reaction to the call for evidence. The regime that existed since the CRD was introduced has reached its limits. The CMU effort comprises a component of proportionality, a component of simplicity, and a component of making it easier for investors to access the market. Due to that the previous regulatory regime was very imprecise because it included a number of entities that were not completely similar.

The discussion on class 1 minus has been an attempt to more accurately calibrate what remains in the old regime and what goes under the new, simplified, regime. The trade-off is between financial stability issues which apply to systemic firms, and a competitiveness and growth issue that makes access to the market easier. As with all legislative pieces there will be a review in three or four years, but it is a good starting equilibrium. The markets will state whether something needs to be changed, but what is interesting is that this had been a true CMU reform as it is very different from what it had been.

A regulator noted that industry representatives on the panel are exposed to different types of regulations and may be able to compare which activities fall under which types of regulations, and how this helps to properly address the risks in different businesses.

An industry representative agreed with a policy-maker. It is important to contextualise the IFR within the broader EU regulatory framework for financial services. The Capital Market Union and Banking Union need to be finalised and the EU needs to be coherent with its political ambition as the competitiveness of its economy is at stake. Market fragmentation should be avoided at all costs, and vigilance should prevail when implementing the new regime, as it is the only way to ensure a sound level playing field between market participants, ensure financial stability, and enhance the competitiveness of the EU.

The assessment conducted by EBA (which fuelled the Commission's proposals) that started in 2014 did not anticipate Brexit. The figures that are mentioned do not take into account the large investment firms in the UK that are at the moment under the CRR, because it is thought that they would remain under this regime and under the supervision of the UK's PRA. As this has changed everyone needs to be very careful about the consequences and risks in terms of level playing field and fragmentation. A thorough impact assessment of the post-Brexit situation is therefore needed when implementing the 30 mandates stemming from the final agreement, in order to mitigate any unintended consequences that result from it.

A regulator asked an official whether European investors have fewer opportunities and higher costs in using third-country service providers in the EU, because of strict equivalence rules, and whether a cost-benefit analysis has been carried out on the issue of tightening equivalence rules.

An official stated that a balance is needed between costs to EU consumers and the rules to which investment service providers are subjected. That has been done internally within their organisation. MiFID II rules might create costs for some customers, but they are meant to protect market integrity. If these rules impose a cost on consumers then third-country service providers that could escape these rules could have a competitive advantage over EU players and offer services at a lower cost, which is the problem.

The aim of the equivalence regime is to ensure that the rules established in the EU in the interest of market integrity and EU consumer protections are implemented. Parties could agree that EU rules do not necessarily need to be enforced; acceptance could be made that foreign rules produce equivalent results. This is the whole idea of the equivalence regime, but the cost that EU rules impose on EU customers are costs that their organisation has accepted to be legitimate in view of general-interest objectives that the EU is pursuing.

❖

# CEE region financing and investment gap

## 1. Changes in the growth model of the CEE (Central and Eastern Europe) region

### 1.1. Deficit of investment in the CEE region

A policy-maker stated that the CEE region is not expected to be affected much by the current economic slowdown in the EU, with a forecasted growth of over 3% in most CEE countries due to strong consumption and the assumption that EU funds will continue to be provided. During the last decade, the investment in CEE countries has been significantly above the EU average, fluctuating between 20 and 25% of GDP, but a number of factors suggest the persistence of a significant investment gap.

Firstly, the capital endowment of CEE countries remains well below the EU average. The level of investment is still inferior to what was experienced in countries that have successfully graduated from medium to high income and catching up would require a long period of higher investment compared to GDP. Second, investment is still below the pre-crisis level in a number of countries. It is not yet known whether that is a permanent or temporary factor, but the crisis has led to an increase in risk premia and Western European investors being more careful. Third, progress in reforms has slowed down, or even been reversed, in many CEE countries.

There are however some significant differences across countries and sectors. The Czech Republic for instance has benefited from a very high level of investment, 5% higher than the EU average. That is due to the weight of the manufacturing sector in the economy, which requires high investment in equipment. At the same time, there has been underinvestment in the country's infrastructure and its connection with other EU countries.

An IFI representative stressed that at present the investment to GDP ratio is aligned with the core European countries, which is a matter for concern because the latter countries have more mature economies, whereas the CEE region needs to build its capital stock much more and increase its investment capacity. An official noted that the capital stock in CEE is less than 50% of the EU average. The investment gap is particularly present in the private sector. In some CEE countries such as Slovakia, almost 75% of the overall investment comes from the public sector and relies on the so-called Cohesion Funds of the European Union.

### 1.2. Changing the growth model of the CEE region

An industry representative stated that many CEE economies have developed thanks to traditional manufacturing activities. Thanks to their geographical proximity with Western Europe they now play an important role on specific steps of the value chain that are outsourced from these countries. Some CEE countries however joined that trend fairly late and were disadvantaged because of their poor economic context and inadequate infrastructure.

The growth model of the region needs to change and be better adapted to ongoing industry trends, notably the development of technology. The use of technology for improving internal efficiency or customer experience is an area where CEE countries can perform very well. In addition, while building the infrastructure necessary to catch up with Western Europe and be sufficiently efficient in parts of the traditional manufacturing supply chains may take tens of years, the time needed to close the digital infrastructure gap with the rest of the EU could be a matter of months. In some areas CEE countries even have a superior digital infrastructure.

An IFI representative explained that innovation in the region is still limited. Recent research published by the EIB and the Commission shows that only 4% of firms can be considered as innovators in the CEE region, compared to 8% for the whole EU and 16% in the US. The region needs to develop its own investment capacity in research and development, which is at present very dependent on EU structural funds and foreign direct investment (FDI).

### 1.3. Developing digital skills and capabilities in the CEE region

An industry representative stated that further developing digital capabilities in the CEE region is essential and requires continued investment in education and reducing the current brain drain to other regions. A "pact for education" would be needed at the regional and national levels, in which all parties should participate. Providing entrepreneurs and individuals with an appropriate quality of life is also important, with the necessary infrastructure (in terms of education, health, transport etc.) and an environment that is favourable to technology and innovation. Successful entrepreneurs also need to be able to become richer in their own country, with the possibility for their company to develop along a critical path that eventually leads to public listing, which currently does not exist.

A policy-maker agreed that investing in education, skills and new talent to support innovative and technological companies is a major objective in the region. There is generally a lack of adequately skilled staff, which leads to skill shortages in many sectors of the economy, particularly in the most technologically advanced ones. This is indeed made worse by a large number of CEE countries facing the migration of skilled staff to Western Europe, which is primarily driven by a difference in wages. It is important for wages to continue to catch up, which however has to be in line with the progress in labour productivity in order to preserve competitiveness.

An IFI representative noted that almost 80% of CEE firms state that their biggest problem is access to people with the right skills. The issue is not the lack of skills produced by the educational system, but the outward migration from the region, which is generating a shortage of skills at every level, including at the lower ones. However, if unidirectional outward migration continues, incentives to invest in education in the region might decrease. More coordinated action at the EU level in terms of skills would be needed.

### 1.4. Improving the predictability of the regulatory framework

A policy-maker emphasized the additional need to reduce the administrative and regulatory burden that companies face in a large number of CEE countries. The World Bank annual ranking on the ease of doing business shows that overall the CEE countries do not score very high on this criterion. There is also a need to enhance the quality of policy-making and the predictability of the regulatory framework, which remains too instable in a number of countries, with frequent changes in legislation and a tendency to make these changes without sufficient consultation or impact assessments. These improvements are essential in particular to continue attracting investment from outside CEE.

## 2. The need to diversify the financing model towards more capital markets

### 2.1. Limits of the current bank-centric financing model in the CEE region

An IFI representative suggested that the almost completely bank-based financial system in the CEE region is a limitation to growth. The increasing need for investment in areas related to intangibles, R&D and skills is indeed not easily financed by banks, which normally require collateral to lend. Consequently a stronger diversification of the financial sector is necessary or a transformation of the way in which banks operate with regard to the financing of innovation and intangible assets.

An industry representative stated that to finance these new projects it is first necessary to understand what banks can and cannot do. Unfortunately, that discussion is often ignored at the political level with permanent calls for banks to provide more credit. Throughout and after the financial crisis, banks have taken too many risks and often found themselves in the position of an equity investor. Banks will remain the main financing source for the CEE economy going forward, the speaker believed, but it is extremely difficult for them to finance entrepreneurs or companies that just have a business idea and are undercapitalised, because banks work with their customers' deposits and cannot take excessive risks. That is a role for risk capital that companies need to better understand and have easier access to. Banks can then provide more financing following that first stage of development.

Another industry representative believed that financing needs to be provided by a combination of banks and capital markets. All channels are necessary. European banks are in much better shape than just after the crisis. They had lent too much before 2007, driven by nominal convergence, but since then they have had time to improve their situation and have benefited from eight years of growth. However, from a regulatory standpoint they are not in a better situation. Their ability to provide credit has not improved. The continuing wave of banking regulation and additional gold-plating by many EU jurisdictions will not allow banks to take more risks. In certain markets, banks could potentially allocate some risk capital to start supporting the critical path of some SMEs to capital markets and help to finance innovation, but this is not possible in the current European and local regulatory environment. Therefore, alternative instruments need to be organised. In addition more needs to be done in terms of financial and business development education, so that entrepreneurs can better understand the benefit for them of following a critical path that may lead them to the capital markets, with funding provided by private equity or investment funds investing in SMEs.

### 2.2. Complementarities and synergies between bank and capital market financing

Answering a question about the possible limitations to the development of capital markets caused by the present domination of the banking sector in the region, an industry representative did not believe that is the case. There might be some conflict between attracting deposits in banks and retail clients investing directly in the stock exchange, but that is not a major issue. Banks have learned that funding activities that can be better financed through the capital market is not necessarily an attractive business in the long run and they are quite active in supporting the listing of companies in some CEE countries.

Another industry representative believed that the dichotomy between bank financing and capital markets is a false one. The two are complementary in the way they approach the financing of growth. The problem is that the mix is not correct in the region, reflecting the fact that the development of capital markets is relatively recent and has never been at the top of the agenda of policy-makers and stakeholders. When looking at how to increase the funding provided through financial intermediation, two resources need to be considered. One is the capital base of financiers, primarily the banks. The other is the availability of liquidity and funds in the market. To bridge the two there are regulated instruments such as securitisation and covered bonds that can help to attract external savings and then contribute to increase the financing intermediation provided in the region. Any regulatory initiative that puts the capital base at risk runs counter to the interest of increasing financial intermediation in the local market.

A third industry representative agreed that banks are an interested party in developing capital markets, rather than an obstacle and that bank and capital markets are both needed. Everyone complains that the demand side in the region is enjoying a very low level of capitalisation. Creating the critical path from start up to listing for companies will help address part of the problem. It is important, when talking about capital market development, that different types of instruments, i.e. equity or quasi equity etc..., should be considered. The type of instrument that will be quite abundant in the coming years will continue to be EU funds. Banks have an important role to play in the fast and meaningful absorption of these funds. Spreading best practices in this area across the CEE region is critical, before considering a real development of capital markets.

Concerning the development of capital markets, a first step where banks can help is building awareness both on the supply and demand sides about the drivers of successful capital market financing and its main components in terms of instruments and participants. Banks can also contribute to putting together a network of interested parties in the different economies of the region (e.g. incubators, intermediaries etc...). In order to kick-start a more active capital market, banks could be allowed to take certain risks either directly or via a participation in specialised funds that they could later sell, once the funds have taken off. Building a successful capital markets union (CMU) is a journey rather than an objective per se, because it means finding solutions on an on-going basis for answering different financing and investment needs.

## 3. Challenges facing the development of capital markets in the CEE region

### 3.1. Limited financial literacy

An industry representative stated that more should be done for the CEE region to be on par with what is happening elsewhere in Europe in terms of retail investment. The starting point is a deficit in terms of financial literacy in many CEE countries compared to the rest of the EU.

Another industry representative agreed that financial education is a major issue in the region. Developing investment in the capital markets is essential for increasing long-term savings and the wealth of savers and also for channelling savings towards the European economy, but savers will not invest in capital markets if they do not understand the underlying mechanisms. Recent surveys show that financial knowledge e.g. about interest rate calculations or the need to diversify investment is poor compared to the rest of Europe.

At the same time, overregulation for example in terms of investor protection will not help the development of local markets and could be lethal for some smaller ones. Some large brokers have already stopped their activities in certain frontier and emerging markets in the CEE region and investors could be put off by the tens of pages of documentation imposed by MiFID II. The CMU is a very ambitious and necessary project, but unfortunately it does not include a workstream on improving financial literacy in Europe. The private sector is leading a certain number of actions in this area but that may not be sufficient. Public intervention is necessary to develop financial education, otherwise it will not be possible to increase wealth in the region through investments. The lack of understanding of financial mechanisms is also likely to increase the support for simple economic ideas provided by populist parties.

### 3.2. Regulatory barriers to the development of capital markets in the CEE region

Answering a question about the regulatory barriers that may impede the development of capital markets in the CEE region, an industry representative considered that a fine-tuning of the implementation of regulation could help, because in many cases, EU directives are twisted when transposed into the local market, which changes their initial intention. A second area of improvement is securities market infrastructures. Infrastructures do not exist in all markets (e.g. some central counterparties are missing) and their legal framework needs improving in some cases. Barriers also exist on the demand side, for example in local corporate debt markets, explaining their very limited development in certain countries. Some of these barriers are regulatory. For example, in Romania pension funds can invest in equities of almost any issuer but they cannot invest in debt instruments of the same issuers unless they are rated in a certain way. This having been said, the speaker did not believe that regulation could create the market. It is the market forces that will foster its growth. One challenge in this respect is that someone has to “pay the price” of developing the market. In most of the fast developing markets in the CEE region, the price has been paid by the early issuers that were floated on the exchange. Initially some of them were state-owned, then they were followed by an array of private issuers. Capital markets have to be helped at their outset in order to build confidence in the market.

### 3.3. Size and quality of enterprises in the CEE region

An industry player considered that the size and economic health of potential issuers is a further challenge in the CEE region. Most of the companies in CEE are micro-companies, which means that they are not compatible with the objectives of the CMU. This reveals an “entrepreneurial problem" that needs addressing in the region and that must be considered when defining whether funding should be deployed via the capital markets or bank financing.

An official confirmed that 90% of SMEs in the CEE region are micro-firms, which also have difficulties in obtaining loans in many cases.

An IFI representative considered that the future of risk finance in CEE is more about private equity than capital markets, because raising capital on public markets is difficult for most small firms. Instruments such as private equity or venture debt are more appropriate and need developing. Well-functioning banks should also be allowed to progressively take more risks using such instruments, perhaps supported by institutions like the EIB.

## 4. Possible way forward for developing more capital markets in CEE

### 4.1. An appropriate ambition and workplan for developing financial activities in the region

An industry representative stated that an ambition for the development of financial markets as a whole i.e. banks, stock exchanges etc. needs to be defined in a collective way at the national and regional levels together with appropriate objectives. Then, the actions required to achieve this ambition need to be defined. Some can be very basic, such as providing a more predictable regulatory and fiscal environment for investment and limiting unnecessary volatility. Retail investors cannot be expected to invest in the stock exchange when, as the result of government action, there are sudden drops in value of 20% almost overnight.

Another industry representative suggested that developing the capital market involves considering the demand and supply sides and also the infrastructure in the middle. On the demand side it is necessary to look at all the components i.e. domestic / international, retail / institutional, etc. Sufficient institutional investors need to be present in the system, particularly pension funds without which it is difficult to develop capital markets. Retail domestic investors also have to be considered and whether the level of education and financial literacy are sufficient in the country. On the supply side, it is necessary to address potential regulatory and non-regulatory barriers to the development of equity or debt markets. Moreover, it is necessary to assess the possible need for further developing securities infrastructures and improving their functioning or regulatory environment.

### 4.2. On-going EU initiatives to enhance investment in the region

An official noted that there are already significant ongoing EU initiatives and instruments provided by the public sector aiming to support investment and the development of capital markets in CEE, such as the Vienna Initiative and the Structural Reform Support Programme.

An IFI representative explained that in the context of the Vienna initiative the EIB has been working with the IFIs and commercial banks operating in the region to assess which tools are working and identify additional ones which may need to be implemented to finance innovation in the region. What stood out in these assessments is that venture capital financing at a very early stage is well covered, because there are many public sector resources. The problem starts at the scaling up phase, which is when firms lack financing.

The EIB provides various instruments aiming to tackle the issue of innovation finance: a capital relief product and a guaranteed product, which is greatly appreciated by banks, particularly when they are structured to take the first losses out from a portfolio. This helps because it reduces capital consumption and allows banks to service clients that they would not necessarily have been able to address otherwise. This instrument is managed by the EIF (European Investment Fund), which is part of the EIB, and provides around € 1.4 billion funding, specifically injected in the region on this project.

Secondly, for the scaling up phase, a complementary financing product - venture debt - is being tested at the European level that is not capital but risk financing. It is a product that is difficult for banks to offer, mostly due to regulatory constraints, because the capital consumption would be too high.

A policy-maker stated that developing investment remains the number one priority of the Commission. A couple of years ago the Structural Reform Support Programme (SRSP) was established aiming to accompany the effort of member states in developing structural reforms. More than 200 projects have been financed in 2018 and there should be about 260 in 2019. In many countries, those projects consist of helping to develop the financial market, which is an important priority in the CEE region.

In the next MFF (multiannual financial framework), efforts to support investment will be stepped up. InvestEU, which will be a single guarantee, will be launched, replacing all the financial instruments that currently exist. The EIB will be present, but for the first time the Commission will allow the National Promotional Banks to have direct access to the European guarantee. This combination of European and local level expertise should help to develop investment in a more effective way.

### 4.3. The possible need for additional and more targeted support from the EU and local public institutions

An industry representative believed that without further support from the public institutions it will be very difficult to develop capital markets sufficiently in the CEE region, particularly in a context of slow economic growth in the EU.

The EU needs to design instruments that would allow the private sector, and not only governments, to ask for European funds to support certain projects. This could be applied in certain areas that require targeted action. A first area is financial education. Developing capital markets indeed requires improving retail investor and also issuer education through action targeting the general public. The private sector should be allowed to tender for projects involving public money in order to develop financial education. Targeted actions supported by European funds could also be used to shore up the issuance of securities in the market. European Funds could be used for example to cover part of the cost of issuance of bonds on the capital market or of IPO costs. Support programmes could also be designed to help simplify and accelerate the listing process, improve research coverage in the CEE region or create regional ETFs.

Another area where public support is essential is tax incentives, the speaker emphasized, because they are probably the fastest way to develop capital markets. Tax incentives should be used to encourage long-term investment, for example in the context of employee stock option plans. Corporates should also be allowed to deduct a part of the cost of a bond issuance or listing cost from their taxable benefits.

Another industry speaker considered that it would be preferable not to use special instruments or incentives to convince people to put their money into the financial system of CEE countries. This should be the result of an attractive ambition defined for the financial market at the regional or national level with all stakeholders.

# SUSTAINABILITY AND LONG-TERM INVESTMENT

## Developing a stronger European investment capacity

The Chair asked if enough has been done to date on long-term investment and if the topic is still high on the agenda. The next Commission will have the challenge of restoring confidence. There is progress to be made on risk-sharing and reduction, as well as on capital markets union (CMU). It is wanted, but when the Commission's first proposal was presented to Eurofi there was no appetite for CMU without unified supervision. Europe must move ahead but there is a loophole in wanting a fully-fledged CMU with supervision by member state-driven institutions.

AML is an elephant in the room. Supervising capital markets cannot be discussed without considering AML. Everybody has in mind what will happen with Brexit and with other trading partners.

Long-term investment must consider Environmental, Social, and Governance (ESG) criteria and sustainable finance. The Commission has successfully married sustainability and finance, although more can be done. The first question is why the EU needs stronger long-term capacity and what it involves, before answering why long-term investment is particularly low in Europe and which sectors need to be strengthened.

### 1. Long-term investment remains low at a time when the challenges facing the EU demand a significant investment effort

#### 1.1. The need for a stronger long-term investment capacity in Europe

An industry representative noted that investment is needed due to a large investment gap in Europe, particularly in sustainability and digital. The Commission estimates that the investment gap for a sustainable model is €180 billion per year, concentrated in energy and transport. The issue is how to accelerate these investments for the public and private sectors. The financial sector can shrink the investment gap by focussing on SMEs. Large companies have other options, but SMEs are dependent on banks. Buildings from an area for action, representing 40% of energy consumption and with 70% of the stock being energy inefficient. Promoting investment by advising SMEs is helpful, as is support via initiatives such as the energy efficient mortgage.

European digital lags behind other main countries, particularly the US on artificial intelligence, and the use of data for good as there is good data protection. Investment in super computers, artificial intelligence, cyber-security, the labour force's digital skills and wide use of digital technologies is essential.

A Central Bank official noted that benchmarking investment in Europe is key. Recent publications conclude that there is under-investment. The last decade's investment evolution for the euro-area and EU explains the devolution of investments. Non-construction investment was around 9% of GDP before the crisis and is around 11% for the Euro-area and 13% in the US. Public investment is low, as governments prioritise reductions against other social expenditure.

Long-term growth has followed a downward trend during the past 20 years, with euro-area figures of around 1.5%, well below those of around 2% in the US. This is driven by factors including low productivity, demographics and persistent weakness in business investment. Two factors represent important obstacles for investment activities. The first is economic policy uncertainty, at record highs in 2018. Global trade policy, Brexit and the lack of decisive steps to further increase European integration affect this result. The second is private and public indebtedness, which remains on average above pre-crisis levels.

#### 1.2. What an EU stronger investment capacity would involve

The assessment that change is needed begs the question of who can create the necessary regulatory, supervisory and economic framework for more long-term investment. Can financial intermediaries use existing regulations like Solvency II, MiFID, IMD, Basel requirements, accounting standards, IFRS and existing product, UCITS, pension funds and PEPP to direct household saving to Europe's long-term investment needs and what is lacking in the economy, regulatory and supervisory framework for strengthening investment capacity.

*1.2.1. Optimising the impact of public financing*

A public representative was concerned to hear that long-term investment is driven by the public side and short-term by the private side. Long-term investments must also engage the private side and so recent legislation must be checked. The EU has been a driving force for developing standards and UCITS was a right approach.

It is important to empower public authorities to make investments as they see fit. Member states need the fiscal space to invest if they want to. The rules of economic governance and those enshrined in the Stability and Growth Pact (SGP) aim to provide space to keep up with regular investments and react in an economic downturn. Rising debt levels in the aftermath of the financial crisis are severely constrained in their ability to act, thus reducing public debt levels by enforcing the current fiscal rules to increase the capacity for public investments when needed.

Private investment is where the biggest impact can be made. The key to unlocking it is removing barriers and obstacles that hinder the taking of calculated risks by providing a high level of regulatory predictability, deepening the Single Market and facilitating access to finance, particularly by completing the CMU, which would also hedge against Brexit impacts. There is no silver bullet to strengthen EU investment capacity; many coordinated measures are needed.

*1.2.2. Focusing investment on education and training*

The annual European Bank survey asks companies about the impediments to investment, particularly long-term investment. In the last one, the first ranking impediment was the lack of staff skills. Eight out of 10 of the surveyed companies, or 77%, mentioned this as most relevant. Last year's ECB digitalisation survey also focussed on this and concluded that staff lacking the right skills is a significant obstacle to the adoption of digital technologies. Public infrastructure investment should focus on human capital. The Chair noted the strong message sent about social investment in education and training.

*1.2.3. Addressing the impediments to investment in some national pension systems and developing the potential of local capital markets*

An official considered addressing impediments to investment in some national pension systems to be a priority. It is crucial to maintain momentum and fulfil local capital markets' potential. Incentivising funded pension plans and mobilising household savings into products which support long-term investment is crucial. Allowing the short-term withdrawal of funds from unit-linked schemes is inconsistent with long-term investment strategies.

Another impediment is access to local capital markets in order to improve the availability of long-term financing for local investment projects. Policy engagement and technical assistance on projects improve investment ecosystem infrastructure and reduce listing or transaction costs. Croatia has recently developed a financing platform to support SMEs and start-ups with Funderbeam. That translates CMU potential into practice which will otherwise stay in the realm of concept.

*1.2.4. Agreeing on a European Investment Fund of sufficient magnitude to cover needs is key*

According to a public decision maker, the European investment stabilisation capacity proposal is reasonable as it can cover the need for public investment in Europe and take a macroeconomic perspective, due to the low stabilisation capacity at the euro-area level. Focussing on investment is crucial as multipliers and expenditure spill overs are high, with positive consequences for long-term growth.

*1.2.5. Defining an EU prudential framework, which properly captures the reality of the long-term investment business model*

A market expert considered that the existing prudential framework does not properly capture the reality of the long-term investment business model, as characterised by stable financial resources, tight asset liabilities management, permanent asset location, portfolio level management, not line-by-line and remote investment horizon. The investment strategy risk analysis should be redone as it is different from those made for Solvency II and banking regulation, which only concern the short-term perspective. The risks are the same, but their assessment may be different. Liquidity risk exists at a low level when managing for the long run. There is also a limited market risk. There is some interest rate risk for the reuse of resources when the duration of assets exceeds the duration of the bonds. This means that the risk associated with bonds is higher than that with equity because there is no maturity with equity.

Credit risk exists but can be managed. Operational risk is lower as a computer can be out of order for days without an impact. There is economic risk from assumptions made about long-term return and there may be variation, especially for infrastructure, so externalities must be considered. Positives and negatives are linked to the portfolio. The most serious risk related to long-term investment relates to mismatch. Making assumptions about liabilities and the association of assets and liabilities has a significant associated risk. There is also some reputational risk if done on a large scale, as savings collection requires a solid reputation. Financial institutions' prudential framework must be redesigned, with resources for long-term investment.

A Central Bank official agreed that the relevance of market and financial regulation must be acknowledged, as there is an agenda. CMU is crucial for the private sector and the private sector is fundamental for long-term EU investment. The EU and the public sector have a role as there is evidence of public sector under-investment in the EU, particularly in some countries. That shows the importance of euro-area investment capacity to increase long-term investment and act as a stabiliser. The third issue is human capital, which is a combination of the public and private sectors. Human capital is provided by the public sector in many European countries, but the private sector can help to increase it. All these issues must be covered, not just only one.

## 2. The EU regulatory and supervisory framework needed to foster long-term investment

### 2.1. Financial institutions' capacity to transform stable resources into long-term investment must not be limited

A market expert noted that it is essential to consider long-term intermediation as the main resource and therefore not to limit the capacity of financial institutions to transform stable resources into long-term investment. Europe relies on powerful intermediation entities that could be combined with the development of market financing to favorably revisit the CMU post-Brexit.

The challenge of long-term investment is that it benefits from a large pool of household savings which are long-term for an aging population, but European citizens are reluctant to directly invest in financial markets. That is understandable seeing what happened on the markets in recent years. Intermediation by large, solid financial institutions is needed to allow them to collect savings and apply them to long-term investment.

Proposals include understanding consumer protection concerning long-term investment and avoiding multiplying the unnecessary liquidity option and restoring financial institutions' reasonable transformation capacity to apply long-term savings to long-term investments through tight asset liability management discipline. Another is redesigning the prudential requirement of long-term investment based on risk analysis and allowing adequate measurement of financial performance by requiring standard-setters to provide practical solutions. That should build a long-term investment strategy, including the comprehensive portfolio approach, the parallel handling of assets and liabilities, and overgenerous treatment of every category of assets to avoid artificial bias in asset allocation to create solid and efficient long-term investment capacity.

### 2.2. Incentivising companies to be listed is challenging

An industry representative agreed that UCITS is a success that has not been replicated. Stock market regulations include the prospectus directive, market abuse and IFRS accounting, among others. Fewer companies want to be in the stock market. CMU can be discussed at length, but reality shows fewer than 1,000 companies listed on Euronext, down from 1,200 10 years ago, a drop of 20%. There were 300 IPOs last year in Europe and 800 annually before the crisis. The stock market is shrinking.

Legislation plays a role. Ten years ago, it was said that Europe had to emulate the US, where companies are financed more by the stock market than by banks. Europe is the opposite. Companies need access to the stock market and are less reliant on banks. A third way of financing is private equity, which has ballooned. The number of companies listed in the US has also dropped as it makes sense for them to be in private hands rather than publicly listed.

At the end of 2018, a mini bear market acted as a stress test and showed herd behaviour, with retail and institutional investors divesting. There was pro-cyclicality of the Solvency rules and a loss of depth and liquidity. Nothing was learned from that and no discussion happened around it, despite it gifting a real-world experience of what could happen in a true crisis.

### 2.3. Reviewing Solvency II and accounting standards is urgently required

An industry representative predicted a review of Solvency II as it is meant to be risk-based but puts the lowest requirement on the most dangerous assets. Accounting is key. Companies will divest from equities before IFRS 9 and IFRS 17 enter into force. IFRS 9 will bring volatility into accounts and require funds in the transition of IFS, which requires divesting from equities. This will happen unless the EU changes course on accounting. An urgent proposal is to take back accounting sovereignty in Europe, transform EFRAG into a fully-fledged accounting standard setter and discuss convergence between EU and US GAAP with the IASB.

A public representative agreed there is a long-term lack of strategic and professional investors. Addressing the issues raised will be key. Having more access to private capital is an aim and it is hoped that the next programme will engage with private capital. Solvency II must guarantee that life insurance is available for private investors and that insurance companies can still do long-term investments. Long-term investments are not well-received, especially at EIOPA level, due to requirements making it less attractive to deliver those products. Systems must be recalibrated with the legislation, including PRIIPs.

Another industry leader agreed that IFRS9 penalises long-term projects. It is not possible for banks to have it all. Long-term maturities are heavily penalised by capital requirements, as was highlighted earlier with a comment that long-term is for the government, short-term for the private sector. This is seen in capital requirements so must be reviewed. The CMU project must be fostered in the areas mentioned, including securitisation.

The Chair noted that IFRS is hailed as the accounting standard for transnational and international capital markets but requires revision. The Solvency II review should ensure that long-term investment is stable, secure and does not jeopardise household savings. This must ensure that the EU is stronger than member states if there is global competition.

An industry representative considered that internal models are accessible to the largest groups. €1 billion of assets is too small to have an internal model as it is costly. It cannot compete with groups that can afford an internal model. A public representative agreed that the medium-term requires a discussion about capital requirements, on Solvency II, mortgages and underlying capital. European and international accounting standards must be reviewed long-term so that they are not an additional hurdle.

### 2.4. Setting up a horizontal review on investor protection

A public representative advised that a horizontal review on investor protection is necessary in the short-term. The aim is to ensure private households, investors and retail clients can invest for the long run and intermediaries can offer products, so both sides must be recalibrated. Europe was a driving force in structures and products. Over the last 10 years, the best disclosure rules on consumer protection were put in place, creating the best-informed clients. Clients may wonder if they are receiving so much paperwork and information on investments because they are not as safe as they were told when it was sold. PEPP is overloaded with disclosure requirements, conservative calibration, fee caps and things which make it less attractive. An unattractive product will not be the market frontrunner.

PRIIPs has similar issues, in that some investments are not accessible for private investors. The legislation enacted shows room for improvement to keep clients informed in a way that they understand because there is a lack of private investors in the capital markets. The Chair advised PRIIPs were not meant to support long-term investment.

An industry representative echoed that the rules reinforce the risk aversion of households. They are warned of short-term volatility and not about the long-term risks of cash. They are also told about fees for investing. It is essential to talk about Solvency II and accounting because nothing has been seen on equity investing and IFRS. PRIIPs requires that retail investors are fully informed of the risks when investing in volatile asset classes. However, the greater long-term risk of lower net returns for savers who eschew equities is not so visible. Investing in equities is costlier than in other asset classes. The transferability of contracts reduces the likely duration of liabilities and thus that of the assets chosen by financial intermediaries to match them. Information about short-term volatility, transparency about costs of equity investing and easy switch of investments between financial providers appear unimpeachable consumer protection goals but may lead retail savers to underinvest in equities for retirement, whether the vehicle to do so is unit-linked insurance contracts, pension products, with profit life policies or UCITS.

### 2.5. Channelling household savings in the local economy in central and south east Europe

A public decision maker advised that there are multiple strengths in the accumulation of household savings in the countries of operation in central and south eastern Europe, that are well capitalised in a liquid banking system and growing institutional investors' balance sheets. In many cases, the limited supply of local investible assets means that valuable long-term resources are not deployed in the local economy but flow offshore or back into the local banking system as deposits. The greatest challenge and opportunity is encouraging local boroughs to diversify their funding sources and use capital markets.

This means identifying reforms to reduce issuance costs, improve the legal and regulatory environment, develop the financial market infrastructure and the institutional investor base. Another challenge in many European countries is measures that undermine the long-term investment capacity of European institutional investors and local pension funds. This results in barriers to long-term investment, which leads to more dispersion and market fragmentation.

The Chair noted that PEPP is an asset manager product with an EU label that does not guarantee that savings in countries where Pillar 1 or 2 is not developed can enter it. There is a contradiction between using long-term savings but not allowing for proper EIOPA involvement, keeping it under national competent authority control and allowing it to be opened in only one other member state. The loophole in the market would not be filled.

An official recognised that it is important to work at the local and European level on pension funds. Legislation that enables investments with a long-term horizon and with a taxonomy linked to sustainable financing is fundamental to having the same framework within the European area. That does not mean not pursuing the right reforms at a local level, while avoiding reforms that lead in the wrong direction. The right reforms are ones that make local investment in infrastructure easier and widen the size of capital markets. It is important to build the right European legislation to create a truly single CMU, while working on supply and demand from the sub-regional level.

A market expert agreed. Liquidity options and documentation must be reviewed. Onerous documentation requirements do not provide the required level of safety and comfort.

**Conclusion**

The Chair noted that this was a controversial roundtable and she does not believe that PRIIPs had overburdened the consumer, investor or saver that would not enter the market. Concerns about the shrinking of the stock exchange in the EU and the US were noted. There is a controversial dimension on the role of public and private investment in ensuring the right dynamic for long-term investment but there is a role for both. The EU is still looking for its new UCITS success and pensions can be a driver for long-term investment, but there is a consensus on changing IFRS. This would be her last chairing of a roundtable in Eurofi as a MEP and the Chair thanked David Wright for his earlier comments. It had always been a huge pleasure to chair or to participate in the work of Eurofi, as it is an utmost important contribution to ensuring things are fixed.

The Eurofi President noted that he was using his prerogative for the first time. The Chair has accomplished five mandates in the European Parliament, or about a quarter of a century. Anybody who has worked with her knows her dedication to the EU and sensitivity to European citizens, social fairness, and progressing files in Europe. The last example is the work to strengthen the European supervisory authorities, where her tenacity in the negotiations was noted. It had been a privilege to work together. She is an embodiment of what Europe is and Eurofi salutes her. She will always be welcome at Eurofi.

# The EU long-term sustainability strategy

### 1. Is there sufficient clarity and consistency between EU strategies and member states?

#### 1.1. Predictability and clarity of EU policies to favour a much bigger pipeline of bankable investment opportunities

A policy-maker stated that currently there is no other subject that is more interesting from the political viewpoint and in terms of public opinion. Sustainability has never been so high, and young people demonstrate in streets across the world. According to the latest Eurobarometer 95% of EU citizens say the environment is their top priority, and 66% say that the EU should do more. At the last Davos World Economic Forum, the top three risks for the business community were linked to climate change, the environment and sustainability, far ahead of cyber, economic crises or protectionism. Sustainability is on the table, and for the first time, sustainability and climate are topics for the next European elections.

The Paris Agreement, the Sustainable Development Goals agenda, the circular-economy strategy and the long-term strategy on climate and energy are all setting the way forward with ambitious targets that require a significant financial contribution. The state of public budgets and finances is well-known, and everybody is looking at the financial sector to make this happen. A policy-maker added that $180 billion per year is the figure which has been estimated in order to achieve the Paris Agreement, but if the investment needed in water, biodiversity, the circular economy and clean air is integrated then this figure is around $320 billion. The EU will not succeed in the fight against climate change if it neglects the protection of biodiversity, investment in the circular economy, water and air quality, and nature. All of it has to form part of an overall strategy, and climate change cannot be dissociated from the rest. Sustainability is a much wider concept and all the elements need to be embraced.

The European Commission is working on the green-bond standards, on the EU Ecolabel for financial products, and on integrating sustainability in ratings and in prudential requirements. Exploration is needed on whether there is sufficient clarity and consistency between the EU and member states' sustainability strategies to provide investment predictability, particularly in order to avoid the risk of stranded assets. If the answer to that question is yes, then discussion is needed on why it is not being translated into a much bigger pipeline of bankable investment opportunities than is currently the case. There also needs to be discussion on what needs to happen, the challenges and barriers, opportunities, whether more or less should be done from a regulatory viewpoint, and whether regulation should be avoided or intensified.

#### 1.2. Energy union strategy

A policy-maker stated that the long-term sustainability strategy of the EU is not only bankability but also compatibility with the capital markets union. It is one of the areas where in some cases it is closer to the banking system, in some cases it is closer to institutional investors, and in other cases it is both.

The strategy is now at a very good point from an EU point of view. The Energy Union Strategy has been created, which has established very specific targets and governance systems for 2030. There are concrete legislation, targets and policy objectives for 2030. The EU has also established a degree of direction for where it wants to be by 2050, which is a completely decarbonised Europe. There is a strategy for the next decade. The energy sector has targets on energy efficiency, greenhouse-gas-emission reduction and renewable-energy introduction, but the EU has also a governance system whereby it will monitor what every member state is doing and is committed to doing, and then review the implementation between 2023 and 2027.

Europe is very close to achieving the 2020 targets on energy efficiency and greenhouse gas emissions, and in some cases over-achieving them. They are not linear, so achieving the 2020 target does not necessarily guarantee that Europe will achieve the 2030 targets. There is a good starting point and a good trajectory up to 2030, but the difficulty going forward is important in many areas. If the 2030 targets are achieved and there is no policy change after that then by 2050 greenhouse gas emissions will only reduce by 60%. There is a gap that needs to be addressed between 2030 and 2050.

A policy-maker noted Europe is ambitious, particularly its public. In the last four years the European Commission has made proposals to increase renewable energy by 27%, energy efficiency by 30% and car efficiency by 30%. It was outmanoeuvred by the European Council and European Parliament, which is very rare, as the targets were deemed too low. The Council raised the bar, so Europe is now faced with an increase to 32% on renewables by 2030, 32.5% higher on energy efficiency; and 37.5% for the car sector. That will have an immediate effect on the investments that are going to be required in the coming 10 to 15 years. The $180 billion figure is the number that the Commission stated when it put its proposals on the table, but it is not what the public sector can do. The EU can provide around $40 billion, so help from the private sector is needed.

European Commission strategy is bankable but also very holistic. It does not fit with the priorities of every investor. There are parts of the energy strategy that require steady investment. An investor with a profile of investing in utilities will be very attracted to that. The same is true for investors who invest in buildings, mortgages or securitisation structures. There are segment of the market and of the energy transition that are attractive to conservative investors, but there are also other more dynamic investment segments that are linked to innovation, such as hydrogen development and new technologies. This holistic approach does offer an investment opportunity for everybody provided that each investor engages in the segment of the market that fits the needs of its client or shareholders.

A policy-maker believed that it is a dynamic environment in many areas where innovation is needed. The EU needs to remain open to innovation. In this respect, there are certain things that can be done at EU level and certain things that have to be done at member-state level. Not everything can be done in Brussels, and the EU needs to rely on this partnership and ownership at the level below. It is the case for innovation strategies that have to be done regionally. If they do not work then the EU needs to give incentives, but there needs to be an aggregation of things at the lower level and a balance. There is an upfront cost, not all of which has to be passed to consumers or end-users. Those costs have to be smoothed out because the net benefit of this strategy is positive for consumers.

### 1.3. Areas of investment

A policy-maker stated that there are six areas that are important within this package. The first area is the important element of energy efficiency. Huge investment has to be made in the energy efficiency of buildings. 66-75% of investment that is needed over the next decade is in energy efficiency. This is difficult for commercial real estate, because all commercial real-estate investors are already investing in the energy efficiency of buildings as it pays off in terms of running costs. However, it is more difficult for private housing stock because of administration and urban regulations, and the lack of a unified mortgage market in Europe. Initiatives need to be taken on the financial markets side as well as in terms of regulations and administrative procedures in order to ensure that the renovation of buildings picks up speed. By the end of the year member states will be obliged to present building renovation strategies so that member states will have a clear commitment around how many buildings and with what rhythm, incentives and policies they will stimulate building renovation.

The second area is renewable energy. Around 20% of European energy comes from renewables, but by 2050 it is predicted to be at least 80%. Renewable energy will triple from where it is today. The deployment of renewables also has an additional advantage in that it reduces Europe's energy import bill. The third area is mobility, which will change drastically under all scenarios. A large part will be electrified but it will not be the only technology available. The fourth area is that industry has to remain competitive and be sustainable, so there is a huge engagement of industry in this area. The fifth area is the smart network and related infrastructure. The European Commission has almost completed its infrastructure for the cross-border movement of gas but has not yet completed its infrastructure for open borders for electricity within Europe. Investment in electricity networks is needed, both in terms of physical infrastructure and the smartness of that infrastructure. The sixth area is a huge room for involvement in new technologies.

### 1.4.Transparency should help leveraging the role of investors to foster sustainability

An industry representative believed that from an asset manager perspective there are three aspects that are key to making sustainability more bankable. The first element is to create the right investment parameters and taxonomy. The second element is the need to standardise and accelerate meaningful company disclosure. The third element, which is the most important, is the need to incentivise or even generate investor demand.

Asset managers play a key role in developing these three areas because they play a key role in the financial ecosystem. They allocate the capital and are protectors of their clients' money, especially long-term savers and pensioners. Asset managers act as a steward of shareholders' interests through active engagement, representing the interests of their clients in the individual investee companies. It is important that these companies and asset managers invest and operate on a sound and profitable basis, and sustainable factors will become more and more important.

The basis of all investment parameters will be the taxonomy. If the taxonomy is right, then it also creates comparability at the investee-company level. It is important that a flexible taxonomy is developed that is nuanced rather than a classification system that is too restrictive, because there is a need to allow those companies that are not yet green but that have a climate trajectory to be included rather than excluded. If they are not, then too many economic activities would fall outside the investable, sustainable universe. Active engagement is most important, and asset managers can move companies who are underperforming into environment, social and governance (ESG), as well as raising their financial value.

Active engagement with investee companies is critical to changing behaviour as well as encouraging disclosure. Divestment is not the answer in terms of companies that are not green yet, because it not only limits the universe but will not make a change and will not allow Europe to reach the environmental targets that it has set. Active engagement is needed.

Last year, asset managers representing 11.5 trillion of assets wrote two open letters published in the Financial Times. The first letter asked for the oil and gas sector to take responsibility for all of its emissions, and the second letter went to utility and power companies, encouraging them to accelerate decarbonisation and the transition. The sector welcomes the Technical Expert Group on disclosure reporting, because it aligns the Non-Financial Reporting

Directive (NFRD) with the Task Force on Climate-related Financial Disclosures (TCFD). If more companies measure and meaningfully disclose then there is more that asset managers can include in their investment processes.

Investor clients ultimately direct the capital that is managed on their behalf. Identification of sustainability preferences is needed, in addition to raising awareness. There is a strong educational element to that in terms of explaining how these EU policies impact them. More focus is needed on raising awareness of what the specific investment opportunities are. It goes slightly into the marketing area, but it is also simply understanding the policies and making them more visible to the end investors. Asset managers can play a key role because they continuously talk to investors.

An audience member asked why the EU does not package and create retail financial products in terms of sustainability, and believed it is very difficult for a citizen to buy a sustainable financial product. An industry representative explained that asset managers are looking to offer more products in the retail space. More can be done to explain what is green and what is not, and to design and label funds. There is no universally agreed standard for funds; a suggestion is to have a spectrum that would allow for the indication of how green a fund is, which would give the consumer the option.

## 2. Long-term views and perspectives

### 2.1. How urgency can be balanced with a long- term outlook

An industry representative believed that there is no alternative but to act as soon as possible. One important point in the landscape described by a policy-maker is the fact that in the future new energy and energy efficiency will come from decentralised sources. It will not be a single site; energy efficiency needs to be built into every building, everywhere. A long-term strategy and investment vision is needed, which is why it is so difficult.

Sustainability is a 'nightmare' for the industry and for finance because there is a lack of predictability. 20 or 30 years ago, nobody could have predicted the situation Europe is currently in, which is also being accelerated. There is a contradiction between transition and an emergency, where Europe currently is. There is a feeling of inconsistency between some Key Performance Indicators in finance around accountability, prudential ratios and what needs to be done. In this sector there is also lots of political interference.

There is a need to finance small projects for the long-term. Financing small projects is very expensive. For this, the industry needs to have people who are able to leverage with the private sector, and actors who have a key role as enablers. The public finance sector can be part of that.

The sectors where the EU needs to invest are in energy efficiency and renewables. About 75% would have to be invested in energy efficiency, residential buildings and tertiary buildings. Despite the fact that there is a regulatory framework, there are lots of degrees of freedom given to member states around how they are going to implement that. At the highest level there is certainty for private sector investment, but in detail it is now up to member states to state how that is going to be implemented. National Energy and Climate Plans detail how member states are going to implement the proposals by 2030. The proposals themselves might not be detailed enough to be bankable for the banking sector. There is more work to be done; that is where the private sector and investors should clearly signal to member states that they need to be clear about how they want to achieve those targets, because that is not mentioned in the EU legislation.

### 2.2. Improving EU financing mechanisms, and in particular EU and national public funding involvement

An IFI representative stated that the investment needed is $250 billion per year. It is about 1.5% of GDP of the EU. The EU is running a current-account surplus that is vastly bigger than that, so it has savings that could be financing that. There has been a very dramatic change in the EU energy system from 20 years ago. That change is essentially based on innovation and improvement in existing technologies. It is not just a question now of developing the technology that exists currently, but also of having to take care of innovation for the future. This is higher risk and a big technology challenge, but this is the field where there is significant need for investment.

In the energy sector the vast majority of the system is organised so that the end users of energy pay. It is not useful to dream up subsidy mechanisms that may not be sustainable. The EU should try to target public resources where it can make a difference, and private finance solutions can deal with the rest. A large proportion of needs are in the energy efficiency sector.

The first problem in that sector is information. Most of the owners of those buildings do not realise how much it costs, whether it makes sense, what it really entails or how to organise finance. Creation is needed of a proper way for pure, straight information. Viewed from the perspective of finance, the EU has to deal with a very granular system of loans or financing requirements. Smart aggregation mechanisms are needed to deal with that. Securitisation is not very popular, but it is a tool on which reflection is needed.

The InvestEU mechanism is going to be the workhorse of EIB activity moving forward in that sector. The EIB does not see itself as just financing; its role is to try to catalyse others to participate in financing. The EIB's means are too small to be able to play a big role on its own. Regarding reconciling ex-ante emissions with ex-post benefits, the answer is long-term investors with huge assets that are able to be amortised over a long period. The InvestEU programme is excellent because it enables national promotional banks or institutes (NPBIs) to have direct access for at least 25% of the EU guarantee.

An IFI representative noted that the EIB has launched its review of the energy-lending policy, and encouraged anybody with a keen interest in the energy sector to communicate with it. The easiest way to do so is via the website.

### 2.3. The importance of carbon price signals in addition to optimised financing mechanisms

An industry expert explained that a huge amount of investment is needed to succeed in the energy transition. Many sectors are involved, such as energy, transportation, buildings and industry. Giving a significant price to carbon will lead to a reduction in activities which are becoming too costly due to its use.

The EU is presently targeting the volume of emissions permits in the framework of an Emissions Trading System (ETS). The recent reduction in its volume has led to an increase in the price of carbon, which increased to €25 per tonne, but has already decreased to €21 per tonne. The price of carbon remains very volatile. What is needed to allow sustainable investment to change gears in the EU is a long-run, predictable carbon-price signal at a speed which is economically and socially acceptable, but which leads to true energy transition. A taskforce for carbon pricing in Europe has been created, made up of firms, think-tanks and academics from all EU countries in order to push this idea at the European level.

A Central Bank official believed the EU has been lucky because Central Banks have greatly helped it in alternative energy. However, it is unlikely that there will be such low energy prices for the next 20 years. A carbon price is needed. Industry players in Austria have stated that the Commission's trading system is a failure, because a reliable long-term price is needed in order to plan in advance. To invest now it is important to know where the carbon price will be in 20 or 30 years, and with the trading system that cannot be achieved. What is needed is a carbon tax which starts at a certain price and increases reliably every year. The income from this carbon tax could be given back to the population. In Austria and most other countries there is a huge tax on wages; if it is given back to lower social-security contributions then there is a change.

A policy-maker believed it is not that easy. Something the EU never expected is the fall in the cost of technology for renewable energy. That has been seen in Europe, with member states setting a particular price on electricity which was foreseeable for many years but was probably the most gold-plated policy ever seen in the EU. It was effective, but consumers are still complaining today. That is the beauty of the ETS, because the price and the price formation take the two aspects into account. It also looks at how cheap the technology is going to be. If the technology is getting cheaper and cheaper, then that high carbon price is not needed.

A policy-maker stated that since the late 1980s the European Commission tried for 10 or 12 years to introduce a carbon tax. It has been impossible to get this through Council and Parliament because of the unanimity. The carbon tax that would be established through an inter-institutional process would not be what would be required in order to get the technologies going. Since then it has tried twice more, but it is not working. However, it is working at national level. There is a carbon tax in Sweden and Norway, which works very strongly because those countries have pushed certain technologies.

❖

# Sustainable finance legislative proposals

### 1. European initiatives on sustainable finance

#### 1.1. This is a problem with enormous time pressure and scope

A speaker from the public sector stressed that sustainability is extremely serious, noting the strong commitment from young people on this issue. Climate change might soon become irreversible, so it is essential to tackle this issue seriously and without excessive pessimism. The speaker evoked the creation by the Banque de France of a network of Central Banks and supervisors with participation from over 30 countries. An official noted that the amount of additional investment needed to cope with the commitments made in the Paris Agreement is estimated to be between €200 billion and €300 billion. Finally, the window to do this in, is approximately 10 years. The world needs a substantial quantum of money, and it needs a consistency of action between public and private-sector funding.

An industry representative agreed with these remarks, noting that it is a testament to the timeliness and importance of the topic that Eurofi has scheduled three sessions on the subject. Another industry representative disagreed, suggesting that the scale of the problem is such that every panel should be on sustainable finance. A third industry representative suggested that the discussion on sustainable finance should permeate every discussion in the industry. Other panels discuss economic growth as if it exists in isolation, but life on earth is at stake. An official agreed that the problem of climate change is a problem of time. There is enough scientific evidence to suggest that the world is already constrained by time to the extent that it must act now to ensure climate change is not irreversible.

#### 1.2. The work of European regulatory and supervisory authorities

An official considered that the role of public authorities is precisely to strike the balance between understanding the seriousness of events and becoming excessively complacent by thinking that the 'cavalry of technology' will solve these problems.

Public authorities must raise awareness of these issues among the community of regulators and supervisors and outline the taxonomy of risks associated with climate change. Indeed, having the right taxonomy and the right description of these risks enables the market to understand whether these risks are properly priced, for example. If there is an excessive concentration of climate events in a particular region or a particular period, this will impact insurance companies and banks. The balance sheets of affected institutions will also have an effect on global financial stability due to the size of these events.

If there is a taxonomy as well as a good description of these risks and a way to improve the pricing of risk, the industry can begin to prevent them. The official felt that work cannot only be done on the prevention side. If the industry works in this direction at the global level and at the level of local regulators, the world might overcome the so-called tragedy of the horizon[1].

#### 1.3. Private initiatives: moving capital in the right direction

An official felt the marriage between climate and finance is not the most obvious one. One way to rationalise it is the existence of big climate risks, which in finance means big returns. An industry representative described how the green bond market developed. The market is up 17% on where it was at the same time last year, and there are clear benefits to having a clear taxonomy that enables product development. The industry speaker described how their institution has developed 11 different products on the basis of this taxonomy. As an example, this institution is able to cross-match the energy-performance certificate data of 27 million UK homes with their own back book. Through the use of defined standards, this institution is able to identify the part of the asset class which is less likely to default. More energy-efficient homes are less likely to default than comparatively less energy-efficient homes. This enables the institution to reflect this in the pricing for this product. Data and sources are an extremely pertinent issue in the debate over sustainable finance.

Another industry representative outlined how their own institution joined the UN Sustainable Stock Exchanges Initiative in 2012. When Sweden established the market for sustainable bonds in 2015, it was the first market of its kind on the planet, handling the environmental, social and governance aspects of sustainable finance. The industry representative welcomes the Commission's Action Plan on Sustainable Finance. However, the entire finance industry must do more and stay ahead of the regulators. This is easy for the Nordic countries, because they are very strong on ESG reporting and transparency. The industry representative described how their institution introduced ESG reporting in 2017, noting that the company is planning to do something 'extraordinary' within the next 4-6 weeks by launching its ESG Reporting Guide 2.0 as a global recommendation for listed companies. Their institution is pushing the envelope with respect to sustainability. First, it has introduced ESG indices on its benchmark indices in the Nordic countries. In Sweden, it has also introduced an ESG index future. Institutional investors in particular can use this derivative to handle their exposure to the Swedish market with an ESG-filtered index, which excludes non-ESG companies. This year the institution is going to launch support for impact investing portfolios in terms of clearing services for tailor-made baskets of stocks.

Another industry representative considered that the industry is 'learning by doing'. Some investors do not feel they are receiving sufficient information. A period where these things are voluntary is certainly helpful as the industry works together to solve these problems. Eventually these instruments and requirements will become mandatory, but a period of voluntary experimentation is essential.

## 2. The European Commission's proposals on taxonomy

### 2.1. The development and functioning of the taxonomy

An official outlined the work currently being undertaken by the European Commission. On the public side, the European Commission is engaging European money. The two big initiatives of the EU are the Multiannual Financial Framework and investEU. Europe has streamlined sustainable finance all over this framework. It constitutes about 25% of the expenditure, which is approximately €40 billion a year. investEU is a policy which uses small public investment to entice private investment, and also gives considerable prominence to sustainable investment. It is important that the public side should be there in terms of money and as a signal that the European authorities believe what they say, but the private sector must provide the bulk of the money.

The Commission is also attempting to ensure that this investment materialises by producing the Action Plan on Sustainable Finance and three regulations. Another official stressed in this respect the role of the taxonomy, which is essential to ensure investment flows to sustainable initiatives. This is about determining a clear classification of what a sustainable investment is. The Commission has identified six environmental goals, and an activity is described as sustainable if it substantially improves one of these goals without becoming a detriment to the other five. The taxonomy is a list of economic activities which are considered environmentally sustainable using the framework of Pareto optimality. However, the existence of certain activities on the taxonomy does not mean that those activities not included in it are necessarily 'brown'. Additionally, the taxonomy does not prescribe anything to financial market participants. Financial market participants would not cooperate, and the initiative would not attract private capital.

An industry representative suggested that exchange operators' function is to bridge companies and entrepreneurs needing finance and investors needing investment objects. Even in the Nordic countries, where there is excellent ESG reporting, there is an ongoing debate around information, because investors feel they do not have the information they need. The industry must understand how to build this bridge between investors and companies in terms of having proper, comparable and standardised information. Better information will enable capital to take the responsibility it needs to take in terms of focusing on investments that will be sustainable over the long-term. Capital should start to leave unsustainable uses over time.

An industry representative congratulated the work done as part of the EU Action Plan on Sustainable Finance in terms of the taxonomy, the bold requirement for ESG being an explicit fiduciary duty and for financial advisors to be compelled to ask investors about sustainability.

An industry representative stressed the importance of the international dimension to this problem. Most observers are commending the EU for being at the forefront of codifying this important space. Switzerland, for instance, follows this discussion very closely. And the Swiss authorities should not 'reinvent the wheel' by developing their own taxonomy. The exportability of EU standards to the global realm is very important.

There is a need for unification, but the rules should not be overly prescriptive, too static or stifle innovation. An official agreed with the need to extend the work on the taxonomy globally because of the importance of the global dimension to climate change.

An industry representative emphasised their institution's sustainable bond market. This market is based on the green bond initiative and the institution's own work with consultancies like « Sustainalytics ». The institution works with over 40 issuers; more than €7 billion of capital has been committed. The positive thing about this is that there is pent-up demand with big institutions in the Nordic countries. The institution is chasing issuers, municipalities and companies. The institution asks these players to come up with new ideas for green bonds, because there is so much earmarked money that wants to invest in them. Therefore, one of the challenges with the new taxonomy is to avoid destroying what has already been created.

### 2.2. Key building blocks to ensure there is appropriate disclosure and that risks are properly addressed globally

An industry representative expressed support for the FSB level Task Force for Climate-related Financial Disclosures (TCFD), which now has almost 600 national signatories. It is an attempt to provide some standardisation in disclosure to ensure that there is action-orientated, decision-useful and comparable data, which is what investors are asking for. Another industry representative agreed entirely with the efforts of the TCFD, noting that discussions around prudential treatment should be driven at a global level, at the level of the FSB or BCBS. On the topic of prudential treatment, senior risk-management professionals have made it clear that the industry should be very careful when incentivising one asset class, not to create the origin of the next bubble.

An official noted that the European Commission is pleased to observe that the Parliament has not placed a geographical restriction on the taxonomy. The underlying activities do not have a restricted geographical description, which is important for global investment. The Banque de France's Network for Greening the Financial System is an excellent initiative. Its focus is at the level of supervisors. The Commission has realised that the leadership of the European Union should not only be a leadership in the sense of acting first but also in terms of being able to export its initiatives elsewhere. In a recent EU-China summit there was a sentence of common agreement indicating that the EU and China would strengthen their cooperation on sustainable finance to channel private capital flows towards a more sustainable and climate-neutral economy. At the conference on 21 March, Ma Jun, the top expert on sustainable finance in China, called for an approximation between the two taxonomies. In the coming week there will be a responsible investment forum in Japan, where these issues will be discussed again. At the end of the month there is an EU-Japan summit in Brussels, where it is likely that something similar will be done. By being transparent and flexible and by using the demand side, Europe can export its taxonomy. Another official noted that the FSB is participating in the network of supervisors and Central Banks while also trying to issue a data set for pricing green bonds.

An industry representative highlighted two practical dimensions in this discussion. First, this work must be aligned to already existing economic-activity codifications. Second, this work must be implementable in IT systems. If the industry seeks to do this in a scalable way, it must be applied when processing investments at scale. In terms of the standards, the European taxonomy contains no geographic restriction for the underlying economic activity. This means that the taxonomy should take into account existing EU and non-European classification activity. There is a plethora of classifications; from a practical point of view, these activities must be integrated and aligned. A speaker queried whether a worldwide standard is practical, noting that labelling and standards might not give sufficient insight into whether an underlying product is green or not. An industry representative stressed the need to avoid the duplication of effort and multiple requirements which are very similar but not identical. An industry representative agreed, noting that climate change will not show any deference to regional boundaries. Citing the remarks made by the Chairman of the CFTC on an earlier panel, the industry representative felt it is important to regulate local markets at a local level with global standards.

### 2.3. Are data and disclosure enough?

The industry representative outlined how SolTech, a small Swedish company which builds solar power plants in China, issued a retail bond. This bond has secondary market trading with a market maker to retail it and it gives a return of approximately 8.75% per year. The bond was in high demand because retail investors felt this was a high return, with high risk, but they were also doing something positive by improving air quality in China. It is essential to develop practical products such as this, and then capital will flow in the right direction.

In terms of return, another industry representative described how there is often a misconception that investing for positive environmental outcomes has to receive lower yields. Unfortunately, that is something that many investors believe. However, if fossil fuels are removed from the FTSE or world indices over the last five years, this sub-market outperforms by 5.5%. Similarly, the FTSE Environmental Opportunities All-Share outperformed the FTSE Global All Cap by 14.3% over the same period. The industry has the data points which demonstrate that low-carbon investment is not only helping the planet but also driving yield. Work conducted by asset managers indicates that green indices can produce yields that are very comparable to other indices.

An official noted that disclosure has been accepted not only in the Council and the Parliament but also by professionals. There is data and evidence which suggests that bringing sustainability concerns to the attention of investors makes them very likely to take up these investments.

Asked whether this was enough, the first official stressed that there are solid interventions in certain areas of finance, such as products. Cars are a good example of this. Diesel cars will be prohibited in cities within the next five years. In other places, there are incentives to buy green cars or to install solar panels. If a consumer asks to finance a sustainable product, it is much more likely that they will be accepted for financing rather than for a car which will not be able to drive in any European capitals within three years.

Another official added that there would need to be further development of technology. The industry must determine how it will finance the transition and the research associated with this development of new technology.

## 3. The future of sustainable-finance policy

### 3.1. Incentivising 'green' or penalising 'brown'

An industry representative felt that the industry is changing quickly on the investor side, noting how superior returns could be achieved by excluding coal-produced electricity from markets. In Sweden, pension companies are trying to determine how they should allocate their capital to deliver pensions in 30 years time. These companies are seeking to move from exclusion-investing to impact-investing. This is where the next 'big wave' will be. An industry representative explained how their institution has been actively investing in the microfinance refinancing space and conducting impact investing for 15 years, agreeing that good returns could be made here.

Another industry representative emphasised that every investment has an impact, but it is for investors to choose whether their investments have a positive environmental impact or not. That might not be how the market speaks, but it demonstrates the necessary shift in mentality. The industry representative described how there is positive data on how global asset managers view ESG factors. Bloomberg and Morgan Stanley recently surveyed 300 respondents from US asset managers with over 50 millions of client assets. The most interesting statistic from this survey is that nine out of 10 are intending to devote more resources to sustainable investing over the next two years across in-house training, the redeployment of employees and making specialist hires. No matter how good the data is, without expertise and leadership it is only another set of numbers. If this is going to have the impact the world needs, the industry needs far more people who are climate-literate and who understand exactly how to interpret this data.

An official explained how in economics there is a well-known question regarding the trade-off between transparency and incentives. Europe must ask itself whether transparency is enough. At some point, perhaps the industry will view it as insufficient to have transparency and decide that it is necessary to introduce incentives. If incentives are necessary, there will need to be both positive and negative incentives. An industry representative agreed on the need for both 'sticks' and 'carrots'. The 'carrot' of the taxonomy is a positive place to start, but the world will also need some disincentives for the 'brown' part of the market.

Another industry representative emphasised that the issue facing the world is one of time. The market is moving in the right direction, but, as economists are pointing out, carbon is the greatest market failure in history, and the market is not moving fast enough. A third industry representative considered that there is an important balance to be struck in relation to the prudential treatment of sustainable investments. There must be a balance between subsidising green versus penalising brown. It is important to incentivise investment, but risk sensitivity must also be maintained.

An official stressed the importance of discussing the 'impatience' that had been mentioned, highlighting the legitimacy of this question. Certainly, Europe is creating a taxonomy and green indices, and people will invest in those indices. However, there are other things that need to be done at the global level. It is important to have a global accord, a direction, targets and financial instruments which fulfil certain criteria. Investors must be able to do some good by purchasing certain kinds of investments, however, some jurisdictions are doing things more directly. For example, some developing countries are subject to heavy levels of pollution, and these countries are directing credit towards removing pollution. They favour prudential rules which have a lower capital requirement for these specific loans. Various jurisdictions such as Brazil use the satellite mapping of rural areas to determine whether certain properties are respecting the minimum reserve requirements in terms of land not used for cultivation and then associating loan-granting to the properties meeting this criterion. An industry representative expressed caution in relation to the prudential argument. Whilst the taxonomy is an extremely positive first step, it cannot be viewed as a panacea. The taxonomy will provide the data that enables the industry to identify the asset classes where risk and return are not currently being appropriately viewed.

An official suggested that Europe is trying to act in a strong and consistent manner. Europe is seeking to exploit the demand side, which at present is very strong. If this is successful, this will be a fantastic achievement. If it is not successful, there will have to be mandatory instruments and requirements. Another official agreed, emphasising the need to be cautious. The political economic equilibrium of any country is a delicate combination of taxes, debt and productivity effort. The industry must ensure the transition is effective and avoids a negative reaction, which would undermine the whole drive towards a low-carbon economy.

### 3.2. The pricing of the systemic risk posed by carbon needs to be improved

An official noted that the carbon bubble previously mentioned is in fact a 'reverse bubble', because the pricing of the systemic risks posed by carbon needs to be improved. This is not necessarily taken into account completely by current instruments. Due to the difference between the social cost and the private cost, the BIS seeks to improve the disclosure concerning these assets, the transparency around the concentration of these risks, and the perception of long-term threats to financial stability that these risks can entail. Market instruments are beginning to price these incentives positively. The markets are realising that it is important to consider the reputation and quality of governance in some of these companies that care about climate-change risk and acknowledge the fact that many green technologies are improving.

### 3.3. Deprived countries will require help in the transition to sustainable finance

An official considered it important to address the costs of financing the transition, particularly for developing countries. Recent discussions have indicated that the world may experience an environment of low interest rates for an extended period of time. The balance sheets of public institutions could be used to finance this transition at a global or regional level. There are public-sector financial institutions that could fulfil this role of financing the transition, including in Africa and Asia. An official suggested that the world must help finance this transition in poorer countries which cannot finance it. All of these initiatives must happen at the same time.

1. "Breaking the tragedy of the horizon" speech by Mark Carney, Governor of the Bank of England.

# Addressing sustainability risks

## 1. What the sustainability risks are

### 1.1. The categories of risks and their differences from other risks

A regulator noted that the definition of 'sustainability risk' is complex and still undefined. It can be considered with regards to the long-term impact of current economic, business and social models. Due to the short-term focus of politicians, managers of companies, regulators and supervisors, the fact that the costs are long-term and to be carried by the next generations is overlooked.

Much is heard about the sustainability of public finances, but there is not as much about the sustainability of pension promises, climate change and the business changes there will be due to digitalisation.

There are physical risks, liability risks and transition risks. The physical risks are known and understood. For climate change and natural disasters, the impact on property and infrastructure can be perceived. This issue of liability risks is less visible, but that is changing as more companies and authorities are sued due to not acting. There will be responsibilities for the consequences of the longer-term risks. The transition risks are very important for the financial sector because of the possible impact on assets with respect to climate change, governance, social factors and the digital economy. The biggest risk is doing nothing and believing that the issues will solve themselves.

A Central Bank official added that the physical and transition risks manifest as risks everyone faces in business as usual. However, they are distinctive along three dimensions. First, they are far-reaching and affect every sector, customer and geography. They are correlated and they are non-linear. Together, that makes them potentially catastrophic. The second dimension is that they are eminently foreseeable. Though the specifics cannot be predicted, there will be some combination of physical and transition risks. The third aspect is that the size of the future risks is determined by the actions that everyone takes today.

A Central Bank official noted that when trying to measure the size of the risk the models are partial, do not capture the non-linearities, have poor data and lack feedback loops. That suggests that current estimates are probably under-estimates. Absent action, the impact on the global economy will be very large in terms of physical risk. The more sophisticated models suggest that towards the second half of this century average global incomes could be reduced by as much as a quarter. Particular geographies and sectors are going to be hit more significantly and could see the effects earlier.

There will be a transition at some point, because the costs of the physical risks are too high, and there will be winners and losers there. The numbers are very large. It is 1-4 trillion for just the energy sector. It is 20-40 trillion for the economy more broadly. Those losses are a large share of global financial assets. While the risks are large, people today can control the size of those risks by acting. The window for an orderly transition is finite and closing.

An industry representative explained that an environmental heat map looking across 84 different sectors and covering approximately $75 trillion of fixed income bonds and other debt outstanding demonstrates that 11 sectors already have elevated credit risk as related to Environmental, Social and Governance (ESG) factors. That is about $2 trillion of debt outstanding. The credit quality of coal mining, coal terminals and the ratings of those sectors have already deteriorated. Other industries in the report are ranked accordingly. Banks and asset managers rank low when it comes to environmental risk. However, given what those industries and the insurance industry have to go through, for them it is more about the changes in the focus, products and liability.

The Chair added that there are risks in terms of consumer choices. The youth of today do not want their own cars. They are, in a way, less well off than the previous generation and they link those things together and understand them much better. An industry representative confirmed that attempts have been made to identify, in terms of overall operating capacity, what the impact will be of the different demands either from consumer preference, ESG factors or consolidation and changing business models.

An industry representative added that there are technological changes occurring, irrespective of carbon considerations and the move to electrification. There are overall regulatory changes that are coming in at different times that will impact the overall transition.

### 1.2. The need for a taxonomy

An industry representative explained that it is important to have a very clear definition and taxonomy when it comes to discussing ESG. In addition to a clear taxonomy and the overall disclosure regime in the ESG space, there is a need to distinguish the different types of risk so that they are not misclassified as credit changes.

An industry representative emphasised that sustainability can mean different things to different companies, governments, individuals and entities. A taxonomy would be helpful, even though the prioritisation of the relative risks will differ depending on the industry. It has been estimated that $1 spent on resilience saves $5 on costs in relation to weather related events.

The Chair stated that the issue of transition is central to any type of transformation. There was a great deal of discussion about transition when the new resolution system was put in place in Europe. The Chair queried what the role of proportionality in a common taxonomy should be, particularly with respect to the disclosure requirements.

A Central Bank official replied that the point of a taxonomy is to help everyone understand what the risk looks like. It must not be a box ticking exercise, not least because where a company currently is, may not be indicative of where it is going to go. A common language is needed, but it is important to recognise that the measure is dynamic and not static.

Being proportionate involves recognising that there are different degrees of disclosure required, reflecting the exposure of the company, its size and its sophistication. Climate change will affect every company so, whatever the answer, it cannot be nothing. A regulator noted that a taxonomy will look at different economy activities and determine the important criteria to take into account in the transformation.

The Chair suggested that some operators may have fewer instruments for understanding and may have to rely more on a clear taxonomy, while other operators may have greater abilities to reflect. The action plan was in March 2018. There were the three regulations in May 2018. Two out of three have already received political endorsement. 10 months, in European terms, is particularly fast. On benchmarks, there is both the transition benchmark and the Paris aligned benchmark. That is quite a remarkable achievement.

## 2. How to mitigate sustainability risks

### 2.1. The transition to a low carbon economy

A Central Bank official noted that with the transition there will be un-burnable carbon, and there is infrastructure, agriculture and real estate for which the value will be affected by the measures taken to stop the physical risks materialising.

The Chair noted that the young will progressively be taking over, and they are more logical about the issues. A Central Bank official replied that everyone has to act. There are opportunities for the financial services sector to deliver products that those young, new investors want to buy. For financial institutions thinking about the upside, the opportunities to finance the transition are important too.

An industry representative suggested thinking about the risks that the joint approach to sustainability has already embedded and identified. The public and private sectors must come together and work with common interests. To effectively bring business in, the impact on business must be understood. On disaster risk, there is a concept of building back better. That should be reflected more, because it is a fundamental part of the response to risk.

The second matter is business models. There are three kinds in nature: those who fight to survive, those who aim to prevail and those who want to leave a legacy. With the financial sector's business model 10 years ago, it was clear that everybody wanted to prevail. Today, everybody wants to leave a legacy. The question is what makes business models sustainable.

For the third matter, to build on Commission action plans, there are two issues. The first is that this is part of a broader plan where a joint response is needed. The second matter is that the Commission builds on existing international frameworks. It builds on UN 2030 and the Paris agenda. There are 17 goals for UN 2030, but the first of those is people.

### 2.2. The threats and success factors to further enabling sustainability

An industry representative noted that another potential enabling factor concerns incentives and neutrality. Regulation should generally be neutral, but sustainability is one good reason for an exception.

Nonetheless, the regulation has to be correct. There is a significant risk of 'hype bias' whereby something is deemed good because it is green, resulting in relaxed due diligence. It should not be pretended that all of the responses are available today. The issue is a long-term one, but it is fundamental to also identify what is meant by 'long-term'.

Shortcuts are to be avoided. There is a question on how to bring sustainability with the Insurance Distribution Directive (IDD°. The audience will advise investors to buy green assets, but from the perspective of fiduciary duty there may be something else to ask.

There is an economic education bias, as economists think in cycles, which demand certain types of responses. However, this is a trend and trends demand structural responses. Approaching the issues as if they are cycles will mean the wrong actions being taken.

It would be premature to introduce reporting requirements regarding the valuation of any impacts because the baseline assumptions are already made with a significant amount of uncertainty. It is also not known what actions will be taken by governments, individuals and companies to mitigate weather-related events emanating from climate risks. The Solvency II framework already allows for sustainability risks to be captured, as long as all short-term and long-term risks are considered.

An industry representative added that there could be an artificially lower calibration of capital requirements to push the move from brown to green. Solvency II is about risk management. As part of the risk mitigation techniques these types of actions could be part of a framework like Solvency II. That would send an extremely powerful message in terms of getting things right and would be embraced by the global community.

### 2.3. The role of stewardship and risk management

An industry representative noted that their organisation has a sustainability team, which reports to the Group Chief Risk Officer who sits on the Executive Committee. That is sponsorship at the highest level of the group. Within that space it essentially goes through a process to identify the risks, assesses them and then takes action. For climate change that has resulted in commitments in four specific areas.

The first area is to develop insurance and risk management solutions to support transition. The second area is to work with customers to enhance their resilience. The third is a commitment to mitigating 5 million tonnes of $CO_2$ emissions through impact investing. The fourth is minimising the organisation's own impact.

Typically, one to three areas flow through the underwriting channel or the investment management channel. Once a position is taken and a risk is identified, assessed and the action determined it will typically flow through underwriting defining attractive products.

A regulator noted that there has been engagement with the insurance sector and also the asset management and pension sectors, both during and prior to formal consultation. The sectors are looking at the issues. There was a true act of leadership by the Commission in having a vision for the future and acting. This is already going on in a niche way in the risk management areas of the financial sector, and specifically on the insurance side. However, it now starts to be mainstream.

This consultation is the first part on the policy side. Advice will be delivered to the Commission shortly. Companies should integrate sustainability in their own risk management system. Not only ESG related products are needed, institutional investors have taking up a stewardship role. In addition, to know the impact, transition risks have to be managed. Excluding certain sectors entirely and too rapidly, will only create huge transition risks. Instead of creating a 'brown' list, a taxonomy should help the 'brown' sector becoming greener. With this stewardship element the transition can be managed and potential financial stability issues mitigated. The legislation will be fine-tuned to clarify that sustainability risks are considered within the overall framework of risk management. It does not prescribe that companies do certain types of investment or underwriting. Beyond customers having a preference for ESG products and providing them and an investment policy that is conducive to that, there is more of a stewardship role for insurers which again should hold for all institutional investors.

The Chair noted that one question indicated that the International Association of Insurance Supervisors (IAIS) has been a front runner in terms of highlighting good supervisory practice in managing climate risk in the insurance sector but queried what comes next and how to move from awareness to implementation.

A regulator confirmed that in addition to consideration in risk management, the impact of the relevant investment and underwriting policies on sustainability should also be considered. Many companies in the insurance industry initially indicated that they did not want to invest in the areas. That is fine, but it needs to just be the first step.

The real desire is for engagement from the institutional investors. There should be engagement both on the investment side and from insurers on the liability side, as well as engagement with customers to allow for a transition that avoids instability and stranded assets. It will come back to the portfolios of the financial sector.

That cannot be the way to move from the current carbon-based economy to a low carbon economy. A button cannot be pushed to bring into existence a new economy tomorrow. The companies of today need to be moving and adapting.

Institutional investors should respond by investing in the companies but confirming they are looking at what is being done in relation to the criteria. They should want companies to create long-term, sustainable value for them and their clients. The stewardship element is what will lead to a good outcome without creating problems with transition and instability.

A speaker asked how Europe should deal with the situation where an important government follows a different path. An industry representative replied that a very systematic approach is being followed with methodologies and heat maps. Depending on the country or region, the speed at which that will move, and the level of disclosure and overall policy, will affect how investors will think about the matter.

Transition will be an inevitability, whichever country an entity is in. Whether there is an upfront requirement to move in a certain direction, or if there is an impairment on the back end, there will be very obvious signs for whether entities are moving along in their industry.

An industry representative explained that when it comes to the ability of any institution or government to meet their obligations the question is whether they are able to generate the cash flow from the assets that they are in. That will also be the main decision for whether investors will actually put their money up in the first place. There may be incentives in certain countries to go much earlier than others, but as time moves on there will be, in the case of energy, different inputs that will come at different costs.

A Central Bank official added that it is important to remember that financial institutions, in their decisions about where to invest and where to lend, can substitute for government climate policy. The risks will materialise regardless of what governments do, and so it is in financial institutions' commercial interests to think about where those risks are.

An industry representative explained that stewardship is exactly the role that their organisation recognises and why it takes the position it does. It is committed to the FSB Task Force on Climate-related Financial Disclosures (TCFD) recommendations. However, there is no need to mandate disclosures because the industry is adopting them voluntarily.

A regulator wants to see companies voluntarily disclosing. Time will be needed to understand what the best practices are, but eventually there will be a need to standardise. Standardisation is what improves the quality of analyses by everybody in the market. To have the whole sector take up a stewardship role, the small and medium-sized companies are also needed, which requires standardisation.

### 3. The broader scope of sustainability issues

#### 3.1. The burden on future generations

A speaker queried how to deal with the required investment in emerging markets, where there is presumably more pollution. A week previously there had been a large conference in Brussels about scaling up sustainable finance. The buy-in from emerging markets had been significant. Europe is 7% of the world population, produces and possesses 22% of the world GDP and produces 11% of the emissions. Even if it was fantastic and had 0% emissions, there remains 90% to take care of. Leveraging Europe's political strength will, and determination is a necessity.

An industry representative noted that there is an opportunity dimension. In Japan, the insurance sector's reputation before Fukushima was even worse than that of banking. In response to Fukushima, insurance fulfilled its business model by delivering on its promises. Insurers used to be risk takers and now they are becoming risk managers. By acting on resilience and building back better, they will diminish the impact of the next type of event. The reputation of insurance in Japan is now great because the insurance sector responded at a time of need.

The costs resting on the next generation is exactly the type of inter-generational transfer underlying pensions. Pensions could be under the ESG agenda. Rather than thinking of how ESG and sustainability as affecting people, the question is how they can affect it. That will probably help to ensure it is dealt with correctly.

A speaker noted that much of the burden for funding the climate transition will come from households buying new cars, making homes more energy efficient and independent, etc. It is not possible to segment the debate on funding to sustainable finance and focus on household savings and access to funding more broadly.

A Central Bank official added that the issue is not about greening only a part of the financial system but the entirety of the financial system. That will only succeed if green finance becomes mainstream. It comes through to banks, for example, when they are thinking about mortgage underwriting criteria they have. The question will be whether they are prepared to lend for 25 years against houses that are built of flood plains and if it is sensible to do so with an annual insurance premium that may not be renewed.

#### 3.2. Other factors that could impact industries beyond the ESG factors

A regulator noted the importance of looking at natural catastrophes and the protection available there. It is now being discussed more seriously and it will definitely be in the public discussion. The evidence of climate changes can be seen. The economic losses of natural catastrophes are increasing tremendously, and the insurance part of these losses, in terms of percentages, is reduced. There is a protection gap which is increasing. For natural catastrophes the contracts are basically on a one-year time horizon basis, so it is possible to really be affected but then either the entity goes out of business or the pricing is adjusted.

It is a systemic risk for society and for the financial sector. The more there are natural catastrophes without protection the more the balance sheets of the banks will shoulder the cost.

This is an area where the insurance sector can have a bigger role by closing the circle in terms of giving the right incentives. If, for example, it is mandated that there should be coverage on natural catastrophes, there will be an incentive because the insurers should do risk-based pricing. Having a house in a flood plain will mean having to pay or not building on the location.

There are also good solutions with public/private partnerships around the world, but there is more that can and should be done to raise awareness, have better risk mapping and to use insurance as a good risk management tool.

An industry representative agreed about the protection gap. However, it is not something for emerging countries only. The Nepal earthquake cost 25% of GDP. Italy had recent earthquakes. That is increasing everywhere. Companies have publicly stated that they do not discuss this risk at the subsidiary level because it is part of the global policy. That should concern regulators.

An industry representative added that as claims experience, risk maps and floods develop that must be reflected in the pricing. However, it is difficult today to say what the pricing will look like in 30 or 50 years. There should be caution around expressing a protection gap that is currently uncertain.

❖

# Review of the Solvency II long-term package

### 1. Challenges to be addressed on the occasion of the upcoming review of Solvency II

Reviews were planned when the new framework for the prudential supervision of the insurance sector was finalised. EIOPA provided technical advice on the review of the Solvency II Delegated Regulation in October 2017 and in February 2018. EIOPA's review of the SCR standard formula is risk- and evidence-based and reflects the intensive engagement of all relevant stakeholders from the start and throughout the project. The amendments to the Regulation adopted by the Commission largely reflected EIOPA's technical advice. It is now up to the co-legislators do endorse the draft by the Commission. A more significant review is planned for 2020 covering different topics ranging from LTG measures to reporting and disclosure. There will be public consultations in the coming months on these different topics. By the end of this year, there will be a final public consultation on the draft Opinion, which will be published and submitted as final advice by June 2020 by EIOPA to the Commission.

### 1.1. Role for insurance regulation in increasing equity investment

With the recent revised calibration of the standard formula for debt/equity that the Commission has put forward, one can question whether the industry is ready to invest more in equity.

An industry representative suggested that with such topics there is no clear yes or no answer. Although their organisation is using an internal model, so from that perspective it has a slightly different scope, the restrictions around debt within the proposal are strong.

The revision is the first move to illustrate that the insurance industry has a role in investing in the economy. The review allows for a long-term perspective with customers. The change achieved on the shock will help. However, all of the restrictions will limit the impact of the shock. More is expected from the 2020 review, which will take the role of industry into account.

For a company, there are incentives to rely on debt, but that is not the best way to finance intangible investment, start-ups or SMEs. More incentives for equities should be created from the investor side. Focusing on fixed income is currently an issue.

A regulator emphasised the benefit Solvency II, leading to a better risk management in the industry, which is a great success. However, he is nervous to hear about 'incentives' and 'supervision' being brought together. There should only be incentives if they are risk-based, prudent and within the framework. The expected global standard (ICS) should rely on market-adjusted valuations. Consequently, provided regulation remains in these boundaries there can be talk regarding incentives.

An official shared the concern about the consistency with ICS as the global standard. There should first be envisaged a reduction of the existing disincentives for insurance companies, while the incentives should not come from the prudential model.

### 1.2. Valuable added value of the Solvency II framework but the pro cyclical effects of Solvency II have to be addressed

A speaker noted that a big increase in equity investment is not expected in the coming Quantitative Reporting Templates (QRT) at EIOPA and asked about the first period of application of Solvency II and what the impact of the package is on long-term guarantees (LTG).

An industry representative confirmed that the issues are not only on equity investment. It is recognised that the framework is based on a one-year shock, whereas insurers are investing long-term for customers. There is a need to find in the regulatory framework the right balance between the risks being taken and offering a good return to the customer, and the capital put in front of that.

There is a need to review the pro-cyclical effects of Solvency II. The Volatility Adjustment (VA) is a good measure and dynamic VA could be extended, even when not using a standard formula. An industry representative added that the volatility adjustment is where there are the opposite incentives. However, those incentives are based on an average industry portfolio, which is not applicable or adequate for a long-term investor. Changes in the 2020 review would make sense, because their organisation stops being a long-term investor and sees strong volatility in its solvency ratios, which will lead to pro-cyclical behaviour. More generally, what will happen in a shock should be looked at to avoid all insurers moving in the same direction.

A regulator noted that Solvency II has generally led to much better risk management in the industry. LTG is the main purpose of the review. The LTG measures have first enabled a smooth transition from Solvency I to Solvency II, especially for legacy books. Since the framework is market consistent, the need was to avoid pro-cyclical effects and to ensure that long-term guarantees remain available.

Equity investments have not declined due to Solvency II. The driver for equity investments is companies' risk-return expectations and not solvency capital charges. However, long-term investments and liabilities (or guarantees) are two sides of one coin that should be brought together in regulatory discussions.

On the macroprudential side, an industry representative suggested the system still has to be made less pro-cyclical and more crisis-proof. Global-Systemic Important Insurers was designated for 2013. A range of issues had to be implemented in consequence, especially recovery planning and liquidity risk management planning. What is right for a large insurer might not be right for smaller insurers, however it makes sense generally.

Resolution is slightly different, as it is up to the supervisors. For some banks in some markets, lawsuits are pending against some supervisors. That must be avoided in the insurance area. There is scepticism about capital add-ons. If they were needed, they should only be used as a last resort and would need to follow clear rules.

### 1.3. Beyond long-term guarantees, a long-term business model

An official noted on the long-term issues that there are successes with Solvency II, which gave companies and supervisors new tools for risk management. It is important to talk about a long-term business model and not only long-term guarantees. The prudential model needs to increase the soundness of companies and of the system, but it also needs regulators in the economy, in order to ensure that long-term guarantees are not an issue, and enable insurance companies to behave as long-term investors.

The long-term business model of insurance companies is not only to provide pension products or non-life responsible coverage. The general characteristics of the activities and liabilities are also important. Their general stability and the general characteristics of liquidity allow for projecting the future and investment in long term products.

The question is not only about long-term guarantees, but rather all of the characteristics of the activities in the business model. Certain assets have been penalised by introducing market value and the related short-term volatility, into the characteristics of the regulatory risk assessment model. Some corrections on fixed income have been introduced and there remain equities issues to deal with.

An industry expert stated that insurers should not be treated as short-term traders. There are implications on the accounting rules, as the risks borne by insurers are mostly not market risks. The consequences of excessive volatility on insurers' accounts are significant and out of proportion with their economic role. Solvency II is a risk-based system and has to be stable. Coming to the risk limits, a reinsurance system could stabilise notation or revaluation.

An industry representative noted that in 2016 it made sense to start with debt as a fundamental economic system. However, when looking at long-term investments, the diverse incentives were of concern. On one side, there is a strong incentive for progress with liability management, which is meaningful. It is subject to the liabilities held.

To address this there are some studies from OECD and figures from EIOPA, but there is an issue regarding the availability of data. Even the most optimistic, from EIOPA and beginning in 2011, shows relative stability of the location. When the values went up there was divestment of equities. This happened after a decade when, generally in Europe, the amount of equities in the balance sheet has already been reduced.

This situation is not satisfactory for regulators as it is not good for companies. It reduces the diversification of their balance sheets. Investment in equity should be linked to the characteristics of the equities, not the model or the capital put in.

For the economy, the regulator needs to tackle the impact. The balance sheet of insurance companies that invest in the capital market is a huge buffer. These companies are the best investors for the long-term, and far better than general policyholders. In the current regulatory context in many economies, there are more and more unit-linked products, so the risk is transferred from insurance undertakings to the general policyholder. It is doubtful that is beneficial for the economy, because it is pro-cyclical in most cases.

This is what was experienced at the end of 2018 when the markets went down, which froze the development of unit-linked. That happens every time the markets go down and is a problem for financing the economy. Currently the companies' level of debt has never been higher. What companies currently need is equity, and some local stabilising.

Changes were made on infrastructure investments, proposed by EIOPA and adopted by the European Commission. These are incentives in the right direction. Although there are many constraints for the new infrastructure asset class, the mere recognition of this asset class is a significant improvement in itself.

More recently, some equities are invested because the insurance company is able to keep them for the long-term. It is what is desired to be recognised in the regulatory model through the proposal on equity holdings for the standard formula. There will be assessment with the industries in Europe to see to what extent this is something that is useful and well calibrated.

## 2. Seeking a level playing field

An official stated that Solvency II is a major achievement in the harmonisation of rules, but the rules have to be applied in the same way throughout Europe. This is an issue of the level playing field and consumer protection.

The common implementation of the rules in Europe is a big issue for the next review. It can be dealt with globally by a Solvency II review, but the issue must be tackled in parallel. There is an issue with a level playing field between companies, but the question of consumer protection is even more urgent.

Some actors are using it to build schemes that are detrimental to insurees. There are also problems with any kind of insurance. It means one country could depend on the supervision in another. However, the markets are still national. There are a few schemes in which insurers go into one country to represent another country.

There are three things to do. First, the issue of supervision must be tackled. It is good to have the same rules, but they need to be implemented with the same quality. An insurance union needs to be tackled. That does not mean a single supervisor is needed, because there are still national markets, companies and products. But a standard is needed, where EIOPA can play a role.

There is also an issue of cooperation and information between supervisors when there is a specific risk in one country. It should be understood by the supervisor, which means reinforcing the role of the host country. Resolution is another big issue. Therefore, this issue has been put forward in the ESA's review to better foster coordination and guarantee an exchange of information, in particular in cross-border business. In the case of near failure, it is important to have some tools to prevent a real failure and all of the negative externalities. France created a kind of framework preventatively, but it is more meaningful if done across Europe.

The third issue is insurance guarantee schemes and having guarantee schemes everywhere to tackle failures. Even with the best supervision in the world, and resolution, there may still be failures. In the absence of a European scheme, it is important to have at least the same rules and have policyholders protected in the same way throughout Europe. The responsibility for that should be on the whole country.

A speaker queried how a level playing field could be assured in a single market without a single strong supervisor. A regulator suggested that things are going well with the recent framework and there is work at the EIOPA level to achieve convergence. The recent ESA review gives the right answer to the question.

## 3. Broader issues facing the insurance industry

### 3.1. Reinforcing insurance sector investment in sustainable and ESG assets and improving the predictability of carbon price

An industry expert explained that the needs for new investment and sustainable growth prospects are immense. Insurers should be the main investor in this field. There are many efforts to improve calibrations to account for a new class of risk, and the positive and negative externalities of certain investments. There is interesting work to define brown and green investments, but they are not always easy to distinguish. The taxonomy is improving. Even if that is done, brown sectors may be penalised without green sectors being incentivised.

One of the central points of all of the objectives for sustainable growth, whether they are in climate, water and other sectors, and the evaluation of risk, is the price of carbon. Many projects depend on a certain predictability of the carbon price from a long-term perspective but the price of carbon is a political question and not purely a technical question.

Insurers need to be in a position to invest after improvements in Solvency II procedures. One possibility for quick results, alongside all of the efforts to improve calibrations or take into account risks from green investments, is to set up a reinsurance system. Some countries have experienced such a system, in which there have been natural catastrophes. One way to think about this is by having a working group on this question in the Commission. This method of co-reinsurance to stabilise the evaluations of green risks should be thought about seriously. It will allow the risks to be taken into account in the efforts being made to establish a long-term carbon price.

A tax on carbon is one way to finance. France has experienced the political price of imposing taxes with the Yellow-vest movement. There is a dependence on both national and global political decisions. The price of carbon can change according to the price of petroleum in the world and the economic cycle.

A regulator stated that nature cannot be saved with Solvency II, but the sustainability point is valid. There is a risk-based and a market-valuation system, and that is the framework to improve. However, supervisors, the industry and regulators should maintain their rules to have market valuations and be risk-based.

A supervisor added that ESG is also about risks. A risk basis is not ruled out from the system. Sometimes political influence is there anyway, as has been seen with equity recalibrations.

An official agrees with the regulator that it is not the role of the prudential model to deal with sustainability. That does not mean that insurance does not have to deal with it. There is a desire to reform the NatCat public reinsurance in France, so that it contributes more to prevention behaviour and the preparedness of companies and insurees on climate change. Long-term commitments should be fostered.

An industry representative noted that their organisation strongly endorsed ESG in its investment approach and from the underwriting side, but because of the lack of data, there is a challenge to having a green or brown risk factor within Solvency II. It is too early for the discussion and the industry is already moving in that direction.

### 3.2. The impacts of IFRS 9 and IFRS 17

Regarding investments, an industry representative noted that for their organisation Solvency II is a metric in every decision about how to invest. It does its own risk assessments, as required by the regulation, and how the Solvency II ratio will evolve under stress is one of the major metrics when going to the board to say how its assets will be invested. Solvency II is discussed a lot and there is good discussion about the review. Yet, IFRS 9 and IFRS 17 are significant for the industry. Accounting is not looked at , at the right level.

As bancassurance, IFRS 9 is already used, but has an overlay. Finally, the impact of IFRS 9 is removed from the P&L of the group. There had been a shock at the end of 2018. P&L would have normally been hugely impacted by the volatility of the markets were it not for the overlay. Some companies are not in insurance but are common companies and had some volatility. The board took the immediate decision to derisk those companies because the P&L volatility was far too high. With the same volatility in the P&L due to IFRS 9, the board would likely say exactly the same things about the assets. Parts of IFRS 9 will be compensated under IFRS 17 with the VFA, but for a lot of the non-life insurer with huge volatility IFRS 9 needs to change.

All of the valuations of assets used to go in OCI. When there was profit or loss, it went in the P&L. That is not allowed under IFRS 9 and there is a push to bring it back for insurance, given insurance's nature of being a long-term investor. That will have a major impact on how insurers invest.

With IFRS 17, there are many technical discussions and the decision-making process is difficult and the work is with the ECB rather than the Commission. How to bring forward some of the key topics about the nature of insurance, such as reinsurance granularity, is not well understood. There are some simulations about the impact of IFRS 17 and significant volatility is seen from the new accounting standard.

There is not enough attention given to those two metrics, which are having a major impact on the industry, which is why the EU institutions will be encouraged to be more involved in the IFRS 9 and IFRS 17 implementations, otherwise there will be a major change in the industry over the next few years.

An industry representative added that the ultimate goal is to introduce IFRS 9 and 17 at the same time. One idea is to introduce a discount for share prices for the insurance industry.

An official shared the industry representative's assessment of IFRS 9 and 17. If what is done on the accountability side of Solvency II is destroyed by inappropriate accounting standards, nothing will have been achieved.

# DIGITALISATION AND FINTECH

## Fostering digital distribution and fintech innovation

### 1. The current situation

#### 1.1. Game-changing technologies and players

An industry representative explained that at a recent financial services conference in Dublin 70% had agreed that they are living in a digital revolution in financial services. Five years previously, very few people would have agreed. The digital revolution in financial services is happening and it is real.

In answer to which technologies are game-changing, it is a combination of all of them. It is not possible to select a top winner today. Blockchain, or digital ledger technology, is another technology development critical for the financial services industry. It is an alternative way to reduce intermediaries in the value chain. There is a big opportunity with this in the bond market, and blockchain has been implemented in digital payments and tokens, as well as areas like tax services on cross-border investments. In the European asset management industry, a working group has been created on blockchain and tax, to see how taxation on cross-border investments can be simplified. There are many areas of opportunity with blockchain.

Robotics and automation are technology tools that are more mature in the private than in the public sector, but they are fundamental tools where as much as possible is being automated, and robotics incorporated into operational functions. This is what is happening; it is real and growing.

APIs are changing the manner of client communication. At the representative's organisation there are more than 300 APIs, and it is not a retail banking institution. APIs are an area of real growth. Five years ago, their organisation would have had less than 100 APIs. There is exponential growth. It will keep growing and the client experience will keep improving.

Cloud-services are another fundamental area of efficiencies in client experience, although from a security perspective, the right tools and controls need to be in place.

Data is the new oil; it is a critical foundation of everything done in financial services. There are plenty of different ways of articulating data, including big data, structured data and alternative data. At the end of the day, good data will help the use of technology tools to provide clients with services. Most private sector organisations now have a chief data officer. Data is talked about as a service and as a business, which is also new. Data is the foundation of digital transformation and translating data into information is the key thing.

A final area is artificial intelligence and machine learning. Machine learning in particular, in combination with humans, is very powerful. Some in academia are talking about artificial intelligence in the financial services as the 4.0 revolution. Whether this will be the case is unclear, but artificial intelligence in financial services will clearly change strategy and business models. Machine learning is happening today, in portfolio management and the Exchange Traded Fund (ETF) business. At the representative's organisation, they are exploring machine learning for surveillance and risk management. It is also attractive in horizon scanning and the analysis of regulation. There is much opportunity.

These are fundamental developments, but one cannot be placed above the others. All of them in combination are making the digital revolution very important. It is not possible to close one's eyes and say that the digital transformation is not impacting one's organisation.

An industry representative agreed that there is a revolution underway, and it is not clear what the final consequences will be. It is the consequences that are important, rather than the technologies or conjunctions of technologies. Many technologies are essential and changing the way that finance is done. The conjunction of technologies is changing the way in which customers interact with the banks, and in which competitors interact.

The market is changing radically in terms of efficiency, convenience and growth, which is affecting the industry as a whole. There are two current trends in terms of competitive landscape players. The first is the change in behaviour of fintechs. In the beginning, fintechs had taken an approach as niche players, in a position of specialised products with a limited range. They are now changing their mind, perhaps because they are not as profitable as they had hoped to be; they now want to be broader players with a full range of products. The other trend is to do with the big tech companies, entering the financial market with the use of their most valuable asset: data. The use of this asset is from a position that nobody else can reach in the short-term. These two trends will have a significant impact on the financial industry.

To begin with, the proposal of fintechs had been to unbundle financial services; to go to a specific segment, most likely peripheral in the financial industry, and be a specialised player. Fintechs are now moving from personal finance management and payments to lending and asset management, and some are expressing a desire to re-bundle financial services and provide global financial services. Some are even asking for fully-fledged bank licenses.

This is a significant move. One successful German bank does not provide only basic accounts anymore but provides a full range of financial products. Revolut is moving in different directions from its beginnings, providing pre-paid credit cards. Mobile-only banks like Monzo or Starling are partnering with other fintechs, to provide personal finance "chatbots" with Bloom, personal finance apps with Money Dashboard, a mortgage broker with Habito, pension management with PensionBee, and so on.

The aim should be to provide customers with an experience comparable to or better than these providers. Partnerships had been entered and acquisitions made to improve the quality of experience for customers and to be a competitive player against these fintech companies that now want to become global.

The approach of Bigtech companies is based on the use of data, with bigtech companies creating their own digital ecosystems with unique access to whole customer data. This fuels two-sided marketplaces, with significant impact on competition, and accelerates the Uber-isation of financial services.

### 1.2. The (necessary new) regulatory approach

An industry representative noted a need to rethink competition policies and laws, and to be firm in the right use of the customer's data, allowing customers to be owners of their data and to get the benefits of the use of that data. There also needs to be a level playing field in the use of data, which is not currently the case. With PSD2, banks have to share the data of payments with third providers, immediately, with technical standards that are available instantaneously. This is not the case the other way around; banks cannot access data from utilities or bigtech companies which they could use in the interests of customers. Insistence is needed that data is the property of customers and has to be used in their own interests, to provide better financial services and products.

A regulator felt there is not one single game-changing technology. All of them are having an effect. Supervisors want to embrace new technologies and innovations but looking at new things tends to also making them see risks. That is their core business: to identify the risks in the operations and to see that they are managed and tackled. On innovation, this is good for consumers, good for society, with on the one hand technology and innovations and on the other the most important core values that supervisors are there to protect, such as financial stability, consumer protection and operational risk management. There is usually a race with new services and technologies, as to who gets to the market first and gets the consequent Public Relation benefit. Supervisors want to ensure that product development lifecycles are not shortened at the cost of operational or cyber-risk management. They want to see them going forward, but in a balanced way.

An official said that there are a number of game changers and there are completely new competitors, in terms of big companies entering the field. There are very new technologies and new capabilities to deal with data. Data has always played a role in financial services, but how there are new technologies to deal with them, and the next Commission needs a broader agenda. This is always about how things are advertised, and fintech is probably the right word for the current mandate.

Indeed, for the mandate for the new Commission, an ambitious, broader agenda is needed on digitalisation, expected to create a single, digital financial market. This is key, because there are a number of challenges that can only be dealt with on a European-level. One is the arrival of bigtech companies, from the United States and from China, into financial markets. Amazon are doing loan finances and other areas. There are issues around a level playing field, and an issue around equal access to data, as well as access to technology; such as who is allowed access to Apple's NFC technology[1]. Conversations need to be engaged in with competition authorities in Europe about what they can do in this field. The sense is that some things can be done in terms of looking at mergers or acquisitions by big tech companies. This needs to be considered in terms of competition law, but that is not enough. In other areas, especially those ensuring equal access, the faster approach may be specific financial services regulation, including in how data is dealt with. This should be a big objective in the next Commission's agenda.

There are other topics as well. European rules are needed to clarify for financial services companies on a European level. There is a need to think more broadly and deeply around the issue of artificial intelligence, as this will fundamentally change how any company will work. It will have a massive impact on how supervisors work, legislators think, and what rules and methods of control there should be for algorithms. What burden can be placed on companies working with AI? This is broader than financial services and needs to be part of a broader digital single market agenda for the Commission, but there are many specific applications and issues for financial services. AI is one. Treatment of data and data privacy is particularly relevant for financial services companies. At the core of the next Commission should be a plan for a digitalisation agenda for financial services, going far beyond fintech and specific new companies.

An industry representative observed that great things are being done in Europe. There is a great deal of focus from the Commission on the fintech action plan, but acknowledgement is needed that Europe is running a bit behind; the Americas the US and Canada are strong on fintech and financial services digital transformation. APAC[2] is moving much faster than Europe. Europe is taking steps to move forward and embrace the digital transformation and innovation, although this is already a reality. To catch up, Europe needs to keep doing what it is doing, and move both quickly and furiously. It is critical that both private and public sectors continue working together. All of the initiatives mentioned are great, but there is a need to continue pushing.

An industry representative agreed that Europe is lagging behind. All of the mentioned initiatives point in the right direction and are welcome but are not going to fill the gap. It should be questioned why relevant innovations have always come from outside the boundaries of the regulated industry, and the significant innovations have come from outside the boundaries of Europe. This should be changed, for Europe not to lag behind and be resigned to copy what is done elsewhere.

A change of mind is necessary in terms of supervision from an entity-based risk approach to an activity-based approach. On sandboxes, there has been hesitation in saying that there should be a sandbox for a new type of company or business model. It is not clear that it is the right way forward. It is difficult to explain to a consumer why they do not need to be protected against a risk simply because it is coming from another company or a new business model. There is a need to be more open to innovation, though, when talking about new technologies. There are areas where consideration is needed about specific cases of lowering regulatory burdens or thresholds for an initial period of experimentation with new technologies.

Indeed, in terms of regulatory sandboxes, bolder activity is needed. It does not matter with AML if new online onboarding is approved, since nothing happens if it is applied to only 5,000 transfers. This should be relaxed to see if it does or does not work. Applying AML rules to one single customer is not the way to advance. It can be recognised that fintechs always come from outside and they harness new technologies. They are not charged with regulatory capital if they invest in software and they are not required to apply the CRD IV remuneration policies, and so they have an advantage. It is logical that they innovate more. A bolder position is needed.

## 2. The EU fintech action plan

A policy-maker noted that the comments made about data are well-rehearsed in the EU fintech action plan. The

European Commission is thinking along the same lines regarding the positive aspects of blockchain.

It is a year since the EU fintech action plan was adopted. Hopefully it is introducing the capacity-building element of the regulatory sandbox. The fintech labs where the regulators are looking at things like the cloud, artificial intelligence, and robo-advice can be brought together to ensure better take-up of the technologies in Europe. Standardisation is also moving forward. There are a lot of possibilities around management of data coming from sensors and going to analytics, as well as artificial intelligence or machine learning, which a smart contract can control in the interests of the consumer and the citizen and keep it from being siloed. There are a lot of possibilities, and the European Commission is working with the industry in areas related to data.

Another thing emerging from the action plan is the European blockchain partnership, which has 30 countries: all 28 EU member states, as well as Liechtenstein and Norway. This year a European blockchain services infrastructure will be implemented, including regulatory tech, regulatory reporting, value added tax and customs excise. The declaration includes very specifically a public/private partnership option. With the financial sector, there are already proposals to do Know Your Customer and Anti-Money Laundering, as a possibility to reduce compliance burdens and have data move between those serving the customer and the regulatory authorities, in the interests of efficiency for the customer.

To ensure that European values and the interest of Europe's traditional industry as well as start-ups are considered, this week there has been the foundation of an international association of trusted blockchain applications, founded and legally present in Brussels, but in association globally. This would have a financial working group, with the idea to have users and developers of blockchain together to develop these data spaces which could again be run by smart contracts, which may require legal clarity in the future. All of the banks, insurance companies and others are welcome to join and participate in discussions with regulators at the IMF.

There would be a conference at yearend in Malaga to address some of these issues. It is up to companies to ask for the subjects they want on the table. The OECD will be there, along with the European Bank for Reconstruction and Development and the World Bank, to look at data challenges and how to give citizens more control. Blockchain is not a panacea, without the legal frameworks and control by citizens; this is an opportunity for Europe to play a leading role.

Those are a few things on the table resulting from the fintech action plan. DG CNECT is working closely with DG FISMA on crowdfunding regulation and other initiatives. There is more around innovation hubs and regulatory sandboxes as well.

On the digitalisation of all European industry, traditional and new, the spirit that the action plan shares with the digital single market, is one of policy innovation and technology moving together, leveraging EU values to design human-centric services, and addressing social needs but improving economic competitiveness. Some of these technologies, managed correctly, can give more control to the individual, and help with a decentralised model fitting the spirit of Europe, rather than siloes of data concentrated in one place and under the control of one entrepreneur.

## 3. Evolving regulatory and supervisory approaches

### 3.1. Sandboxes

A policy-maker noted that the European Commission put together the sandbox approach and innovation hubs but cannot as part of their mandate prescribe what member states should do. There is agreement with those countries using sandboxes in the EU that consumer protection should not be lowered at all. Its uses are apparent for new technologies such as blockchain; in the original sandbox for the Financial Conduct Authority at one point it had been 50% of the proposed collaborations in the experimentation.

The Commission is obviously not a supervisor, but brings the national supervisors together, which is a positive in some of the sandbox implementations in that it raises the knowledge of the supervisors – less so with the bigger and better-equipped ones, but with smaller ones – on what is in the market and what might be introduced. With the fintech lab, this is the part with the most modern and newest market innovations under discussion.

A new network has been set up to share best practice. Consumer protection should not be lowered at all. It is a question of utilising the proportionality. Currently in progress is a research and innovation project bringing together universities, regulators, supervisors and fintechs on coordinated training support on risk management and new technologies, focusing on compliance-side, regulatory and supervisory tech. This can be utilised without compromising any consumer protection, working in a regulatory, innovative way.

There is a greater need to look across boundaries. There are issues of data regulation, cyber-security regulation across multiple sectors, and with multiple supervisors who might be implicated in introducing a new technology. This is something where more effort can be made in the next Commission, to bring the European Data Protection Board and member states responsible together with sectoral regulators and stakeholders, as well as the European blockchain services infrastructure, in implementing regtech applications.

A regulatory sandbox is also being undertaken together in a way that is not weakening the rules; this is completely new. It is just a new way of doing something, in which errors may be made along the way. Hopefully this will not happen, and it has not happened yet, but in this way, they can be identified as quickly as possible with software developers working with policymakers and supervisors responsible for, for example, ensuring that data does not leak and that there are no breaches.

A regulator noted that all European supervisors have an innovation hub, which is essentially a dedicated contact point for firms to raise questions related to innovation and technology. There are five sandboxes in Europe, and these are environments in which new types of services can be tested in a controlled way. Sandboxes are based on application, and only for a select number of participants.

From experience, much has been learned. Through the innovation hub, there are signals of what types of services are being planned; supervisors are learning a great deal. They are challenged to think about how the law is applied to new services, and the questions received are not at all simple, as these services are new and innovative. It is a learning experience for everyone.

What is faced often is misunderstandings related to sandboxes; some still think that sandboxes are environments where almost everything can be done and there is no need for compliance with the rules. This is not the case. In a sandbox programme, one is subject to all of the rules, but with hands-on guidance from the supervisory side to explain how to comply with the rules. Another misunderstanding is that there are no consequences for violating the rules. This is another myth.

Supervisors need to engage more with the fintech community. Even with dedicated points for contact, the feedback is still that there is a certain threshold to approach the supervisor. Supervisors still seem remote and even scary and need to go out and speak at events and signal to fintech companies to come and speak with them. Start-up entities have good skills in technology and user experience, but lack knowledge on regulation. If they miss something important, it may even be that the service they are building is not compliant with regulation and cannot go to market. This is why they need to be encouraged to speak to supervisors as early as possible. Experiences also need to be exchanged between supervisors.

A question from the audience was related to whether there is scope for developing fintech bridges across Europe, connecting existing sandboxes to allow fintechs access to a wider market. Hopefully sandboxes would not end up as a jungle of sandboxes, where nobody understands what is going on. They questioned how a broader legislative or regulatory approval would be handled and whether it is necessary to handle it inside the financial regulations in parallel with something else, or whether the specific financial regulation has to be given up in some sense.

An official felt that it depends on the specific area. Sandbox bridges are not needed; a sandbox can be done in one country. The underlying issue is how quickly fintechs can scale up in the single market. However, critical areas of regulation need to be identified, mostly financial services regulation, that prevents this. One is AML KYC. In theory there is single European legislation on this, but it is implemented through 27 separate national rules. The national administration needs harmonisation, as it is an important issue for a fintech that wants to grow quickly.

There are other areas where discussion is needed, specifically about financial services legislation or regulation, such as APIs and the access to financial services data. Whereas with areas like data privacy or AI, it will need to happen in a broader discussion of how it is handled in the digital single market. Both approaches are needed.

### 3.2. AML KYC

A policy-maker noted that on AML KYC, the Commission is building a regtech European blockchain service infrastructure cross-border with all member states. It will have a public/private partnership and some of the first suggestions are coming from the financial sector around connecting the processes of banks and other players with the supervisors. All member states will be online as nodes. This can be explored together, with an industrial policy element. It is an opportunity to lower compliance costs and come up with new models of regtech that can be exported.

### 3.3. Digital education

An industry representative noted that there is an opportunity in Europe for education on the digital space. This is something for the incoming Commission to think about; is Europe strong enough in educating new generations on technology chains? This is a long investment, but a worthwhile one. Starting early would mean that talent will grow internally in the European market.

A policy-maker noted that looking at this approach in the next Multi-Annual Financial Framework, the digital Europe programme is coming, which will include skills and AI. The financial sector is already involved, but for those interested there is a possibility.

An industry representative observed that there is not a 'magic bullet' to tackle this. It would not be a bad idea to think about recommendations from the Commission to member states about education in the digital space. Non-European countries are teaching children how to programme from the very early stages, particularly in APAC. To be leaders in digitalisation and to implement the right technologies in financial services, the right talent is needed in the region.

A regulator noted that it is everybody's responsibility to educate consumers on digital skills, and their rights as data subjects. Payment data on their accounts say a great deal about consumers, so they need to be educated to read carefully through the main points of what they are consenting to.

1. Near Field Communication (NFC) enables devices within a few centimetres of each other to exchange information wirelessly.
2. APAC is the region that includes the following nations in Asia: Bangladesh, Bhutan, British Indian Ocean Territory, Brunei, Cambodia, China, East Timor, India, Indonesia, Japan, Laos, Malaysia, Maldives, Mongolia, Myanmar, Nepal, North Korea.

❖

# DLT and digital tokens: opportunities and challenges

## 1. Current development of DLT solutions and lessons learned

### 1.1. Current development of distributed ledger technology (DLT) applications in the market

An official explained that DLT is a way of recording and sharing data (e.g. a record of transactions or a set of account balances) across multiple data stores (also known as distributed ledgers), which each have the exact same data records and are collectively maintained and controlled by a distributed network of computer servers, which are called nodes. One of the key elements of the DLT proposition is that there is no need to rely on a trusted intermediary[1] for the performance of these activities, necessitating trust in the technology and underlying algorithms (see Appendix for further detail on the concepts related to DLT). DLT may strongly impact financial services activities, but it is still unsure whether this will eventually happen on a wide scale. While some have propagated the idea that distributed ledgers will be a core feature of the financial sector going forward, others are sceptical about the potential of DLT. There has been an abatement of the hype surrounding DLT and blockchain over the last few months, which may be due to more detailed reflection upon their applications.

A Central Bank official outlined that the "Gartner Hype Cycle" applies to DLT: after the development of the initial idea, there was a hype phase. This may now be subsiding to the following phase of disillusionment which normally precedes a more stable state of realism. The speaker however remains very positive regarding this type of innovation. More needs to be done to understand how to realize its full potential and Central Banks in particular are building blockchains to do this. It can bring about greater efficiency, improve the functionality of the markets and improve financial stability, as it can help to solve liquidity problems. With Brexit, Europe faces more fragmentation across various financial marketplaces. Blockchain could also help to bring the liquidity of the different European financial marketplaces together.

An industry representative stated that their company, a financial market infrastructure, has launched a bilateral payment netting service using DLT[2]. Several major market participants are utilizing the service, and participation is growing. The service's functionality has been based on DLT rather than conventional technology to allow the company to be in the DLT space and to better understand DLT's potential. Although there is less talk about DLT today, the potential of the technology is very powerful and should be supported. This service is, however, a targeted application and the company chose what it thinks is an appropriate service to apply DLT. The company has not put its core service on DLT, as to do so would be a risk and potentially 'a bridge too far'. The technology needs to mature and develop in sensible increments.

Another industry representative confirmed that their company – a major post-trading service provider - has not put its core settlement services on DLT either. The initial predictions, that the whole post-trade industry would be replaced by DLT in a couple of years, did not materialize and major players in the post-trading industry have actually reached an all-time high in revenues in 2018. This does not mean that DLT is not a promising innovation, but it is not ready to replace existing technologies or fundamentally reshape the functioning of clearing and settlement infrastructures. The industry representative agreed that in the maturity steps of every innovation there is a phase of euphoria. This phase has probably passed, and a more realistic approach has now been adopted. This is good, because this realistic approach enables the barriers and obstacles to be identified and tackled to make progress. These developments have been positive for the speaker's firm as they have helped it to gain knowledge of what it can and should do to progress.

A regulator observed that there is generally a consensus that it is too early to fully leverage the potential benefits of DLT. As DLT solutions are gradually implemented, they offer new opportunities but also raise challenges which must be addressed. The speaker agreed with previous remarks that an implementation of DLT in financial markets has the potential to increase efficiency, enhance the post-trade process and reduce the cost of financial services for providers and users.

### 1.2. Lessons learned and conditions of the further development of DLT in the financial sector

An industry representative observed that DLT has done itself an enormous disservice by trying to sell itself on the possibilities of the ultimate end state. DLT is a powerful technology for: storing data and transaction records in a way that is common and shared; implementing smart contracts; and streamlining processes. The representative's firm has learned a number of lessons with the application of DLT. First, implementing new technology is operationally very difficult. The number of PoCs (proofs of concept) happening in the market is not a valid indication of the operational challenges. The real test of the success of a technology is how many people are taking it to enterprise level and building it in a way that the market will trust and use. Second, DLT application should focus on operational functionalities. Business lines want functionality and not necessarily a DLT-based product. Third, integration of DLT applications into existing environments must happen safely because DLT applications cannot exist in isolation. Fourth, technology, particularly DLT, requires a network. Networks need simultaneous store of data and a sufficient number of nodes, without which the value of DLT is questionable. The most important aspect, however, is that there must be an operator of the system, as is the case with permissioned systems (see Appendix for a definition). The idea of a non-permissioned ledger and trusting the technology, and not a central person, was initially put forward with bitcoin. A ledger does not need to be centralised, but it is important to know who to turn to in case of problem or to improve the system (particularly if DLT is going to be used at a certain scale in financial services). Knowing who to turn to is particularly important in relation to cross-border activities.

Another industry representative observed that there are many conditions regarding the further development of DLT in the post-trade sector in particular. First, it should add value to the existing service that is offered in terms of efficiency, speed and costs. It should also ensure at least the same level of safety, security and integrity as the present system, since the post-trade industry and the market as a whole will not make any kind of trade-off on these aspects. Without this guarantee, the post-trade market will not move towards DLT.

The representative further observed that it should be proved that there are possibilities for this technology to scale up and absorb all or part of the existing volume on the market because at present DLT developments are limited to quite small compartments of the market. Another condition is providing sufficient transparency for supervisory purposes. There are also some legal issues to solve, and work is ongoing to identify any need for the adaptation of existing regulations. In the settlement area, there are two main regulatory components: the Settlement Finality Directive and the Central Securities Depositories Regulation (CSDR). If a DLT system is providing services governed by CSDR, it should take the setup of a proper CSD. This could be an obstacle in terms of requirements, but that is the price for entering the game.

The paradox with the possible use of DLT in securities post-trading, the speaker believed, is that, while DLT systems are normally well adapted to these processes because registers are being monitored for a closed or limited number of participants, the activities of the industry are so critical to the market and the level of safety needed is so high that it is not an area where trial and error is acceptable, making it difficult to implement DLT systems in the first place.

A Central Bank official stated that while Central Banks are very interested in how the future role of banks will develop with this technology, they are also concerned by the stability and control issues that their use involves in an industry as regulated as finance. Blockchain is indeed one of the few technologies which could disrupt Central Banks with some of its applications. Supervisors are also concerned about potential risks related to the use of DLT and would not accept the kind of "anarchy" that was initially intended with bitcoin. For it to work, particularly given its cross-border characteristics, there is the need for someone to be responsible in the system. Applying DLT to finance is different from other areas, because the sector carries greater risk. There must be people to monitor these risks and ensure a certain reliability of the technology, checking whether there are flaws or cheats.

Another official observed that the limited scale of DLT applications so far also raises the question of whether this is due to insufficient standardisation and interoperability concerning DLT solutions and whether other elements may be missing such as the possibility to integrate assets and the cash side on ledgers.

A Central Bank official considered that it is too early to say whether there will be standardisation and a widescale development of these technologies. Their potential and end benefits are still being probed. There may be different kinds of DLT in the end, in which case interoperability will be needed and the industry is already starting to think about the interoperability of the different technology sets.

### 1.3. Prospects of digital tokens to support DLT systems

An official suggested that distributed ledgers can particularly benefit from the concept of digital tokens. Digital tokens being representations of assets – potentially of cash – offer the possibility to integrate the asset and cash sides in the distributed ledger environment. That may lead to more widespread usage of DLT, because at present there are aspects of the provision of cash settlement which may not yet be suitably served from a market perspective.

An industry representative observed that problems with transferring value are a recurring criticism of DLT. If there is a significant amount of activity on a ledger, it would be good to have a store of value on it. However, that does not have to be achieved on day one for the technology to show its use.

Another official noted that the BIS does not view cryptocurrencies positively, and this includes digital tokens to a certain extent. This having been said, all settlements involve a cash and an asset leg and in the future it could be necessary for digital tokens to be involved in one or both of the legs. It is hard to put a suitable solution in place, one of the reasons being that it would be preferable if the cash leg could continue to be in Central Bank money. Surveys of how Central Banks are handling digital currencies and tokens show that while 70% of them are experimenting with DLT and digital tokens, very few are considering actually issuing such assets in the short to medium-term. The challenge for the industry will be that if only one side of the settlement transaction is working on DLT (the asset leg) this will cause uncertainty as to how the two sides can be made to inter-connect. There is also uncertainty as to whether the settlement system can work without Central Bank money issued on a ledger.

A Central Bank official considered that digital means of payment will need to be available on DLT systems in any case if they are to develop more widely. For example if distributed ledgers are used to support sales processes, there must be a technical possibility to send the money back. Therefore, as the DLT develops in other fields it will automatically bring about payments on the internet, which makes it necessary to be attentive to the currency issues and ensure that they are solved in parallel.

Another Central Bank official observed that there are many on-going assessments and PoCs in Asia concerning the use of DLT and blockchain technology, which should lead to reviewing the whole architecture of incumbent systems including the cash side and assessing ways to improve their efficiency, which would be a starting point in the region.

## 2. Risks posed by DLT and current policy approach at the EU level

### 2.1. Main risks and challenges posed by DLT remaining to be tackled

A regulator observed that possible issues and threats related to DLT technology include cyber-attacks, potential performance challenges of the technology and the higher degree of interconnectedness that DLT could lead to, potentially raising market volatility risks. Concerns have also been raised over some grey areas not regulated under current legislation and which may prove difficult to regulate due to various features of DLT platforms. There are local standards or standards specific to certain platforms, but these are not mature yet.

A first question is that of which jurisdiction rules should refer to, since DLT platforms are a decentralised structure made up of multiple nodes potentially located in different jurisdictions. Since there is no central entity in this network, it is unclear which legal framework is applicable to it. There is also the question of the legal framework applying to transactions and services managed on the platform. With regard to the attribution of risk and liability in relation to faulty DLT services, this must take into account all parties involved. Another issue is the handling of data privacy, as DLT may increase the level of transparency beyond what is suitable. Property of the information in the database can also be a problem as well as consent of people whose data is on the ledgers.

Questions are also raised about the standards applying to smart contracts used on DLT platforms. These are contracts which are automatically executed when certain pre-specified criteria embedded into the contract are met. Using DLT eliminates the need for intermediary parties to confirm the transaction, leading to self-executing contractual clauses. It is also important to have greater user responsibility, since many existing DLT systems have no central authority to go to in the event e.g. of individuals losing private keys or incurring losses as a result of revealing a private key. Also, there are no features to restore forgotten passwords and usernames, as exist for other products and services.

An official emphasized that the cash settlement side on the DLT is another area of concern. Cash has so far had a consistent legal environment, generally considered as a claim against an account provider, unlike securities, which have differing legal qualifications across jurisdictions. With tokenisation this may change and there may be a phase where the legal context of cash, broadly speaking, will be more fragmented than at present.

### 2.2. Existing policy approach at the EU level regarding fintech and DLT

An official observed that there are many ongoing attempts to enhance the regulatory environment pertaining to DLT and crypto-assets, and some EU member states have either already taken action to adopt laws or have projects to modernise their laws in those fields with the aim of enhancing legal clarity and removing regulatory obstacles. This may carry a risk of fragmentation and piecemeal approaches. Efforts have been made at the European level, in particular by the Commission, to improve the framework applying to fintech and digitalisation, with the fintech action plan and more recently the launch of the joint forum of the supervisory authorities, to combine efforts undertaken regarding sandboxes and incubators.

A regulator agreed that a legal framework is necessary, as it brings clarity and moves DLT into a better-defined space. The question, however, is of when is the right time to take this step at the EU level. Member states have taken different approaches to regulating DLT technology. Some, such as Malta, have decided to regulate DLT technology at the domestic level, with the aim of providing clarity on the classification of DLT or improving some licensing requirements. Many states are more reluctant and would prefer to wait until there is a tried and tested legal framework at the European level. The regulator supported the principles-based approach presented by the Commission regarding fintech in general, which also applies to DLT based on three key principles: technological neutrality, proportionality, and market integrity. Supporting the scaling up of technological innovation in the financial sector across the EU and enhancing the convergence of supervisory practices in this area are key objectives of the Commission defined in March 2018. The aim is to promote greater engagement between the competent authorities, financial players and providers of technology with a view to developing the knowledge of the competent authorities about the opportunities and risks related to technology and clarifying the needs in terms of regulation and supervision.

Proportionality should not come at the expense of market integrity. A proper risk management process will be needed to mitigate risks and protect consumers, because insufficient trust on the consumer side will hinder innovation. Financial services using DLT must respect the same high security standards as existing financial services firms. A responsible balance must be reached between encouraging innovation from new market participants and protecting the safety and soundness of the financial system.

## 3. Policy approach needed for facilitating the development of DLT solutions

### 3.1. Avoiding regulatory fragmentation at the EU and global levels

A Central Bank official highlighted the need for both a European and a global approach to blockchain and DLT, which by nature have no jurisdiction. Technical standards in particular should be handled at the global level. There is a tendency to establish national frameworks first, making the harmonisation of regulations at the EU level difficult. As the area of DLT and blockchain is relatively recent, there is an opportunity to set standards on a global level before national jurisdictions have taken their stances. The official thought it would be wise to be proactive and pre emptive in this regard before everything has been settled by the industry or individual jurisdictions. Defining what needs to be done at the European level is more difficult, the official felt, as DLT is developing at the international level. As has been seen in the past, some areas where Europe could act as a frontrunner are data protection, governance and the safety and soundness of DLT systems. The role of the EU in relation to DLT and digital tokens could be in balancing the need to foster technological developments with the need to cope with potential risks.

An official agreed that there should be a focus on global solutions. Prior attempts at harmonisation of existing legal rules, particularly in securities, suggest this may be challenging at EU-level.

An industry representative emphasized that avoiding fragmentation and potential conflicts of rules across jurisdictions are a key priority for securities post-trading infrastructures. This is true at the European and also at the global level. When a new technology or service comes onto the market it is understandable that there are some local initiatives at the beginning, which is positive in terms of quickly building a first reference for a new topic. However when the market starts to mature, national or local regulators should let the EU or international regulators manage the process.

Another industry representative considered it critical for regulators to coalesce on the regulation of the DLT space in the EU, observing a spectrum of positions with Malta being fairly ambitious and close to regulating the technology itself and others following more the mainstream position of technological neutrality.

A Central Bank official noted that what is happening in Japan and other regions around the world is almost no different from what is happening in Europe when considering DLT or many other digital developments. The international dimension of these developments requires a tight cross-border connection between regulators about the legal and regulatory regime that applies. With a new technology there is an opportunity to start regulatory thinking from scratch at the global level possibly in conjunction with other micro-level discussions at industry level, where more specific guidelines can be developed by industry associations. This is however easier to do in the financial sector where this type of process already exists than in other business sectors.

### 3.2. Standards applicable to the structure and operation of DLT systems

An industry representative was in favour of technological neutrality and avoiding exemptions for new technologies. A question is whether DLT systems can be allowed to develop in regulatory sandboxes that give exemptions to certain rules in order to permit them to grow. Having closer supervision or advice from regulators in sandbox systems is probably helpful for the development of this type of innovation but this should not lead to regulatory exemptions.

Another industry speaker agreed, adding that technology neutrality does not mean that international rules such as the Principles for Financial Market Infrastructures (PFMI) developed by CPMI-IOSCO should not evolve. The PFMI principles were written in 2012 to apply to infrastructures that existed at that point in time. Many questions and issues relating to the development of DLT in financial services concern the operator of the system (i.e. who is setting the platform's rules, who is responsible for privacy, who is liable, etc.). Regardless of how much the system is distributed, the role of the operator of a DLT platform will be critical in the future if DLT takes off.

The speaker added that while regulating technology is not appropriate, regulators should consider how existing business models, structures and roles will change with DLT, and how the financial services regulatory framework may need to change to deal with these evolutions. Otherwise, there is a risk that two sets of rules may emerge: one very strict set of rules applying to traditional market infrastructures, due to their systemic implications; and a different set of rules applying to other systems developing in different parts of the market, but performing some similar activities to traditional market infrastructures. Some operators are connecting counterparties transacting in different systems, but are not handling transactions themselves. However, it would not be appropriate to simply wait and apply the PFMIs to operators that have set up permissioned platforms resembling a payment system or another existing type of infrastructure.

Another industry representative urged pragmatism and was not in favour of new rules. The PFMI principles should be used as the cornerstone of the regulation in this area and it should also be possible to assimilate digital tokens to certain categories of securities making existing regulatory concepts still applicable. The representative agreed that regulation should recognise the importance of the role of the third-party operator in guaranteeing the functioning, accountability and reliability of DLT based systems. CSDs are playing a similar role to a certain extent in all settlement systems as operating a settlement between participants. Thought is being given to defining the role that could be played by institutions such as CSDs in the new DLT environment, in terms of how different roles and systems can be combined to the benefit of different business needs, rather than DLT replacing the existing system.

An official explained that standards should depend on whether DLT is permissioned or not. Different types of DLT have different regulatory implications. In a permissioned environment, the existing standards such as the CPMI IOSCO PFMIs should remain the relevant standard. Whereas in a permissionless environment there are some issues including those concerning anti money laundering and consumer protection for which an adaptation of standards would be needed. That has already been well documented. In any case, the speaker did not see these latter systems as having much potential going forward and hoped that the 'bubble would burst'.

**Appendix:**
**DLT and blockchain**
**Definitions and main concepts**
(source Cryptocurrencies and Blockchain – European Parliament – July 2018)

DLT is a way of recording and sharing data across multiple data stores (also known as ledgers), which each have the exact same data records and are collectively maintained and controlled by a distributed network of computer servers, which are called nodes.

Blockchain is a particular type or subset of so-called distributed ledger technology ("DLT"). Blockchain is a mechanism that employs an encryption method known as cryptography and uses (a set of) specific mathematical algorithms to create and verify a continuously growing data structure – to which data can only be added and from which existing data cannot be removed – that takes the form of a chain of "transaction blocks", which functions as a distributed ledger.

In practice, DLT is a technology with many "faces". It can exhibit different features and covers a wide array of systems that range from being fully open and permissionless, to permissioned:

- In an open, permissionless DLT system, a person can join or leave the network at will, without having to be (pre-) approved by any (central) entity. All that is needed to join the network and add transactions to the ledger is a computer on which the relevant software has been installed. There is no central owner of the network and software, and identical copies of the ledger are distributed to all the nodes in the network. The vast majority of cryptocurrencies currently in circulation are based on permissionless blockchains (e.g. Bitcoin, Bitcoin Cash, Litecoin…).
- In a permissioned DLT system, transaction validators (i.e. nodes) have to be pre-selected by a network administrator or operator (who sets the rules for the ledger) to be able to join the network. This allows them, amongst others, to easily verify the identity of the network participants. However, at the same time it also requires network participants to put trust in a central coordinating entity to select reliable network nodes. In general, permissioned blockchains can be further divided into two subcategories. On the one hand, there are open or public permissioned blockchains, which can be accessed and viewed by anyone, but where only authorised network participants can generate transactions and/or update the state of the ledger. On the other hand, there are closed, private or "enterprise" permissioned blockchains, where access is restricted and where only the network administrator can generate transactions and update the state of the ledger. What is important to note is that just as on an open permissionless blockchain, transactions on an open permissioned blockchain can be validated and executed without the intermediation of a trusted third-party. Some cryptocurrencies, like Ripple and NEO, utilise public permissioned blockchains.

In principle, any node within a DLT / blockchain network can propose the addition of new information to the blockchain. In order to validate whether this addition of information (for example a transaction record) is legitimate, the nodes have to reach some form of agreement. Here a "consensus mechanism" comes into play. In short, a consensus mechanism is a predefined specific (cryptographic) validation method that ensures a correct sequencing of transactions on the blockchain. In the case of cryptocurrencies, such sequencing is required to address the issue of "double-spending" (i.e. the issue that one and the same payment instrument or asset can be transferred more than once if transfers are not registered and controlled centrally).

A consensus mechanism can be structured in a number of ways. The two best-known in the context of cryptocurrencies are the Proof of Work mechanism (network participants have to solve so-called "cryptographic puzzles" to be allowed to add new "blocks" to the blockchain, which is commonly referred to as "mining") and the Proof of Stake mechanism (a transaction validator (i.e. a network node) must prove ownership of a certain asset (or in the case of cryptocurrencies, a certain amount of coins) in order to participate in the validation of transactions. This act of validating transactions is called "forging").

Every user on a blockchain network has a set of two keys. A private key, which is used to create a digital signature for a transaction, and a public key, which is known to everyone on the network. A public key has two uses: 1) it serves as an address on the blockchain network; and 2) it is used to verify a digital signature/validate the identity of the sender.

A user's public and private keys are kept in a digital wallet or e-wallet. Such a wallet can be stored or saved online and/or offline.

1. The execution of financial transactions normally requires a third-party intermediation e.g. a securities settlement system, a custodian, a trade repository. DLT involves decentralizing trust and enabling decentralized authorisation of transactions.

2. The service aims to increase the levels of payment netting calculations while introducing standardization and automation. The aim of the product is to drive operational process efficiencies, such as optimizing intraday liquidity, enabling real-time awareness of currency and counterparty exposures, and reducing risk.

❖

# Cloud outsourcing: opportunities and challenges

### 1. The benefits and opportunities provided by cloud technology in the financial industry

#### 1.1. The main benefits of cloud computing

A regulator stressed the increasing rate of adoption of cloud outsourcing in the financial industry. An EBA assessment in December 2018 conducted mainly among the larger banks in the EU found that cloud computing is an important driver of business for these banks. Over 50% of respondents have adopted cloud computing for some part of their activities. Another 30% were considering it or planning for it, and only a small proportion had no plans to do so. An industry representative noted that people often say that financial services companies are increasingly becoming technology companies, but the reality is that they want to be able to leverage and harness technology, but they do not fundamentally want to become technology companies.

Several speakers detailed the benefits provided by the use of cloud computing services in the financial sector.

Cost is a first factor. An industry representative stated that cost reductions are a major motivation for businesses using the cloud, but many of them have not yet managed to realise all the benefits in this respect. This is largely because institutions have sought to replicate the same types of technologies and the same ways of implementing them in the public cloud that they have used historically rather than conceiving new ways to leverage technology. Another industry representative felt that there could be cost benefits in the form of future cost avoidance. If a business information system is moved to the cloud, it will require less additional investment in 5 or 10 years.

Improving scalability and time to market is a second potential benefit of cloud computing. An industry representative explained how the modernisation of IT systems using cloud-services can support shorter time to market, create faster business services to customers and create a more internally agile organisation while also providing a scalability benefit. In terms of time to market, with cloud-services businesses can create services or applications on a small scale in one country and then expand them easily across the world or on the contrary decrease the service if it proves inefficient or if activity drops in the future.

Thirdly, the cloud also facilitates innovation. An industry representative considered that the venue for exploiting new technologies such as Distributed Ledger Technology (DLT), Artificial Intelligence (AI), machine learning, enhanced and next-generation data and analytics, automation and robotics will increasingly be the public cloud because it is impossible to leverage some of those capabilities within a traditional technology environment. One of the prerequisites for institutions being able to leverage these new services is the availability of large amounts of data which only exist in the public cloud. Quantum computing is another area where great progress is expected over the next five years and which institutions are expected to leverage mainly as a public-cloud-service. Another industry representative added that the cloud allows businesses to utilise these technological innovations with far less investment than if they were to do this alone. The cloud also allows a business to change the way it functions internally and externally more easily and rapidly.

### 1.2. Future development of cloud computing in the financial sector

An industry representative stressed that simply moving existing applications and systems to the cloud does not allow institutions to reap all the potential benefits offered by the cloud. This does not achieve cost reduction, is not innovative and certainly does not transform an institution's business model. Rather than replicating what was done in the past, businesses are now seeking to exploit new platforms and capabilities. Firms would be able to enjoy more fully the benefits of the cloud if they move away from infrastructure as a service, which is akin to how IT is delivered to enterprises today, towards software as a service (i.e. providing access to application software from any device with an internet connection and web browser – see Appendix for definitions). This is the case notably with new technologies such as AI, machine learning and smart analytics. An increasing number of fintechs are expected to offer software as a service propositions in the future, as some services become less differentiating and institutions will need to use the public cloud to access these technologies. A regulator also saw many benefits with the use of the cloud in terms of innovation and increase in data-analysis capacity. For the first time, some firms are seeing the value of their data and understand how it can benefit their business. They are also using the cloud to transform their business. The cloud is a substantial shift in how IT technology employees operate. Rather than having a linear production line of monthly releases, they are moving to more agile dev op teams which are able to respond much more quickly with more frequent releases.

### 1.3. From a basic utility to a more sophisticated service

A policy-maker drew an analogy between cloud-services and the provision of electricity. If the panel were taking place in 1919 rather than 2019, there could have been a similar discussion about the adoption of electricity by the banking system. An industry representative broadly agreed with this analogy. Increasingly, the technology now available in the cloud is essentially a utility service provided in a cheaper and more innovative way. Key regulations are driving this behaviour. For example, FRTB (the Fundamental Review of the Trading Book), which particularly affects capital-market institutions, requires an eightfold increase of IT infrastructure spending by some institutions to comply with the regulation, due to the enhanced risk modelling and the number and frequency of calculations required, as well as the amount of data involved. In a banking environment with depressed returns on equity and capital and diminished IT budgets, it does not make sense to make this kind of investment in technology.

An official however considered that the analogy with an electricity utility does not hold true for several reasons. First, electricity is produced locally rather than on other continents. It is a regulated industry and institutions know what they are purchasing. From a supervisory perspective, the supply of electricity has a simple solution in terms of business continuity with the installation of an emergency generator. That is quite different to the cloud, and it poses a number of questions about the regulatory framework needed for the cloud. In addition, institutions using the cloud for relatively sophisticated applications such as analytics or the provision of essential software, must be aware of how the analytics are produced, unlike with electricity. The policy-maker agreed that the utility analogy mainly holds for fairly basic applications of the cloud.

## 2. Existing regulatory and supervisory framework at the global and EU levels

### 2.1. Existing frameworks at the international level

An official commented on the results of a study conducted by the Financial Stability Institute (FSI) of the BIS on the regulatory and supervisory approaches to cloud computing in the insurance sector in Europe, Asia and North America[1]. Three main approaches were identified relating to outsourcing; governance and risk management; and information security. Cloud computing is generally considered in existing frameworks as a form of IT outsourcing if the outsourced function or activity is material. However, the materiality criteria are different between jurisdictions and are frequently unclear regarding cloud computing. In jurisdictions where cloud computing adoption by financial institutions is increasing, some authorities have enhanced their approach by clarifying their regulatory expectations regarding the use of cloud computing and addressing the specific risks posed. There is value in this approach. Some authorities have allocated specific cloud sections in the regulations with binding requirements while others have published specific guidance, recommendations, information papers and discussion papers.

These cloud-specific provisions or recommendations do not regulate the technology itself but the underlying governance and risk-management framework and mainly focus on six areas. The first area is the materiality assessment of the arrangement. Besides taking into account the outsourced function or activity, authorities recommend considering the type of deployment model[2]. The second area of focus for authorities is the due diligence of cloud-service providers and what it takes into account[3]. The third area relates to the risk assessment of the cloud solution, in which authorities expect institutions to classify risks and determine the actions they will take to mitigate these risks. The fourth area relates to data location, in the sense that authorities generally recommend that institutions understand the legal environment of the jurisdictions in which their data will be located and processed. In some cases, authorities even require that institutions' particularly sensitive data should be hosted locally. The fifth area is about business continuity and exit plans. Authorities require institutions to include in their contracts performance and service levels, such as maximum downtime or processes for the removal and deletion of data at the end of a contract. Finally, the sixth area is urgent access rights, where most authorities require a specific clause that grants access to the insurer concerned, its auditors, data and business premises.

In the EU, the FSI observed that most national supervisors in the insurance sector consider the EBA recommendations on outsourcing to the cloud as a reference and EIOPA has decided to develop guidance based on these recommendations, with minor adjustments related to the specific risks of insurance. The FSI concluded that there are three main considerations for all financial authorities to take into account. First, there is value in clarifying regulatory expectations in order to address the potential specific risks associated with cloud computing and to support market participants in the responsible adoption of the technology. Second, supervisory frameworks must be enhanced to ensure that authorities assess and monitor the specific concentration risks arising from the market structure of cloud providers. Third, international cooperation is essential for the effective oversight of cloud-computing activities in the financial sector.

### 2.2. The EU's regulatory approach

A policy-maker stated that the Commission supports the transition to a cloud-based economy, but this transition must happen within a regulated framework. The EU legislation that underpins this subject is the free flow of non-personal data regulation, known as the fifth EU freedom, which was adopted last November and comes into force in May 2019. Some sector-specific requirements may be needed. In the financial sector there are three main areas of focus: security, data protection and the reliability of cloud-services. This is why the Commission welcomed the EBA recommendation on outsourcing to cloud-service providers, published in December 2017, which has been integrated into revised guidelines on outsourcing in February 2019. A regulator added that the EBA's assessments have indicated that there is a correlation between clear regulatory frameworks and the appropriate use of cloud. This concerns primarily the larger institutions but can also be of relevance for the smaller ones.

## 3. Challenges posed by the increasing development of cloud-services and potential need for additional guidelines

### 3.1. Potential risks posed by the development of cloud services

A regulator outlined the main risks posed by cloud computing. These concern data security, data protection and the disruption of systems. Requirements for providing cloud-services for the regulated EU financial-services sector need to be clear, even if there is not a total alignment among regulators and industry players on all points across the Union, because this clarity facilitates the use of the cloud within the EU financial sector. There are also other risks around control over access, residency and concentration risk, another regulator added, which are being monitored by supervisors in the EU. An official considered that the established industry players are not the most concerned about the reliability and security of cloud-services. Feedback received from the market suggests that disrupters and new companies such as fintechs seem to be the most interested in an additional regulatory framework defining the type of service it is safe to use. In terms of other areas such as data protection and encryption standards, there are issues about the reliability of services. Interactions in cases where institutions use the cloud as an essential software service or for analytics are also relatively complex.

An industry representative noted that there are still many concerns about moving large amounts of data into the public cloud in regulated industries such as financial services, which is necessary for reaping all the benefits offered by the technology. This raises questions regarding what access cloud providers have to customer data, what they may do with it, where it is located and whether it is communicated to anyone else, illustrating the difference between cloud computing services and typical outsourcing. The speaker's company – a major cloud provider – endeavours to be as transparent as possible on these different elements. The industry speaker also highlighted the importance of security, noting that the public cloud has incorrectly been perceived as less robust than a traditional infrastructure environment. Security in the public cloud is at least comparable if not higher than in traditional environments given the significant investments public cloud providers make e.g. in terms of employing large teams of security engineers and putting in place elevated security models.

### 3.2. The division of responsibility between cloud providers and their customers and the role of supervisors

A regulator considered that outsourcing to the cloud entails a shared responsibility which can be stronger than in other types of relationships. There are many different types of services in the cloud (e.g. infrastructure as a service, software as a service, platform as a service). Firms need to define who is responsible for what and where the shared responsibility lies to ensure that governance and accountability are clear and to avoid gaps in security and incident management. In terms of responsibilities, the speaker felt that outsourcing to the cloud should be considered as any other third-party outsourcing arrangement. A firm should remain responsible for its own operational resilience and business continuity and also its outsourcing arrangements and therefore cannot contract out its regulatory obligations. This was set out in the FCA's 2016 cloud guidance. In addition, as part of its oversight on operational resilience, the FCA, jointly with the Bank of England, has issued a discussion paper on operational resilience, which is also relevant to technology-related outsourcing. Firms should be able to absorb shocks rather than contributing to them and therefore they should understand how to restore business services in case of disruption and make the investments required in order to ensure resilience.

Another regulator stressed that the EBA's outsourcing guidelines are relevant for all types of outsourcing and notably cloud outsourcing. Different layers of activity can be outsourced to the cloud, from infrastructure only to the full package. Even if a firm is only making use of the cloud for infrastructure, it will still have to apply the rules, but this can be done in a proportionate way. This might make exit planning easier to manage, but security and availability will still remain an issue. The intensity of the rules can differ depending on the type of outsourcing, but the EBA's basic principle is essential: firms remain responsible for the activities they outsource. An industry representative felt that the model of shared responsibility in the public cloud poses a question over where the boundary lies between the responsibilities of cloud-service providers and customers in a context where increasing amounts of responsibility could potentially be delegated to cloud-service providers. This requires transparency on the part of cloud providers in terms of how the data is handled and what type of access cloud-service providers have to it. Another industry speaker added that companies using cloud-services must also prepare appropriately their internal processes and organisation in order to achieve the best outcomes from cloud use.

### 3.3. The possible need for additional or more specific guidance on the provision of cloud-services

An official explained that fintechs would prefer a licensing system establishing standards to be met by cloud-service providers that are safe to use. This would allow them to use these services without having to bother about assessing them. Supervisors however are usually not favourable to this approach, because it allows the management to exonerate itself in the case of a problem, by blaming the cloud-service provider. On the other hand, it is difficult for the full responsibility to lie with the management of institutions outsourcing to the cloud, particularly in the case of fintechs which are small companies that have very unfavourable negotiating power compared to the major foreign cloud providers. It might be beneficial to have a European framework to express the essential requirements for cloud-service providers. This framework would describe the minimum standards for the provision of these services, but not a 'sufficient' standard because some responsibility must remain with the company outsourcing. It should include, for example, the requirement for companies to allow access to supervisors. Another issue is when the usage of data is outsourced completely and the institution does not understand the algorithms being used, it will be impossible to hold managers accountable for business decisions taken on the basis of this analysis. In that scenario, it is important to think about the distribution of responsibilities and to determine what standards should govern the interactions between cloud users and cloud-service providers.

An industry representative suggested that a certification process could be used in order to support the adoption by European countries of some cloud providers and emphasized that several important topics need considering in regulation. First, there is no single regulation on cloud in Europe; harmonisation in this area would be highly beneficial across sectors and jurisdictions. The cloud introduces a new paradigm, especially in respect of access to data, allowing institutions to classify information and put it in the right place. There is also a question concerning data retrieval and the related time and flexibility, because data needs to be provided at the most appropriate time. The US CLOUD Act is another issue and how it will interact with European regulation such as GDPR.

A regulator suggested that any set of rules or framework should be harmonised, but principles-based and high-level, and perhaps supported by guidance, in order to keep pace with innovation and developments. Otherwise, it will very soon become out of date.

Another industry representative mentioned some issues that might require further guidance. First, there are specific transparency implications in relation to shared-responsibility models in the context of 'software as a service' provision that need considering. The users of that type of service do not need to really understand how the service functions, however, financial services firms will need to be able to prove to regulators how they are operated. Obtaining prescriptive guidance from regulators about the evidence that is needed would be very helpful. For example machine learning and AI are increasingly being used in "software as a service' solutions. Efforts are being made to increase transparency and eliminate biases and it would be useful to know how to evidence this. Secondly, there has recently been helpful guidance on encryption and the requirements for data moving into the cloud. If data is moved in support of materially outsourced workloads or applications, should it be encrypted? If it is encrypted, how should the encryption be enacted? Does the customer of the encryption key retain control or should this responsibility be devolved to the cloud provider? Prescriptive guidance from regulators on this topic would be very useful also.

### 3.4. Potential data location issues

A regulator suggested that the EBA has taken a very risk-based approach to data protection in its guidelines, which is sufficient and suitable for both the sector and the cloud-service providers. Having more specific location requirements is undesirable, as there are other ways to protect data. An industry representative felt that the issues around data localisation remain a barrier to the uptake of cloud-services in Europe. A solution adopted by some large cloud providers is to have datacentres in different European countries, but there will always be business locations where there is no data-centre presence. One of the key solutions here might be open-source technology, for example.

### 3.5. Financial stability issues

A regulator noted the EBA's responsibility for the macroprudential side of the cloud. There are macroprudential concerns in terms of cyber-risk, but the 'elephant in the room' in terms of financial stability is potential concentration risk. A question is whether a specific regime is needed for these providers. The ESAs will shortly be providing joint advice to the European Commission regarding potential legislative improvements in this area. This proposal considers the establishment of an appropriate oversight framework for monitoring critical service providers. This process is still in the very early stages of development, however. This is a complicated issue, but some of the thinking in this proposal will soon be delivered and made public. It is also important to consider what is happening on a global level.

Concerning the potential concentration risk, an industry representative explained that enterprises increasingly leverage multiple cloud providers, which begins to address this risk. The speaker's company provides guidance to financial services institutions on how to take advantage of multiple cloud providers, recognising the requirement from regulators not only to mitigate concentration risk but also to address issues such as exit strategy. In the event of a commercial failure, for example, an institution might need to move its materially outsourced workloads or applications to another cloud provider. Cloud-service providers need to engage with regulators and prospective financial services customers on how this can be done.

**Appendix: overview of cloud computing**[4]

In common terms, cloud computing could be defined as a model that enables on-demand network access to a shared pool of configurable computing resources. The US National Institute of Standards and Technology (NIST) defines cloud computing as a model for enabling ubiquitous, convenient, on-demand network access to a shared pool of configurable computing resources (e.g. networks, servers, storage, applications or services) that can be rapidly provisioned and released.

According to NIST, cloud computing has five essential characteristics, three service models and four deployment models.

**Five essential characteristics**

The main characteristics of cloud computing are on-demand self-service, broad network access, resource pooling, rapid elasticity and measured service:

- On-demand self-service: users are able to access computing resources without any human interaction with the service provider.
- Broad network access: computing resources are accessible over the network, supporting heterogeneous client platforms (e.g. mobile devices and workstations).
- Resource-pooling: the provider's computing resources are pooled to serve multiple users under a multi-tenant model, with different physical and virtual resources dynamically assigned and reassigned according to user demand.
- Rapid elasticity (scalability): capabilities can be elastically provisioned and released, in some cases automatically, to scale rapidly outward and inward, commensurately with demand.
- Measured service: cloud systems optimise resource use by leveraging and metering their capabilities appropriately according to the type of service. Resource usage can be monitored, measured, controlled and reported, providing transparency for the provider and user (pay-by-use).

**Three service models**

There are three main types of cloud-service models: Infrastructure as a Service (IaaS), Platform as a Service (PaaS) and Software as a Service (SaaS):

- Infrastructure as a Service (IaaS). Providers offer access to computer infrastructure resources as processing power, storage, servers, networks and other resources where users are able to run an operating system with applications of their choice on it. Virtualisation allows many users to share one physical server. Users have control over storage levels, operating system and specific network components.
- Platform as a Service (PaaS). Providers offer a computing platform where users can run and develop their own applications using libraries, languages, databases, tools and other providers' resources. This option provides users with tools for developing new online applications. Users have control only of their own applications that run on the platform plus the platform's configuration settings.
- Software as a Service (SaaS). Providers offer access to application software from any device with an internet connection and web browser. Off-the-shelf applications are free or paid via a subscription, accessed over the internet from any device, facilitating collaborative working. Users have control only of configuration settings specific to the application.

Cloud computing services are constantly evolving. As emerging technologies evolve and are applied to different use cases, new services are being offered, such as Business Process as a Service (BPaaS), Cloud Management as a Service (CMaaS), Blockchain as a Service (BaaS) or the recently launched Quantum Cloud-services.

**Four deployment models**

Cloud computing can be deployed in different models according to the type of use. There are four types of deployment model: private, public, community and hybrid. The main differences between these deployment models relate to the availability of the cloud infrastructure:

- Public cloud: available for open use by the general public.
- Community cloud: available for the exclusive use by a specific community of users from organisations that have shared interests.
- Private cloud: available for the exclusive use of a single organisation.
- Hybrid cloud: composition of two or more distinct deployment models that retain unique infrastructures but are interconnected.

1. FSI Insights on policy implementation N°13 - Regulating and supervising the clouds: emerging prudential approaches for insurance companies - Financial Stability Institute - December 2018.
2. i.e. whether it is a public, community or hybrid cloud; whether it is an infrastructure, platform or support service, which involves different shared responsibilities and also the level of criticality or sensitivity of the data stored and processed in the cloud.
3. i.e. the adequacy of the cloud-service provider's risk management and internal control procedures, compliance with data protection and data security regulations, and the adequacy of their recovery plans.
4. Source FSI Insights on policy implementation N°13 – December 2018

# Priorities for the next EU legislature in the payments area

## 1. The changing market and the competition from BigTech

### 1.1. Increasing digitalisation and the use of data

A public representative believed that there are gaps in roles for dealing with customer data and keeping it secure. PSD 2 and GDPR are heavy-duty pieces of legislation that were drafted independently of each other and, as a result, do not quite marry up as well as they perhaps need to. GDPR asks for consent whilst PSD 2 asks for explicit consent. However, there is no guidance as to what explicit consent is.

### 1.2. Instant payments

Regarding innovation, a speaker noted that the hope is for instant payments to become a new norm in Europe. A Central Bank official explained that the ECB looked at the development in the market of payments. The main issue is an increased digitalisation of the way payments are made, how that affects the manner of paying in Europe today and how efficient it is within Europe. There was consideration of how the new generation of payment services should be developed in TARGET.

In the context where there were different projects and different enhancements of the current services, provided by TARGET 2, which settle the transactions of the financial market in Central Bank money, a new generation of payments, an instant settlement function called TIPS, introduced in TARGET. is being developed. A landscape is being developed that will allow each bank to have good access to Central Bank money and have an optimal use of their Central Bank liquidity for the diverse purposes in the financial market.

The capacity to manage liquidity will be completely integrated for the whole area, in a domestic manner, with a single technical access, single network access and single process that allow a maximum optimisation in interacting using ISO 20022.

It is difficult to see how much the coming regulation will be able to catch up with all of the recent developments with the introduction of instant payment. However, that is being attempted with good coordination among the market participants and stakeholders. A contact group with the markets has been created.

There are attempts to allow innovation to flow in Europe and to allow innovative payment solutions to come to Europe. It is important to develop a context for innovation where it has certainty. In a digitalising world, without cash as a way to have the Central Bank 100% involved in the retail space, there needed to be a mechanism with digital transfer of retail payments available to citizens and integrated in Europe. That capacity has been allowed with TIPS. The aim now is for all of the banks to connect to TIPS for further services to the market.

## 2. The role regulation plays in the industry

### 2.1. Innovation versus regulation catching up with rapidly changing technology

A Central Bank official noted that payments have been regulated mostly with the aim of harmonising European payments in order to make a more competitive marketplace. On market dynamics, the whole regulatory burden placed on banks since the financial crisis should be considered. The regulatory changes are always mandatory for the banking sector and, depending on the bank's capability for making revenues, there is the question of how much room there is for innovation and business development.

It takes years to write regulations like PSD 2 and the technical standards. The more rapid the technological change, the more challenging it is for authorities to keep up. The question is what the incentive is for the banking sector to invest in innovation. A major concern is whether such actions are making payments an unattractive business for the existing players, opening the market for institutions which are not tied by all of the regulatory burdens that the banks are.

If there is room for it, innovation comes from outside the banking system. The competent authority responsible for technical standards has indicated how challenging it is to understand the new technologies coming forward and to meet the requirements with regulations and technical standards.

An industry representative queried whether there is a need to be more proactive. The industry needs to help policy-makers to understand the products, though it will be difficult for that dialogue to be structured around anticipating issues rather than trying to solve problems. Regulating technology might stifle it. Sometimes regulation with the best intentions can generate unintended consequences.

A public representative noted that there has been a suggestion that explicit consent can take the form of a clause in a contract, but the lack of clarity leads to banks erring on the side of caution to avoid fines or breaching. There is a need to establish answers to questions on where liability resides, what consent is and whether due diligence needs to be done before transferring information. High-profile breaches will allow case law to be established and guidelines to be written. That is a slightly controversial approach, but it will provide some needed clarity for the market.

Strong Customer Authentication (SCA) is a fantastic area where there also still needs to be plenty of guidance from regulators. From the industry perspective, all parties in the ecosystem are struggling to get to terms with the regulation. This ambitious framework that has very long-term implications is not sufficiently clear even today, five months from the SCA entering into force. PSD 2 is a maximum harmonisation tool, but that may not be achieved, at least not in the short-term, because without clarity each jurisdiction can take the approach that makes sense in a specific context.

An industry representative stated that payments are at the core of the trust-based relationship of banks and their customers. That relationship is the banks' most valuable asset, so much attention should be paid to anything that might endanger it. Banks are not experiencing any specific demand from customers regarding a potential new European scheme. That may be because customers do not limit their payments to the Eurozone.

A speaker noted that the new payment services directive will soon come into force, and queried whether the market is prepared, especially the smaller merchants. An industry representative explained that six years ago their organisation started with the very simple idea of making money digital and electronic. Today it is looking at new innovations and what consumers are asking for, which is to pay in the way they want whilst being safe and secure. It decided to be an open platform as it is convinced that cooperation and partnership are key to helping the industry to be innovative and to shift from payment with plastic cards at point of sale to payment with mobile, with your watch and IT using tokenisation. To be successful in the next decade, there is a need to continue to listen to, anticipate and understand consumer demand in order to be able to create what consumers expect. The changes in the next few years will be more material than those of the past decades.

The industry has a significant responsibility. PSD 2 means increased security, but consumers acting to pay the way they want cannot be forgotten. Internet of Things (IoT) is coming. With IoT devices and wearables there remain open questions. The industry has to help consumers advance, but regulators have a responsibility to ensure the regulatory landscape will be shaped in a way that reflects the new dynamics.

A holistic approach should be taken, and the current position should be considered before any new legislation is adopted. A 2018 McKinsey report indicated that the opportunity for digital payments in the next years in Europe will grow to $750 billion. From a policy perspective, there should be consideration of where the weights are placed.

An industry representative noted that in any case, PSD 2 has catalysed the activity required in the financial industry to learn about the technology, deploy it, etc. If banks are going to take their place in these digital ecosystems and provide value, they will need to change large parts of their business model and the way they think.

### 2.2. The impact of PSD2 and interchange fee regulations (IFR)

An industry representative explained that IFR and PSD 2 are complementary and were enacted together. The process of implementing them was not quite simultaneous, but as with any regulation there were some positive outcomes and some downside consequences.

One of the unintended consequences is the result of the open access provision of PSD 2. It was intended to increase competition amongst the banks and acquirers in the Visa and MasterCard modelled networks. However, it does not fit with closed-loop payment networks and three-party schemes. For a small percentage of transactions, it sets up what is effectively a franchise operation. That is true in Europe and other countries around the globe. The open-access requirement would have forced three-party companies to fundamentally shift their business model toward a four-party scheme by letting all acquirers and all banks onto the network. Three-party companies chose instead to end that portion of its business, which resulted in roughly 7 million card members being phased off of the network, therefore diminishing competition.

A second impact concerns merchants, particularly on the interchange fee regulation. There has been a reduction in the cost of acceptance. However, some of that benefit has been eroded by price increases. Indeed, there has been some disparity between the benefits that large merchants and smaller merchants have seen. For the next round of regulation, transparency of pricing and pricing increases would make things easier, particularly for small merchants.

The third, consumer-focused, area is surcharging. The last round of regulation prohibited surcharging in most, but not all, instances. It left to the member states a choice as to how they want to address the remaining transactions that are not banned EU-wide. Markets have taken different approaches. For the next round of regulation, and for consumer benefit so that they are not surprised when moving from a market to another one, similarly surcharging the consumer for those transactions would be beneficial as well.

A Central Bank official noted that the interchange fee regulation is a global trend whereby the burden on merchants is growing significantly. The only way for consumers or merchants to make right decisions is to have sufficient transparency on the fee structures. The SMEs should be treated somewhat differently from large companies because their capabilities are different.

An industry representative believed there is a need for an impact analysis on Multilateral Interchange Fees (MIF) because it is unclear whether the lower fees that have been passed have a direct impact on customers.

In terms of reduced cost, an industry representative noted that there is a recent study from the Bank of Italy which indicates that the cost for merchants has been reduced quite substantially, by 22%. The missing element is the impact on consumers. There needs to be more transparency in analyses. Interchange fee regulation needs to be measured against impact on the banking sector, the merchant sector and the consumers as well as the evolving dynamics of the market.

### 2.3. Ensuring a level playing field for market participants and avoiding unintended consequences

Regarding the safety of data, an industry representative stated that GDPR regulations should be imposed on all actors that gain access to the personal data of customers through the payment change. It is the same for the new CLOUD regulations. There are regulations and consequences from GDPR which impact banks' ability to use big schemes. It is very difficult to have an open discussion with the big American actors, because they do not want to take the GDPR regulation into account in the way they manage the cloud-services.

A speaker asked whether an argument can be made that banks also benefit from the customer data that an independent payment service provider does not have access to, such that they can provide their own additional services. An industry representative agreed that is correct. However, a service like Airbnb can make great use of all of the information on the use customers make of its own services. That is different in the banking sector, which is quite limited in its ability to use the personal data of customers.

Regarding the variety of business models, an industry representative noted that it is important for Europe to ensure a level playing field among all actors. The new actors in the payment industry have a very dynamic use of the data that they capture through the payment system, to improve their core business. They can then under-price the service of payment and compensate with the added value that they create on their own business. That business model is not open to banks. It is important, when planning the future of payments in Europe, that all of the different actors receive equal treatment.

Regarding the risk, it is also a matter of the independence of the Eurozone and ensuring there is not 100% dependence on non-European actors in the field of payments. An industry representative explained that there are currently discussions on a potential new European scheme. However, there is no demand coming from the customers themselves in that field. One suggestion is to make sure that all actors in the payment system are submitted to exactly the same groups.

A Central Bank official noted that a functional approach to regulation is very important. However, even though the discussion is not about introducing a card scheme for Europe today, there is an intuition that customers want to be able to pay globally but be independent from a global scheme. It seems that there would need to be an alternative scheme in that case.

With instant payments, there is a solution which can help in developing routines and probably capacity to pay, which can probably integrate the world of cards with the current national schemes. It could have a connection to a solution like TIPS, which would allow it to have the pan-European reach in Central Bank money instantly while using the card as a means of identification or allow better management of fraud.

Having a European approach without creating a card scheme will eventually open the room to a card scheme without having to restart a big project that is difficult to lead in the field. It could bring an answer to the dilemma of having capacities to pay outside, but also with a European way of doing so. That is how independence is preserved. The international role of the euro, which is at the top of the agenda these days, will also be preserved and would allow for development of internal capacities.

One question is also how the competition traditional banks and service providers face from big technology firms from outside Europe, and the use of platforms for payments and other financial services, will affect the payments market.

A Central Bank official explained that it seems that the data is more interesting than the payment and queried what will happen if the payment as a business is not interesting. Banks often say that they are going to provide a platform for different service providers. The payment provision or the service provision, which is linked to payments, are going to be provided by various entities and the bank may just provide a platform for them.

When banks say that they may provide a platform for various services, they also say that in the future they would actually join another platform. There is then a question of who will provide the payments and whether they are providing them for the payments' sake or for the data's sake. There is also a question of who is liable for doing what, requiring to know who is providing the service so that it is known who is liable if something goes wrong.

## 3. Future developments for the industry

### 3.1. Standardisation and the development of APIs

A public representative believed the right rules are in place. However, there is an expectation that in September there will be a seamless transition into open banking, and everything will be fine, which is unlikely. Open banking is a process that is being worked through and has only just started.

The first hurdle to overcome is application programming interfaces (APIs). There are many banks in Europe, many of which are small. Not all of them will have developed fully functioning APIs by September. It is up to the member states and the national competent authorities to determine what a good API is, what a bad API is and how to resolve that. There is little guidance there. Feedback will be required to develop the standards and fine-tune the framework for open banking to function.

Regarding standardisation, an industry representative stated that with the CMA 9[1] there has already been a slight rehearsal in the UK of what might be expected in September with PSD 2. The bulk of the banks are ready, but perhaps not ready enough and not as interoperable as they might have been. This concerns large companies that are hyper-connected and doing business with one another, the way that is growing and the share of the economy that it is making up. There are figures from McKinsey showing that $60 trillion in annual revenues is expected to be distributed through these kinds of actors by 2025. That is a third of the year's total. Businesses are combining and interacting in a way that has not been seen before.

One thing that all of these players share is that they have a need for financial services. The institutions that are going to service them are going to have to meet them where they live, which is in the cloud. It is about being able to provide 24/7 digital services that are easier to integrate. Financial institutions that get past the compliance aspect of PSD 2 and start to recognise that this is transformational and puts them in a good place will start to realise some real benefits by being able to fit into these ecosystems and apply these APIs.

A Central Bank official added that that is being attempted with the Euro Retail Payment Board (ERPB). A scheme on how the API, in context, could be broadly defined in a harmonised way by the industry, and not by regulation, is being attempted. Consultation among the industry to define a scheme for APIs broadly could be a way forward.

The bank will have to invest in new technologies. The digitisation is there, whether it is liked or not. Globalisation is there as well and therefore there needs to be integrated solutions that reuse the same technology. Those technologies could also be reused beyond Europe thanks to ISO 20022.

There is collaboration across Central Banks, at least for Central Bank services, in the G20 and CPMI contexts. This also brings value to the investment, which can be made here and reused there. Consultation is the way forward; a scheme for APIs found together with industry will help everyone.

A speaker suggested that there might be a more general question when it comes to new standards for all sorts of innovative new services and the new technologies that can be used, about how to find the right balance between the regulators setting the standard and the industry coming up with a solution on its own. The question is whether Europe has the right balance.

An industry representative suggested that for APIs a way is being found going in one direction and then the other. However, at some point the right balance between what needs to be imposed at the regulatory level, what can spontaneously come from the industry and what structures are needed to achieve that, will be figured out.

A Central Bank official noted that the ECB has three ways in which it can act: it can regulate, operate or be a catalyst for change. Typically, in this circumstance it is a catalyst for change. It is not there to regulate. It needs to create a dialogue among the different parties of the industry to find an appropriate scheme for APIs that services both parties and is able to deliver something useful for the market.

### 3.2. The amount of investments suggests leveraging more evolutive standards

The euro systems were early adopters of the norm ISO 20022[2]. The lessons learnt from the standardisation of the SEPA and international payments, suggests a need for standards in the API space as well. They have been allowed to evolve so far. There have been various different actors involved in trying to corral the different implementations.

Instead of having rigid standards that cannot be changed, the EU needs data standards that allow ecosystems to coalesce and inter-operate cleanly, rather than having to constantly have break points where different organisations actually have different interpretations. It is a new world, but it is also a continuation of the old world. It is something where, from a standards perspective, there needs to be improvement.

An industry representative explained that the difficulty banks are facing with the new regulations is the cost of implementation. The costing for the core banking system and IT is very large. In a context where there are already a number of investments to be made and other regulations and demands from the supervisors. All of these new burdens have to be coped with. It is understood that it is ultimately the best thing for the system as a whole. However, a hierarchy between all of these investment needs should be created. The industry is just coming out of IFRS 9, which was very demanding for all of the teams in the banks and for the IT systems. All of these investments need to be furthered, and it is quite a challenge for banks in the low interest rate environment.

A speaker believed investing and providing those new services will be inevitable because competitors will offer them. A Central Bank official noted that there has been agreement on the SEPA subset of ISO 20022, but it was not accepted before strict regulation was made that the standard has to be implemented. The question is whether that will happen with the PSD 2 APIs. There are technical standards, but they are quite broad. For anyone who wants to connect to the account-holding bank, it has to be tested bank by bank.

An industry representative believed the SEPA example is a good one. It did take an imposition. The hope is that that will not be needed in the case of APIs, and that the industry can converge over time to allow the necessary level of interoperability. One of the difficulties with SEPA is that the standard that was implemented is the same today as it was at the outset. It has been very difficult to make that service evolve as a result, though there is some evolution coming.

With the notion of digital ecosystems and cloud-based businesses that the industry is trying to serve, the added flexibility from the API technology is needed. However, it cannot be a free-for-all either, so there has to be a middle way. One area of experimentation is having standards less rigid than the messaging standards from before, where what the data is going to be is exactly specified. There may be reusable building blocks, based on ISO 20022, which allow the data to be easily tagged, validated and passed on. Everybody in the value chain will understand what it means without necessarily rigidly imposing what will be transported.

### 3.3. Lowest-cost, faster and ubiquitous payments will extend the demand and reduce cash and cheques

One issue is how the competition between card payments and services based on instant payments, is seen for the future. An industry representative suggested that there is so much activity in payments because there is a blending of commerce and payments. When the first charge cards were created, they were replacing cards or accounts that were used for specific merchants. It was connecting and creating a global marketplace where general-purpose card products could be used everywhere. Today the marketplace is creating its own payment solutions. Apple, Amazon or Alibaba are creating a large marketplace. They create a unique payment institution that can be the dominant or favoured player in that marketplace.

In those countries where instant payment has been introduced that competition is not really taking place. Card payments continued to develop progressively while instant payments were catching up, even in countries where they started quickly, like England, Denmark and Sweden. Those mechanisms are complementing what is already available, rather than replacing card payments. They are answering a use case which could have been answered by cards or a normal credit transfer.

At some point, there will probably be some payment done today by default in one way or another. Cheques, physical payments and payments that cannot be done due to a lack of capacity are good examples. Parents could wish to give money to their children who are far away but not be able to do so in real time.

There are new capacities and new use cases offered. They are answering consumer needs that were not there yesterday. Cards have a lot of value in all of the anti-fraud technology that has been developed with them. With cards it is clear who is paying, whereas instant has the speed of settlement. They can be complimentary and offer use cases that are not available today. If someone wants to be in control of their cash flow in a secure and convenient way, that can deliver a very good service to the consumer. How this comes together is an important development. There is a competition element, but not only that.

Combining the lowest-cost payments and the faster payments initiatives that are taking place in Europe and other areas of the world, will extend the demand. However, one question is whether there are solutions where the interoperability of market schemes becomes a competitive alternative. Another is whether they compete in some of these marketplaces and provide value to both the online and offline solutions. It can be asked whether they provide value that the consumer can see in other forms of payment. There is room for it, but some demand has to be found.

Competition in network industries is very challenging because the value of the payment scheme as a network is directly linked to size. It is very difficult to compete with a vast network without a network; that is why social media networks have been promising candidates.

Layering the convergence of offline commerce and online commerce on top of that, for existing payment systems to maintain relevance and provide value to the consumer, requires accessing the benefits they have with the full relationship with both the merchant and the consumer. It can be asked where value for the merchant can be combined with value for the consumer, and if the data can be used in a way that marries the two and is beneficial to both. Regarding the ease of payments, especially when the easiness regards credit, the flipside is the cost of adapting, which needs to be tackled when looking at the rapid development of ubiquitous payments[3].

Cash is still needed in order to give a benchmark for electronic payments, because cash is an instant settlement, completely technology neutral and always works when someone has it. That is also a very good benchmark for electronic payments in the future.

An industry representative stated that whatever a consumer needs makes sense. Today that is security, convenience and being in control. Even if a consumer is paying for their fridge, they want to know where their money goes. They want to know what happens if whatever they order with their fridge does not get to their door and what their protection is. Today there is a lack of clarity. The ultimate goal should be driving innovation and digitalisation of payments. $17 trillion is spent globally on cash and cheques. This is something that needs to be tackled. Provided the consumer is asking for it, there is security, resilience and other important points. However, there is no innovation that could be trusted unless there is heavy investment in cyber resilience.

### 3.4. Innovation goes hand in hand with cyber security challenges

Indeed, cyber resilience is an issue. Central Banks see a role for cash going forward. The question is whether instant payments will become electronic cash, and whether consumers can be sure that they are in control of where the payment is going and that it is always secure.

A Central Bank official agreed that cyber is very important when speaking of digital and agreed with consumer needs covering security, convenience and control. If Europe is moving on instant payment, with part of the market being covered by a Central Bank settlement service, that is because there is belief that the marketplace may be out of control. The trust in the currency should not be jeopardised by a non-bank's outside space that Central Banks cannot control, so the way the banking system is working is the best way to ensure the trust and the security in the functioning of the currency.

1. In the UK the Competition and Markets Authority (CMA) found in report that the market is "still not as innovative or competitive as it needs to be". In response the report outlines a package of remedies which includes mandating that larger banks (CMA 9) adopt and maintain a common standard for open APIs (Application Programming Interface).

2. ISO 20022 is a methodology, which can be followed when creating financial messaging standards.

3. Ubiquitous payments enable consumers to pay through any Internet-connected device present anywhere.

# Data protection, fairness and sharing

**1. Making the necessary and appropriate changes in response to the changing data and privacy landscape**

### 1.1. The GDPR has created new mechanisms enhancing the protection of individuals

It is one year since the General Data Protection Regulation (GDPR) came into force in the EU. Similar legislation has been developed in other jurisdictions. Financial entities have to face increasing data related competition, as well as adaptation challenges related to the recently adopted regulations.

A regulator emphasised that the GDPR created new mechanisms in order to enhance the protection of individuals throughout the European Union. Any person may file a complaint with any supervisory authority. Data controllers may have recourse to some innovative mechanisms of co-operation and consistency. There is a new mechanism through which data controllers may go to a single interlocutor in the European Union, which is the data protection authority where the data controller has its main establishment. GDPR allows both controllers and individuals to find a better position to ensure both the protection of their fundamental rights and the free movement of information throughout the EU.

An industry representative noted that though the conceptual thinking behind GDPR enhanced existing rules, the real game changer is the associated enforcement and empowerment, which has really helped to bring an unprecedented level of attention to the topic. GDPR has also made data protection a more holistic concept and implies a great deal of individual responsibility and self-regulation.

### 1.2. GDPR is not yet able to provide answers for a world, which is becoming further digitalised

An official suggested that the real game changer is the world, which is becoming fully digitalised, rather than GDPR itself. This will result in changes that GDPR is not yet able to provide answers for.

Consequently, there are significant ethical questions to be tackled, particularly for liberal democratic societies. The norm is that individuals have to be protected from the power of the many, including the state.

However, conversely there are also now scalable groups of individuals who can present a threat to the state with only a cell phone. That has to be balanced out with the legitimate concern about protecting the data of individuals. There are also security concerns. Balancing those and building anew the value proposition to citizens, while making sure that they are completely protected, is a very difficult task.

### 1.3. Data fairness specificities regarding the insurance sector

An industry representative raised the question of the extent to which there needs to be an overlay of additional, sector specific regulation notably regarding the insurance sector. This is related to the question of what 'fairness' means in the insurance sector. Indeed, data is the basis of what insurers do and is used to assess riskiness and set the premiums for those who want to enter a risk pool and be insured. Conversely, there are other business models in which collecting data is the purpose, which is very different from insurance companies' activities. Involved in fairness in insurance, there must always be a consideration of there being both an individual policyholder and a collective of all policyholders. The stake is notably to find the right balance between the protection of the individual and the collective.

### 1.4. The transitional journeys of organisations to achieve privacy and appropriate use of AI

In this context, regulation will change and there will be a move towards a financial consumer protection thinking, which is closer to the consumer on many points of the regulation and legislation than has been the case.

An industry representative stated that the financial services industry is on a journey and conforming fully is extremely challenging. In addition to the privacy question an important issue is whether machine learning and AI are to be used in deciding customer outcomes. Finally, financial entities must further refine their approach to the whole data challenge. Given that in addition, regulation and legal framework are the starting points, the industry is on a journey regarding how it uses data in order to demonstrate that the outcome for the end customer is defensible and also that it shares data with an ethical consideration.

A Central Bank official noted that in this context, Central Banks are in the midst of the dilemma between protection, privacy and the openness of data.

One additional important challenge for Central Banks and the financial industry is to address the volume of data. While the institutional and policy frameworks are being rethought and reorganised, there are huge organisational IT impacts. Should there be a breach of data from a Central Bank, the impact is much more important and systemic than from other semi-public or public organisations.

Another challenge is how to make both the participants in internal system and the public at large aware of the challenges and the new landscape. Awareness is improving but needs further improvement. Central Banks also have to play a role as go-betweens for the public and the private sectors on data protection.

An industry representative believed that GDPR is a journey for any organisation. However, it is less of a challenge for insurers as their business model is already based on data. Long before GDPR, data was at the core of their businesses. The insurer's relationship with the consumer runs on trust, so the fact that insurers had to handle their data meant they were in a slightly different position from other types of business.

The representative's journey on fair handling of data started long ago and before GDPR, just by it doing business. Indeed, by 2013 there were binding corporate rules, which regulated the flow of data between companies in the group. In 2015 a data privacy advisory panel, made up of external people, was created. Finally, data privacy commitments aligned with GDPR were issued in 2016 and have been applied since 2018.

## 2. The balance between individuals and organisations in an increasingly regulated environment

### 2.1. Data fairness: a permanently evolving cross sectoral ethics challenge, in the international context

An industry representative suggested that the impact of what is now in place in terms of regulation is a game changer because of the fines. It has resulted in a new degree of attention paid to data protection across sectors. GDPR could be the new standard in other regions and has been an important step.

An official noted that there is often consideration about when the market for data developed, and now there are fines that may set quite a high price. The financial sector has been in the business of trust, and reputational risk is very important. The technological change taking place would drive financial entities to think about the ethical issues in any event and to contemplate how best to protect customers. GDPR changes the way entities have to think about things, and the fines make it extremely efficient.

A regulator believed it is important, before considering the fines for breaching GDPR, to be aware of the importance of respecting the GDPR legal provisions. The European Data Protection Board (EDPB) is a newly established European Union body composed of representatives of data protection authorities. In less than one year it has already issued a significant number of guidelines and opinions to help data controllers understand the GDPR legal provisions and to improve their implementation in daily practice.

There are guidelines on data portability, transparency and consent that also give concrete examples from the authorities' experiences, and which clarify the notions and legal provisions of GDPR.

However, the ethical limits are yet to be defined. In addition, it is a challenge to figure out what happens next, particularly with the suggestion of financial entities becoming platforms. Platforms so far, particularly social media platforms, have been evading responsibility. When that business model change happens, it is hoped that respectability and trust will remain.

A Central Bank official added that understanding the complexity of the whole issue is an issue, and there are various levels of complexity. GDPR creates new and eventually harder problems. GDPR is not very attuned to the needs of the financial sector, for instance on market abuse regulation and the need to gather data for the regulators to do their job.

The level of greatest complexity is the need to find a balance between the national and the supranational. In addition to the EDPB there is the European supervisor, who is part of the board, but who works on a different set of provisions. The EU has a different set of data protection provisions for the institutions of the EU. Within the national remit, there is both the regulation and national rules.

### 2.2. Improved transparency and accountability should enable the deepening of data privacy and fairness

An industry representative queried whether rules and regulations alone can frame the issue appropriately and capture it. Litigation funds over the last 12 months have raised money in order to go after the deep pockets in life sciences, technology and financial services, and class actions are emerging. The principle of respecting human agency includes the fact that it is the end citizen or customer's data and not those of institutions.

GDPR tries to emphazise the question of fairness. There is a great deal of pressure to combine the personal data with machine learning and AI in order to come to a decision about how to demonstrate fairness. That leads into the question of transparency. Many people talk about black boxes being applied to data, but it should instead be about glass boxes which can be opened up to regulators.

It is very important that people at board level should appreciate these issues and accountability within organisations is defined according to who can do what. The chief data officer (CDO) currently has no regulated role. Seemingly no organisation in financial services has a head of ethics or is looking at the ethical outcomes. There is a rush to hire data scientists without understating the behavioural impact of data or employing data scientists who look at the unforeseen consequences of taking somebody's data, processing it and sharing it in a particular way.

## 3. The international situation

### 3.1. Combining data fairness and innovation

The Chair noted that Mark Zuckerberg is calling for more regulation. Regulation can probably help to give clear guidelines for accountability and make financial and economic institutions more comfortable complying with the rules when they are well known. GDPR is based on a territoriality principle linked to the consumers and citizens within the EU, and that probably raised awareness in third countries. EU consistency is also one of the objectives the European Commission had in mind when it proposed the regulation instead of a directive.

Another important factor, in addition to fines, is the way the courts will be applying and interpreting the provisions of GDPR. It may be fruitful to start thinking about a transition of the EDPB towards being a semi-European institution like the European supervisory authorities. Technology may catch up and change the rules of the game before any revision of GDPR.

Having a good data protection policy in place is already a certification of being bona fide when a company is competing in European or global markets. Data protection itself has become a good economic asset. The old perspective of merchandising data has to change somewhat, because the most important thing is to bear in mind the interests of the individual who is the owner of personal data. GDPR puts an emphasis on transparency obligations for the data controller. For many aspects of the processing carried out by data controllers, transparency and consulting the data subjects are part of any privacy policy.

A speaker noted the desire to find the right balance between protecting consumers and not standing in the way of innovation.

The information asymmetries in the systems would be greatly reduced if there was open, widely shared data that somehow ethically respected the individuals' right to say no and to take their data with them when they want to. The question is how to tackle the development of that sort of market and transparency, particularly with learning algorithms, black boxes and cognification. It is not clear how to regulate when something that is completely opaque is allowed to make the decisions. It is an interesting question as to whether ethics can be taught to such black boxes.

A Central Bank official stated that it is very difficult to have a global agreement on how to tackle the issues.

Within the existing sectors it is impossible to find real harmony between the competing objectives. GDPR has not even start to tackle the artificial intelligence and big data issues.

An industry representative stated that GDPR did not tackle AI and big data. GDPR was a catch up. Some governments and jurisdictions are going to think about it in the appropriate way, including the European Union. Some state actors and others will diverge from that. That is inevitable.

True AI is not yet deployed anywhere. There is plenty of machine learning, and it has inherent biases written into it. The programmers are predominantly male, and so there is a gender bias in machine learning.

The industry has to catch up and will continually be doing so. Laws and regulations take too long. The private sector getting together and looking to implement principles is going to use a far more expedient approach. Some organisations are going to employ their ethical use of data as a differentiator and see it as part of their value proposition.

### 3.2. The challenges imposed by existing diverse data privacy ethics globally

There is a question of whether a balance is to be found at the EU level, given the awareness of EU citizens regarding data privacy. An industry representative suggested that that goes beyond data protection, and GDPR specifically, and into the ethical considerations that need to be taken into account. It is the technological and societal development that leads to those questions. It is not clear that the ethical questions are even understood.

The other challenge is that there is no universal concept of ethics for data privacy. It might differ in different regions, and it might also change over time as society and technology further develop. There is a challenge there even before considering whether regulation could help. There will eventually be a regulation of the boundaries and the red flags from an ethical standpoint, but the political and societal debate has not developed far enough to be able to set up the red flags.

Trust is a licence to operate. Whatever happens in an area where there will be red flags, it will have a significant impact on the reputation of the relevant company and others. There will be spill-over effects. There is also a set of questions about whether something specific is needed for financial services and insurers.

The Chair queried how the potential contradictions arising out of different notions of ethics and data privacy awareness around the globe can be dealt with, and whether any aspects or competing views should be taken into account. He questioned whether the Clarifying Lawful Overseas Use of Data (CLOUD) Act in the US raises worries amongst supervisors or regulators.

An official noted that different countries have independently chosen different paths in developing their views. The challenge is with those nations that maintain that they are allowed to spy on their citizens and nudge them in a direction the citizens may not have wanted. It is difficult for there to be global agreement on how to protect data when the US comes from such a different angle.

However, there will be a consumer push on all continents, and there will be some form of convergence. It comes back to the point about the ethics and the value systems put in place. It is a political question.

### 3.3. Challenges to level the competition field between financial entities and BigTechs

The Chair indicated that there had been a first sanction for non-compliance regarding GDPR. It was from a French data privacy body resulting in a €50 million fine for Google. One question is whether GDPR and the sanction process is something that can help financial entities to be competitors in the field, because they know how to respect the data privacy of their clients, or whether it is a challenging matter for the financial sector.

The Chair queried whether people are more willing to trust GAFAs than insurance companies on data handling. An industry representative replied that it depended on the generation of the people.

An industry representative emphasised the importance of the regulation being cross-sector. The representative's organisation is very attentive to the protection of personal and consumer data prior to GDPR. An industry representative emphasised that financial services organisations, as well as FAANGs and BigTech, do not own the data; they are the custodians of individuals' data. Fines for not applying the rules incentivise greater caution in new entrants.

The game changer is the change of the economy and the way the economy is functioning. There is an emergence of platforms and the fragmentation of the financial business, the disruption of the way business is done and the introduction of new players in the chain of value.

As the pressure has come onto financial services organisations for returns on equity and capital etc., and they have been the providers of product, they have looked over the approaches of technology companies, and have seen their valuations, and have responded by indicating that they need to consider becoming platform-based businesses rather than product-based businesses.

There is a moral hazard element to that, because in moving to a platform area some of the previously abided by regulation can break down. Very often people use a data scientist for particular situations and ingest vast quantities of data. Regulation is not considered when doing so. Outcomes can result in non-conformance with rules and regulations as they apply to financial services, but that can be acceptable for BigTech. Pressure is something the financial industry has to be very wary of in migrating to more platform-based businesses.


eurofi
The Eurofi
High Level Seminar 2019
BUCHAREST | 3, 4 & 5 APRIL

Bucharest 2019

# SPEECHES

Full transcript

# Eugen Orlando Teodorovici

Minister of Public Finance, Romania

## Priorities of the Romanian EU Presidency in the financial area

Distinguished guests, dear colleagues, it is a pleasure to open the Eurofi gala dinner; in fact, it was already open, organised as part of the official programme of the Romanian presidency of the Council of the European Union. Let me welcome you all. I really hope that you have enjoyed and will continue to enjoy these days in Bucharest.

One might say that we choose Bucharest because as Mr Isărescu, our Governor, used to say, Bucharest and its surrounding region could join the eurozone even tomorrow. Apart from its economic and financial achievements, and apart from its beautiful old building, avenues and monuments, you can discover Bucharest is a city of many cities, built between east and west, past and future, challenges and hopes. In a way, that is what Europe is about today. Our common hope is that when we speak about the economy, not only in Bucharest but in the European Union, divergence is reduced so that further troubles should not arise.

Dear guests, Eurofi has proven over the years that it is the perfect environment for discussing ideas that address the European agenda and has become an important platform for exchanging views and for networking between public institutions and financial industry in the EU. There are many topics on the agenda that need to be addressed, starting with Brexit and continuing with the need for deepening the capital markets union and the Banking Union, and, furthermore, reaching final agreement on InvestEU, a programme that will boost public and private investment across Europe in the next multiannual financial framework.

The European Union in 2019 is not just the year of Brexit uncertainty; it is also the year of elections for the new European Parliament, a new Commission and a choice for a new President of the European Central Bank. Also, a new multiannual financial framework, a seven-year budget plan for 2021 to 2027 has to be decided upon. The European Union is at a time when the economic growth has been solid for a few years, employment is stable and public finances have improved across the region. Also, some countries are still struggling with high levels of public debt. However, there are challenges lying ahead as the European Commission, in its European Semester Winter Package, considers that there is a need to promote investment, some fiscal policies and implement well-designed reforms.

Furthermore, in my opinion, we need to implement unitary reforms regarding investments, and we need to promote equal rules for all stakeholders in the European market, and to be prepared to support new mechanisms for investments in the member states. Cohesion is the core value of the Romanian presidency, and I advocate that all discussions regarding further deepening of the economic and monetary union should involve all member states, and that we have to look for solutions that are not only for the eurozone but are also for the member states that are not using the single currency.

Reducing the gaps between member states and enhancing access to finance will make companies across the EU even stronger when competing with companies from the United States and China. A recent Bruegel study shows that among all top-20 technology firms, none are from the EU, while 11 are from the US and nine are from China. That is why we have to finalise the Banking Union, to integrate and connect the European financial centres. In order to provide better access to funding across the EU, in order to compete successfully in the global market, EU companies need to be innovative and cost-efficient. On top of all these measures, we will have to make sure that the fiscal policy is effective, fair and transparent. A new challenge has arisen as we face the erosion of confidence in the independent and accountable public institutions, and we are also witnessing growing challenges related to fake news and negative campaigns.

All this is to be discussed about, but please do not panic. I took into consideration your last vote for a short speech during the Eurofi dinner. I would like to warmly thank David Wright, Didier Cahen, Marc Truchet and Jean-Marie Andrès for organising such an important event for all of us and for shaping our future roadmap. I thank all of you for coming and supporting Eurofi. Have a nice evening and enjoy your stay in Bucharest. Thank you. ■

# Mugur Isărescu

Governor, National Bank of Romania

## Is European financial integration stalling?

Distinguished audience,

Ladies and gentlemen,

First and foremost, a very warm welcome to Romania, which, for the first time since joining the EU, holds the rotating Presidency of the EU Council. In particular, let me welcome you to Bucharest, a highly vibrant, up-and-coming European capital. Please allow me to thank Eurofi for organising this

landmark event here, in Bucharest, as well as for giving me the opportunity to share with you today's opening remarks – it is both a great privilege and a great personal satisfaction.

This highly distinguished financial policy forum is a perfect occasion for exchanging views and liaising with representatives of public authorities and of the financial industry across the European Union, as well as with participants from the non-financial corporate-sector. We are very honoured to meet so many outstanding guests and attend discussions on a wide range of relevant topics.

These discussions aim to help us all sail on rough seas, a journey that can only be made through candid and thorough dialogue until we reach common ground and the best possible solutions. Knowing that our mission is to foster sustainable growth and safeguard financial stability, our interaction is meant to build bridges and shed new light on possible ways to handle the great challenges that lie ahead of us.

A great variety of topics – from Brexit and systemic challenges to the priorities of the upcoming European Commission – will be tackled during this seminar, at a time when Europe needs a viable long-term common vision. I assume we all agree that healthy financial integration is a topical issue, critical for both the soundness of the financial system and the sustainability of economic growth in Europe. This is true because financial integration is an essential driver for enhancing competitiveness and allocating capital across Europe. Moreover, it fosters a smooth and balanced monetary policy transmission throughout the euro-area, being key for underpinning the EU's Single Market. Space for improvement certainly exists and countries, especially those with an emerging capital market, could significantly benefit from deeper financial integration in the EU.

If the appropriate level of banking sector integration is difficult to assess, what is indisputable, in my opinion, is that pre-crisis levels may not be proper benchmarks, for negative spillovers propagated at a fast pace. Having said this, a collective deposit insurance scheme and a much stronger Resolution Fund are a must for the Banking Union, paving the way for a sustainable financial integration. In addition, the introduction of instruments that can help Member States deal with asymmetric shocks is also needed to improve risk-sharing among them. Moreover, I cannot imagine a realistic scenario in which the institutional risk-sharing set-up required for strengthening the Banking Union and breaking up the sovereign-banking system doom loop comes into existence in the absence of a firm commitment to fiscal discipline.

In the aftermath of the crisis, a fragmentation of EU banking markets along national borders has taken place. It was the consequence of risk mispricing during the boom: fragmentation has increased simply because market participants were not aware of or ignored that the institutional architecture of the Economic and Monetary Union was incomplete. The lacking institutional pieces could no longer be left aside after the crisis. Completing the Economic and Monetary Union, which involves risk-sharing tools and risk-reduction efforts, is the way forward to address financial fragmentation.

As for its consequences, they concern mainly the transmission mechanism of the ECB's monetary policy. Financial fragmentation hampers the functioning of the standard interest rate channel. While financial fragmentation has been mitigated as a result of broad-based non-standard policy measures taken by the ECB, there are limits to unorthodox policies and monetary policy will eventually need to be normalised. Having in place an institutional set-up that also relies on risk-sharing is a prerequisite for a well-functioning Economic and Monetary Union and an effective monetary policy.

A few years before the global crisis broke out, Andrew Crockett, former General Manager of the BIS, emphasised the important role of financial stability, distinct but complementary to price stability. The aftermath of the crisis has shown us that crisis management and resolution is also a public good, correlated with, but independent from, price and financial stability. The reforms of the regulation and supervision of the financial industry have taken us in the right direction, making our banks and the overall system safer. The European banking sector has reduced non-performing loans through balance sheet clean-up measures and is now better capitalised. But due heed should be paid to systemic risks in non-bank financial markets.

Fostering sustainable finance and using new technologies to improve the functioning and efficacy of the financial sector are currently important challenges to financial integration. Moreover, the challenge of Brexit, a major discussion topic at this seminar, may lead to a form of disconnection, with major disruptions, in a Europe striving for deeper integration. Of course, Brexit entails high uncertainty, shaking the foundations of planned investment, future trade and free movement of labour. It would also occur at a time of economic slowdown all over Europe, an erosion of multilateralism and a broadening of trade disputes. However, I am confident that we will be able to find the right way towards an EU financial and economic configuration that is compatible with a strong and resilient Europe.

Irrespective of when and how the odyssey of Brexit ends, the future will always look uncertain. What we can and must do is to try to be better prepared for it. An important part of this preparation is to discuss all the relevant issues related to the financial and economic integration in Europe and to assess carefully its challenges and prospects. We all have to stay open-minded and to keep close contact with the shifting economic reality in order to be able to articulate and implement effective policies.

Let me conclude by recalling the words of Jean Monnet, one of the founding fathers of the EU project, who thought that "Europe will be forged in crises, and will be the sum of the solutions adopted for those crises".

I would like to wish every success to this High Level Seminar. I look forward to thought-provoking insights instrumental for finding wise solutions for our common future.

Thank you for your attention and I hope that, at the end of the seminar, you will have plenty of reasons to consider these days well spent. ■

# Mahmood Pradhan

Deputy Director, European Department,
International Monetary Fund

## EU financial integration

Thank you very much Didier, for your kind introduction and good morning to everyone. Let me start by thanking the organisers, especially Didier Cahen, David Wright, Marc Truchet and Jean- Marie Andrès, for very kindly inviting me again to speak here. It is always an honour. And thank you Governor Isarescu for your hospitality. This is my first time in Bucharest, for which I apologise, but I am enjoying it immensely.

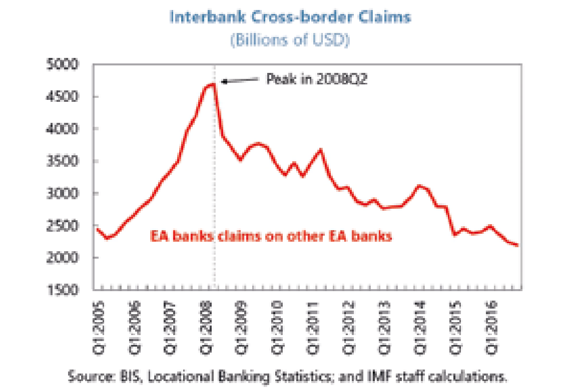
It is always a pleasure to attend this event because it gathers so many experts from this industry. I know that I can say for myself I always learn a great deal. My remarks today on financial integration in Europe will focus on a brief overview of where we are now. I am fortunate in that I can take a summary snapshot because, as you know from the programme for the next three days, there are many sessions devoted to specific aspects of this subject, and I am sure you will benefit more from listening to the experts.

Before I get into the subject of extent of financial integration, let me say a few words about why we all should care about this. I would highlight two motivations. Financial integration would promote private risk-sharing in the EU – that is familiar – and especially in the euro-area through financial markets. Conceptually, risk-sharing in this context means spreading across countries the impact of shocks, particularly the costs of asymmetric negative shocks. In practice, as you know, risk-sharing can occur through a number of channels, including cross-border fiscal transfers - the public risk-sharing channel – the income from cross-border investments and labour, and credit markets. I will, of course, not cover all these other channels this morning, particularly public risk-sharing, but it is something on which the IMF has put forward a very detailed proposal – what we have called "Central Fiscal Capacity".

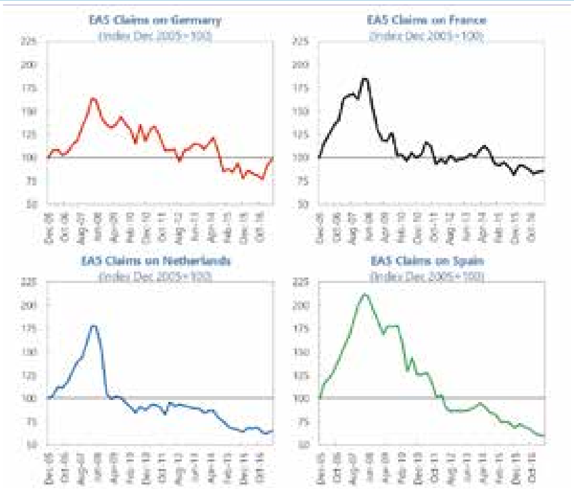
The second motivation – and equally important, in my view – is that financial integration is necessary for an integrated capital market to promote a more even cost of credit across Europe and across the euro-area, and to reduce fragmentation. This is important to encourage real economic convergence, and I will come back to this later.

With that as a brief introduction, let me turn to where we are with respect to financial integration, and I would like to start with showing you some slides – I promise there will not be too many – starting with banks. One concern is that crossborder interbank claims between euro-area banks are now back to their pre-2005 levels, and this retrenchment is not entirely driven by banks from northern euro-area countries pulling back from exposures to southern euro-area countries. That was a characteristic of the crisis a few years ago.

**Graph 1.** Private risk-sharing through banks back to pre crisis levels



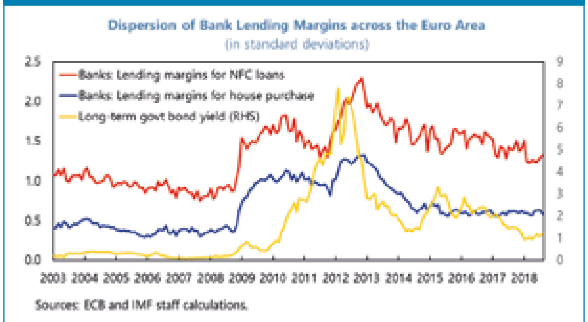

**Graph 2.** Cross-border banking: Pervasive decline



These figures illustrate the crossborder claims of euro-area banks from Germany, France, Spain and the Netherlands on banks in each of the respective countries. This has meant a substantial unwinding of financial integration in the euro-area, and it reflects an increased fragmentation in the euro-area banking market since the crisis. Unfortunately, it is also indicative of pressure from national supervisors for a greater ringfencing of banks' capital and liquidity, perhaps understandable when the costs of bank failure remain largely national.

Let me show you further evidence of increased banking-market fragmentation in the euro-area. This indicates a higher dispersion of lending margins – the difference between a bank's lending rate and its cost of funding – again for banks across euro-area countries. The red line shows the dispersions in margins for lending to non-financial corporates, and the blue line the similar dispersion in the margin for lending for house purchases. For comparison, I have also included the dispersion in sovereign yields – the yellow line on the right-hand axis.

**Graph 3.** Fragmentation: higher dispersions in bank lending margins since the crisis



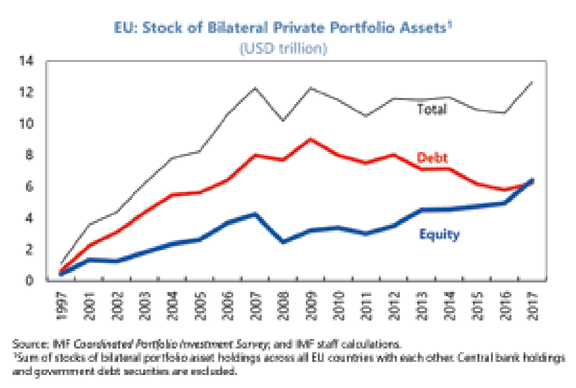

The dispersion in lending margins has declined since the euro-area turmoil, suggesting some success on the part of euro-area countries and the ECB especially, to counter the sharp increases in financial fragmentation. However, we can also see that it remains significantly higher than it was pre crisis. Some of this increase in the dispersion in lending margins may be driven by increased risk in some countries, but the pullback in crossborder claims between euro-area banks suggests that there may also be less competition and greater inefficiencies that contribute to this dispersion.

The policy implications stemming from this are familiar to all of you. Completing the Banking Union is critical. That means a common backstop for the Single Resolution Fund, a common European Deposit Insurance Scheme, which Governor Isarescu has already referred to this morning, and the strengthening of the Single Supervisory Mechanism in order to reduce national discretions.

It is not, however, all bad news. Fortunately, compared with debt securities, crossborder holdings of equity investments have increased following a brief dip during the crisis. This is particularly encouraging for the underlying prospects of more private risk-sharing when we think of the EU's plan for a capital markets union. I know that this is one of the topics that will be discussed in more detail in later sessions. Much.

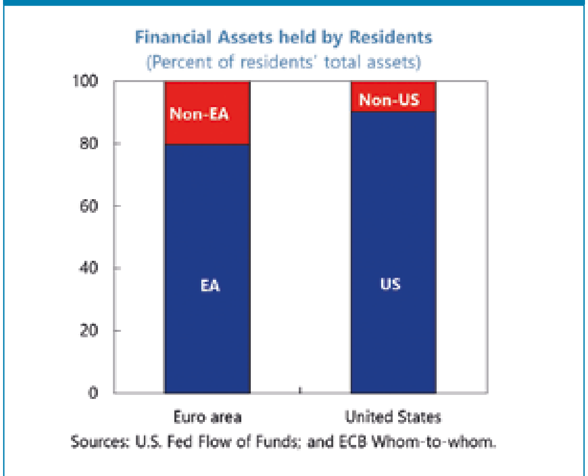
Now let me turn to a snapshot of crossborder asset holdings, where home bias and a predominance of bank liabilities are still pervasive. When comparing the euro-area to the US, the overall extent of home bias appears similar. Like the US, euro-area residents – here including all households, governments and financial institutions

**Graph 4.** Private risk-sharing through equity markets has recovered

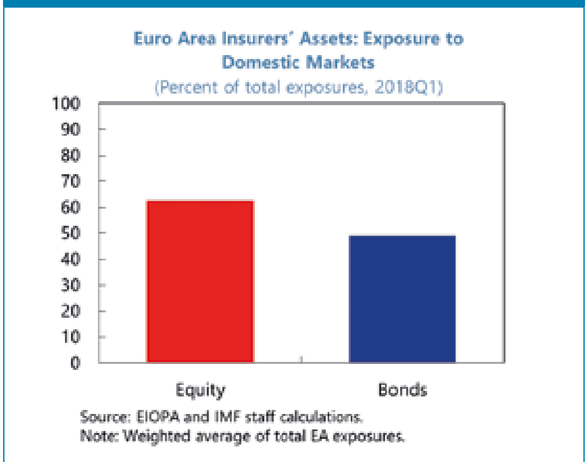



– hold most of their financial assets within the region. However, within the euro-area, there is a pervasive home bias even among professional investors such as insurance companies and pension funds.

**Graph 5.** EA residents mostly invest in euro-area (similar to US)



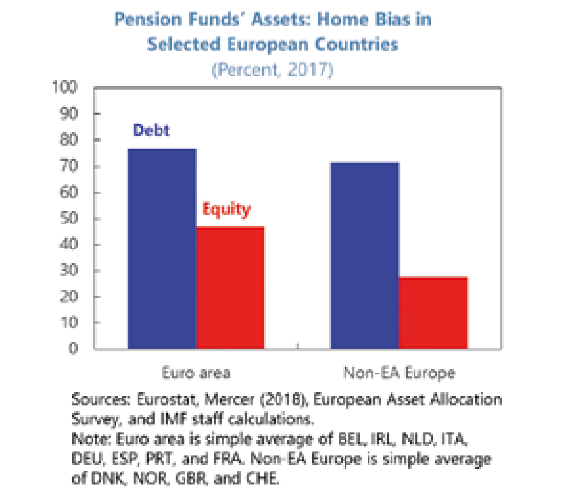

**Graph 6.** Pervasive home bias within the EA, even for sophisticated investors




This figure here illustrates the weighted average across euro-area countries of insurance companies' asset exposure to their domestic markets. For equities, the share is over 60%, whilst for bonds it is around half. I will not go into the detail of the home bias, because I am not showing it here. It is slightly smaller for smaller countries, because their markets are smaller.

Let me turn to a similar picture for asset holdings of pension funds. On average, pension funds in euro-area countries exhibit significant home bias and more than those in non-euro-area EU countries. For pension funds, the share of their domestic exposure in their debt assets is over 75% for euro-area countries and around 70% for a small sample of non-euro-area EU countries. Home bias in equities, at around 50%, is lower for euro-area-country pension funds than in debt securities. The difference with pension funds for non-euro-area European countries is even more striking, where it is closer to about 25% on average.

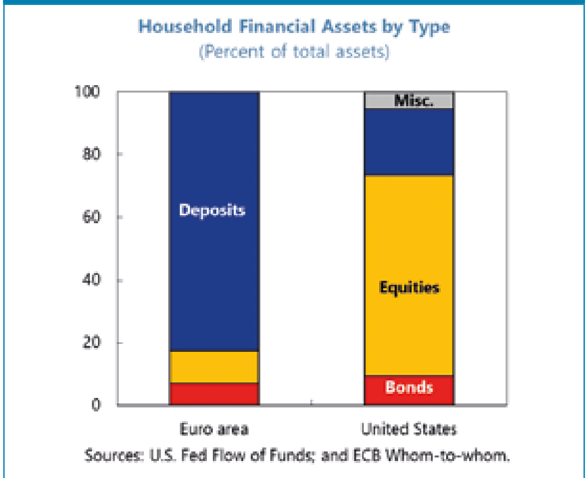
**Graph 7.** EA pension funds' home bias more than non-EA European funds




Sources: Eurostat, Mercer (2018), European Asset Allocation Survey, and IMF staff calculations.
Note: Euro area is simple average of BEL, IRL, NLD, ITA, DEU, ESP, PRT, and FRA. Non-EA Europe is simple average of DNK, NOR, GBR, and CHE.

Finally, turning to household balance sheets, this picture of asset holdings is particularly relevant for the discussion of a capital markets union. We once again compare them to the US, where we observe some very obvious differences. Euro-area households' assets are very much skewed towards deposits, comprising over 80% of their assets, compared to around 20% in the US. The much greater share of assets devoted to equities in the US arguably provides for a much greater degree of risk-sharing.

**Graph 8.** Household balance sheets in EA are overly skewed toward deposits




Sources: U.S. Fed Flow of Funds; and ECB Whom-to-whom.

With that as a brief snapshot of where we are, let me offer some concluding remarks and summaries. We see too little crossborder investment by households and firms in the euro-area, which implies fewer crossborder income sources to help smooth country-specific shocks. Even professional investors such as banks, insurance companies and pension funds are far too concentrated domestically. This means they are more exposed to domestic shocks – and here we are reminded of the sovereign-bank link mentioned this morning – and they are not instrumental in providing crossborder funding to firms. On some dimensions, financial integration does appear to have stalled, but there are some encouraging signs that crossborder equity investment is gradually increasing.

As my final remark, let me emphasise that the EU Single Market in goods and services has been instrumental in increasing economic integration in Europe and promoting economic convergence. In my view, the ambition to obtain financial integration should be similar. Financial integration can promote economic convergence by not only increasing resilience to idiosyncratic and country-specific shocks but, even more important, by reducing the divergence in the costs of borrowing for households and firms.

I want to conclude here. Didier, you might be pleased that, coming from the IMF, I did not mention structural reforms even once! But let us not forget that even in a fully integrated, frictionless EU capital market, capital will only flow to countries that offer attractive returns. This reinforces the need for real sectors to be competitive. Thank you very much. ■

# Valdis Dombrovskis

Vice-President for the Euro and Social Dialogue, also in charge of Financial Stability, Financial Services and Capital Markets Union, European Commission

## EU financial integration: where do we stand?

Ladies and Gentlemen,

It is a pleasure to be here in Bucharest – thank you to Eurofi for inviting me once again. Or as they say in Romanian: Multumesc!

I also want to say multumesc to Romania for their skilful Presidency of the EU Council since the beginning of the year. In its first 12 weeks, the Romanian presidency closed an impressive 60 legislative files and reached provisional deals on 12 more. So congratulations to them for this success!

Today I want to focus on how we can help Europe's financial sector respond to the opportunities and challenges of the future.

But before that, I need to spend a moment on present risks, on Brexit. Recent developments have increased the chance of a no deal. Next Wednesday, European leaders will meet again to assess the situation. Since early on, we have called on the financial sector to prepare for all scenarios, and I call on you to complete preparations urgently in the coming days and weeks.

On our side, the Commission has acted to address financial stability risks, with temporary equivalence decisions for UK central counterparties and central security depositaries. Member States are also taking measures in areas of national competence, and we have provided them with clear guiding principles for action.

But it is also clear that we cannot mitigate all the economic impacts of Brexit.

This makes it all the more important to focus on shaping the future of the EU's financial sector. In Europe, capital markets are clearly less developed than they are in similar economies, like the US.

I am happy that on the Capital Markets Union we have managed to reach agreement on 11 out of 13 proposals put forward during this mandate. That is 11 concrete steps towards a single market for capital that can deliver real benefits for Europe's citizens, companies, and for our economy. I count on the next European Commission to continue to champion this project.

Now it is up to you – market players - to make best use of these new opportunities. I count on Europe's many capital market companies to develop attractive products, based on our new frameworks for securitisation, covered bonds, or personal pensions.

And I count on our authorities to make active use of the new tools for supervisory convergence. Even though we would have hoped for more ambition, Emir 2.2 and the review of the European Supervisory Authorities are positive steps. Because it is not enough to have a single rulebook, if the rules are not applied in a similar way in all Member States.

Capital markets also have a vital role to play in the transition to a climate-neutral economy. So I hope for many new activities based on our recent deals: on EU low-carbon benchmarks, and on investment managers disclosures how they factor in sustainability.

Now, Member States need to make progress on our proposal for a sustainable finance taxonomy. This is about giving climate-conscious investors clarity on where to direct their money. And it is about unleashing the many business opportunities offered by the transition to a climate neutral economy.

I will make full use of the remaining months of my mandate to move this agenda forward. In June, our technical expert group will publish a report that includes climate-related disclosures for companies, and EU green bonds standards, amongst other things. Our experts are also working on an EU label for green financial products.

In the future, I see three challenges for our work on Europe's capital markets union:

- First, the EU needs to strengthen its capacities in terms of funding sources for companies, market infrastructure, and financial market supervision.
- Second, we need to keep boosting local and regional capital markets in all parts of the EU. Here in Romania, my services are helping to strengthen the supervision of capital markets. Actually today I had a meeting with Bucharest Stock Exchange to discuss how exactly European Commission can support the local capital markets in Romania. As another example, they are helping Estonia, Latvia and Lithuania to establish a pan-Baltic capital market.
- And third, a well-developed Capital Markets Union needs to be closely integrated with global capital markets, while protecting financial stability in the EU.

To prepare for the future, we should also keep strengthening Europe's banking system.

We have made good progress to reduce risks and strengthen its resilience, most recently with the banking package. Thanks to a number of reforms, banks are better capitalised, less leveraged, and overall better prepared to withstand economic shocks.

Before any decisions on further regulatory change, including on the completion of Basel III, we have to consider the impact in detail. And we will have to look closely at what our international partners are doing.

The average level of non-performing loans in the EU is down to 3.3% as of the third quarter of last year, but progress is uneven. We now have a political agreement on a legislation to prevent the build-up of non-performing loans in the future, so called prudential backstop. So I hope that the Council and the new European Parliament can finish what we started, and move forward on secondary markets for NPLs and accelerated collateral enforcement.

On the risk-sharing side, we reached an agreement on setting up a common backstop to the Single Resolution Fund, which is currently being implemented. But on the European Deposit Insurance Scheme, progress has been slow - both in the Council and the Parliament. And progress has been equally limited when it comes to allowing banks to integrate further across borders.

To get there, we need to create confidence that shared risks are well managed and controlled, and confidence that financial stability in each and every Member State will be protected as banking markets become more integrated.

Ladies and gentlemen,

Banking Union is certainly not the only trend shaping Europe's financial sector.

Already today, technological progress is probably the most transformative trend. Millions of Europeans contact their bank mainly via their mobile phones, and use the services of companies like N26, Klarna, or Transferwise to perform financial transactions. With new technologies like artificial intelligence, cloud computing, and blockchain, the pace of change will accelerate.

For Europe to seize these opportunities, our first task is to allow innovative solutions to scale up across the single market. And we need to help companies – new and old - to innovate, while protecting consumers and safeguarding financial stability.

One example is our crowdfunding proposal, which the Parliament recently adopted. Once agreed by both co-legislators, this would allow crowdfunding platforms to operate across the EU based on a single license.

Supervisors and innovators should also work more closely together. Already, Europe has 21 innovation hubs and 5 regulatory sandboxes. Just this week, I helped to launch a European Forum for Innovation Facilitators, for supervisors to learn from each other, work together, and reach common views on these topics.

Big changes are also on their way in the payments sector.

Thanks to the revised Payment Services Directive and the General Data Protection Regulation, control over payment and account data is given to each account holder. This creates new opportunities for innovative payment and account information services. We must continue work in this area, to create a level playing field among banks, Bigtechs, and new players.

Europe must act together on these topics. In China, instant payment solutions reaching more than a billion consumers are already reality. With the Single European Payments Area, the EU has made transactions in Euro across borders as cheap and simple as domestic ones. And we have recently agreed to extend this to transactions in euro to and from all EU countries.

Now we must work with industry and stakeholders to scale up instant payments to the European level, reaching almost 500 million consumers. The necessary infrastructure already exists, so the main challenge now is for banks and merchants to take up the new schemes.

Another area for Europe to move on with a joint approach are crypto assets.

Despite the risks, crypto-assets still hold potential, for example as a funding source for start-ups. Between January 2017 and January 2019, the capital raised through initial coin offerings and private tokens amounted to 24 billion euro globally.

We have to make sure that our financial sector rules do not inadvertently hinder this type of useful innovation. And this starts with legal certainty. The European Supervisory Authorities have mapped rules across Member States: some crypto-assets fall under existing law, but most of them, including Bitcoin, do not. This leaves consumers exposed to substantial risks, and to fragmented national rules across the single market.

I have therefore asked my services to prepare the ground for actions by the new Commission: for crypto-assets that are covered by EU rules, we will review our legislation to make sure that it is fit for purpose and can effectively be applied to this type of assets. For crypto-assets that are not covered, we have launched a feasibility study on a possible common regulatory approach at EU level.

Ladies and Gentlemen,

Let me close on a broader note. A few months ahead of the European elections it is time to look at what Europe is delivering for citizens and businesses. Over the past years in the EU, we have managed to find joint responses to the key challenges in the financial sector. This is in spite of the challenging environment for cross-border cooperation.

I would like to thank you for your support. And let's continue to look ahead, ask the questions of tomorrow, and find answers together.

Thank you. ■

# François Villeroy de Galhau

Governor, Banque de France

## Opportunities for developing EU autonomy in the financial area post-Brexit

Ladies and Gentlemen,

It is a pleasure to be in Bucharest today to conclude this Eurofi High Level Seminar. I am grateful to D. Wright and D. Cahen for offering me the opportunity to give this keynote speech... but perhaps less grateful about the theme they asked me to address: "Opportunities for developing EU autonomy in the financial area post-Brexit". We are still faced with great uncertainties, and Brexit is and remains bad news, not only for the United Kingdom, but also for Europe. This unchartered territory has nevertheless the merit of making one thing very clear: it costs dearly to leave the single market. So we are still hoping for the best, but we have to prepare for the worst: a no-deal Brexit and all the risks it implies. This will be my first point today. Then, your theme obliges us to look ahead, beyond Brexit: Europeans should use the demands created by the current context to build a more integrated "financial Eurosystem", and add some pillars to Europe's financial sovereignty.

**I. Preparing for the risks**

It has been – first and foremost – the responsibility of the financial industry itself to prepare for the consequences of Brexit, starting with the loss of EU passporting rights. Supervisors both at national and European levels have encouraged and monitored the implementation of contingency plans. Up until now, most major players have taken the necessary steps, but some concerns linger regarding the preparedness level of the smaller players, particularly electronic money and payment institutions. On the other hand, public measures have been taken to deal with the specific risks of a no-deal Brexit that could threaten financial stability or consumer protection. The temporary and conditional recognition of British CCPs should prevent cliff-edge effects, as well as temporary waivers on mandatory clearing and bilateral margin exchange for a limited category of products. Member states have also adapted their domestic regulations or are planning to do so. In France, legislation has been enacted ensuring contract continuity for cross-border activities and an extended access to UK settlement systems.

**II. Building a financial Eurosystem**

Let me now turn to the heart of my topic. The unfortunate reality is that Brexit leaves us no other choice: we must now reshape the European financial system and develop its autonomy. The euro-area can already build on strong assets: an effective monetary Eurosystem, the legal framework for a single financial market and essential components of a Banking Union. However we do not, as yet, have a "financial Eurosystem", made up of stronger pan-European financial institutions and market infrastructure. Let's be clear: there will not be a single City for the continent, but rather an integrated polycentric network of financial centres, with specialisations based on areas of expertise. A polycentric system of this nature can function, as illustrated by the United States: New York's financial centre is favoured by corporate and investment banks, Chicago's financial centre handles futures, while Boston specialises in asset management.

Starting with the Banking Union, its success depends on the completion of a robust resolution mechanism, probably even more than a full common deposit insurance scheme. Regarding the backstop of the Single Resolution Fund, in the interests of financial stability, we should consider extending the maturities on the credit lines. But we will not achieve an effective and profitable Banking Union without cross-border consolidation in Europe: there are still too many roadblocks and not enough cross-border restructuring. Compared to the US market, the European banking sector remains fragmented: the market share of the top 5 European banks amounts to 20%, compared to more than 40% in the US. So we should aim to create a "single banking market", as recently proposed by Annegret Kramp-Karrenbauer, where genuine pan-European banking groups could operate more effectively and better face foreign competition. On top of that, banking integration makes banks more resilient as it reduces their exposure to asymmetric shocks which leads to enhanced risk-sharing and a better allocation of resources. A useful step towards forming genuine pan-European banking groups could be to lower capital requirements of European subsidiaries, while safeguarding their financial position through credible cross-border guarantees provided by the parent company, which could be triggered both in normal times and in crisis situations. This would be based on European Union law and enforced by European Union authorities.

I add the obvious, on bank regulation: it is now desirable that we stabilise visibility on total capital requirements, adding up from various origins. The smooth transposition of Basel 3 is part of this clarification, including the implementation of the output floor only at consolidated level within the European Union: if not, we will have introduced a new obstacle to cross-border activities within Europe.

Together with the Banking Union, a genuine Capital Markets Union (CMU) is essential to strengthening financial integration in Europe: we advocated it strongly with Jens Weidmann, President of the Bundesbank, in a joint paper published yesterday, and it will be a key topic of today's informal Ecofin, thanks to the Romanian Presidency. Despite some recent achievements, progress on this topic is proving difficult and slow. Let us finally move on from a rhetorical consensus in principle to concrete headways, notably on instruments, access to finance for SMEs, and supervision.

In this respect, I welcome the progress achieved on a Pan-European Personal Pension Product (PEPP): this product is portable across member states and offers consumers a wider range of investment opportunities. We should also make progress towards the harmonisation of insolvency regimes. It should facilitate cross-border investment.

One of the most challenging issues of the CMU is to provide cheaper and easier access to equity for SMEs in order to support their growth. Equity financing is a key driver of innovation: it is better suited to the uncertainty and offers long-term returns associated with innovative projects. The euro-area is seriously lagging behind in this respect: equity only accounts for 80% of GDP, compared with 122% in the United States.

Integrated capital markets also require effective supervision. Here again, milestones have been reached thanks to the outcome of the recent review of ESAs towards enhancing their role. Concerning the supervision of financial markets, ESMA will as a first step contribute to furthering convergence of supervisory practices. Yet in the longer run, the scope of its direct supervisory powers should be expanded starting with the supervision of wholesale markets. Regarding the insurance sector, a particular attention was paid to strengthening the supervision of cross-border activities through EIOPA. I welcome also the enhanced EBA role on AML-CFT issues, an area where progress in the European framework is absolutely needed.

Finally, the Capital Markets Union needs robust market infrastructure. Thanks to EMIR II, Europe has given itself powers – via ESMA – to directly supervise third-country CCPs which have a systemic footprint vis-à-vis the EU. This being said, EMIR II is not the end of our journey. Much more needs to be done regarding either the role of the ECB or ESMA's prerogatives over EU CCPs.

Both the Banking Union and the Capital Markets Union are the key components of what we call with Jens Weidmann a genuine "Financing Union for Investment and Innovation": this idea is a way of better channeling our abundant resources – our EUR 340 billion savings surplus in 2018 – towards the concrete needs of the European economy: the energy transition, SMEs' equity or digital innovation. This unified branding has the merit of highlighting the purposes of this Union to the general public: investment and innovation, or in other words the financing of the future.

**III. Some pillars of a European financial sovereignty**

In the longer run, we should build three key pillars of the future European financial sovereignty. First of all, the EU needs to strengthen its position as rule maker through enhanced equivalence regimes. Brexit has given new momentum to this topic: a comprehensive reassessment of current equivalence regimes is essential given the scope of the relationships between the EU and the UK. Beyond the issue of Brexit, the review of equivalence regimes also provides an opportunity to improve them. There is a need for greater transparency in the procedure for granting equivalences, within a comprehensive institutional framework. The monitoring and control of equivalence decisions could also be improved by granting more power to ESAs, and by providing the European Commission with more gradual options through flexible tools in the case of regulatory divergence: for example, temporary, partial or conditional lifting of equivalences.

The second pillar of European financial sovereignty concerns the efficiency of retail payments and market infrastructure. Regarding retail payments, while the Single Euro Payments Area (SEPA) has proved to be successful, further convergence is still needed in response to the growing influence of major third countries' firms in payments solutions. In order to preserve our sovereignty, a European strategy for retail payments would be necessary, with a view to (i) addressing market fragmentation and promoting unified European-based solutions, (ii) improving the protection of payment data and (iii) encouraging European players to take part in the current concentration in retail payments. Regarding infrastructure, the European System of Central Banks shouldered its responsibilities in strengthening European post-trade integration, notably through the Target2Securities platform. In the coming years, the set-up of a unified collateral management platform operated by the Eurosystem will be another key step directly contributing to an effective Capital Markets Union.

Moving on to the third pillar, the international role of the euro is a key component of our European financial sovereignty. After a significant rise, the international use of the euro has declined since the financial crises of 2008-2012 and remains limited in comparison with the dollar. The US dollar is a clear advantage in the exercise of American power, while China cares about the internationalisation of the renminbi. A larger use of the euro would help to protect our businesses against foreign exchange risks or legal disputes abroad. In this regard, the concrete measures identified by the European Commission in December are particularly relevant. The development of fully unified European instant payment systems, integrated capital markets, and the possible creation of a safe euro-denominated asset should among others contribute to the international expansion of the euro.

At this critical time, let me conclude with verses from Othello: "To mourn a mischief that is past and gone is the next way to draw new mischief on". In modern English it means: "when you lament something bad that's already happened, you're setting yourself up for more bad news." Making the best of such a misfortune as Brexit is the surest way to overcome it. Our collective response to Brexit should be the further integration of Europe: if we remained mired in technical nit-picking with self-satisfaction in some quarters and attacks from others, and distrust on all sides, we would not only have missed an opportunity, we would, collectively, have failed in our duty. Thank you for your attention. ■

# Bruce Thompson

Vice Chairman, Bank of America

## The implications of Brexit for EU financial firms

**1. Preparedness for a possible no-deal Brexit in the financial services industry**

Regarding the level of preparedness of Bank of America for Brexit, Bruce Thompson noted that the bank's initial Brexit strategy had assumed a hard Brexit. It has set up a European bank through merging what used to be its UK bank with its Irish bank. This process, undertaken in connection with the Central Bank of Ireland and the SSM, has gone well and in a timely manner. The merger concluded on 1 December 2018. Since that date all of its traditional banking services and some corporate derivatives activities have been set up in this new entity and are functioning the way they will post-Brexit.

Bank of America's EU investment firm was licensed in Q4 2018; after some tests, client activity started in Paris in March 2019. Roughly two thirds of the EU-based clients with which Bank of America had activity in the UK have been onboarded onto the new EU investment firm and are now available to start trading.

Generally speaking Bruce Thompson felt that the financial services industry is currently well prepared for Brexit, although the structures differ across companies and some players may have moved less people to new entities than Bank of America. A series of regulatory changes have been made to address the potential issues created by a hard Brexit. There are however some remaining uncertainties and concerns such as the implications of a hard Brexit scenario for the movement of goods and the potential impacts on the real economy.

**2. Implications of Brexit for clients**

Bruce Thompson explained that the re-papering of clients is a major issue as it is essential for investment firms to be able to continue servicing them. Up until the end of February the re-papering had gone slower than Bank of America might have hoped. However, in the last 30 to 45 days the re papering activity has dramatically increased; more than 50% of Bank of America's EU investment firm clients have now completed with timelines in place for others. Some clients are still hesitant to switch over to the new European entity until they have had confirmation that Brexit will actually happen. It is likely that most affected banks are in a position to put in place the incremental resources that would be needed to accelerate the process if a hard Brexit is confirmed.

One of the biggest impacts of Brexit for banks is the human impact, which Bank of America has managed well. This issue is often overshadowed in Brexit discussions by more technical questions such as contract continuity or CCP supervision, but it is essential. Preparing for a hard Brexit implies making changes to the structure of the company and the location of business, which in many cases involves movements of people. These changes can be anticipated and the employees potentially concerned can be informed but they are dependent to a certain extent on the final Brexit scenario and the possibility of a transition period.

The proper management of this reorganisation has been enormously costly for the bank, given that the amount of business and the customer base are unchanged. There has therefore been a net increase in the cost base. Within Bank of America's European bank roughly 100 people have been moved, 75 80 of those into Ireland, and 20 25 into continental Europe. More than 100 people have also been moved to Paris. This set up will be fine tuned as there is more clarity on the final outcome of Brexit. The cost of building the technology infrastructure needed to be Brexit ready is also very high, contributing to total estimated Brexit costs of around $400 million.

**3. Prospects of back-to-back trading arrangements**

David Wright mentioned that the topic of back-to-back dealing often comes up in Brexit-related discussions with regulators, with examples such as a company trading in its continental subsidiary but passing the risk to London.

Bruce Thompson stated that Bank of America has operated under the assumption that it wants to have real substance and risk management in the new entities that have been set up in the EU27. Over the last five years it has tried to simplify the structure of its operation and eliminate as much back-to-back activity as possible. In the short-term it is likely there will be some back-to-back trading to help facilitate a transition, but as a company it is doing everything possible to be able to book and manage risks within the individual legal entities.

**4. Potential impacts of a hard Brexit on business and financial markets in the EU and the UK**

Asked by David Wright to comment on the potential impacts of a hard Brexit on the EU and UK economies and financial markets, Bruce Thompson felt that such a scenario would inevitably lead to some disruption and change. Although different assumptions have been made about Brexit, companies have generally been preparing themselves. For example, some car companies have taken actions to adjust their manufacturing plants. However, it would be naïve to assume that there will be no supply chain disruptions in particular.

It is likely that the impact of a hard Brexit on the UK economy would be stronger than on any individual EU country. In the EU most countries have no more than 5-10% of their activity with the UK, which is a relatively small percentage, whereas the UK is more exposed to the EU as a whole.

Concerning the impact of a hard Brexit on the UK financial industry and taking the example of Bank of America, in Europe today 85-90% of the bank's activity and people are in the UK. The amount of business within the investment bank part that will be moved out of its broker-dealer in the UK would be between 20-25%, so London will still be the main basis in Europe for the company, and in all likelihood that is the same situation throughout the financial industry. It is nevertheless expected that the activities and infrastructure provided out of the new EU27 entities will grow over time as a result of Brexit.

David Wright wondered whether Brexit would damage the reputation of Europe and its financial markets and if this could potentially advantage other regions. Bruce Thompson stated that Brexit does not change the importance of Europe for Bank of America. There is a great deal of political variability around the world, it needs to be managed and Brexit is an example of that. But the bank needs to continue providing its customers with the services and products they need in the countries where they operate. As its clients are global clients they expect Bank of America to be able to transact for them throughout the globe. Brexit implications might be managed differently by certain regional financial institutions, but a large global financial firm needs to be wherever services are required by its clients. Europe is still one of the places that very much needs financial services, Bank of America is very committed to supporting its clients in the region; it would not have spent the time and devoted the resources it did to make sure clients operating in Europe can be serviced seamlessly post-Brexit if this was not the case. ■

# J. Christopher Giancarlo

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

## Developing EU-US regulatory and supervisory cooperation in capital markets

Good afternoon. It is my great pleasure to be here again at Eurofi. I wish to thank David Wright, Didier Cahen and Marc Truchet for organizing once again a great conference.

I also wish to express my deep appreciation to the Romanian Presidency of the European Union, the Prime Minister, the Minister of Public Finance, and the Board of the National Bank of Romania for inviting all of us to Bucharest.

Being here in Bucharest, it seems fitting to begin my remarks by recalling the great wit of Romanian writer Ion Luca Cariagiale, who joked:

***"Opinions are free, but not mandatory."***

Since I am here in what is most likely my last appearance at Eurofi as Chairman of the U.S. Commodity Futures Trading Commission, I hope you will forgive me if I put forth a few free opinions. Of course, they are not mandatory!

I understand that Ion Luca Cariagiale also said:

***"Do you want to get to know things? Look at them closely. Do you want to like them? Look at them from afar."***

If you will permit me, I would like to use my time to look both from near and afar at EU-US regulatory and supervisory cooperation and lay out a vision for the future.

Having led the CFTC for the past two years, I have been very closely engaged in this cooperation, and I believe I see it clearly. But I also have the benefit of some distance which gives me great affection for its effectiveness and durability. From both vantages, I see its even greater potential.

**Why It Matters**

I am optimistic because I know it is a priority for European and U.S. policymakers to strengthen our regulatory and supervisory cooperation. Only through such cooperation can we ensure that our financial markets will continue to support the growth of our mature market economies and increase the prosperity of our citizens. Should we fail to cooperate, we will stunt the efficiency of our markets, producing fragmentation and denying our firms, businesses and farms the necessary capital and risk hedging tools needed to increase productivity, research and develop new technologies, hire more workers, and invest for the long-term.

Equally importantly, Europe and the United States must continue to show the world that we can work together. Europe invented entrepreneurship, and America embraced it. Together, we are champions of the rule of law, the protection of person and property, and free market economics. These attributes have made ours among the world's most important economies. That is why I am optimistic that, working together, we can show the rest of the world the benefits of free and open markets underpinned by sound regulation and strong enforcement.

What this means for financial regulation is that the standards and rules we – Europe and the United States – develop together to govern how we trade, invest and hedge set the standard for financial market conduct around the world. In this respect, cooperation between Europe and the United States represents a demonstration of leadership that goes well beyond our respective markets.

**Overcoming History**

I speak before an audience of experts of trans-Atlantic financial markets. You, of all people, know that Europe and the United States have not always found it easy to cooperate on matters of financial regulation. You know that now is the time to overcome any pessimism grounded in the disappointments of the past. Now is the time to focus on how we can work together now and in the future.

The first step to overcoming this history is by confronting it head on. Nearly five years ago when I joined the CFTC, I came to Europe and gave an honest assessment of the CFTC's cross-border policies[1]. I admitted that the CFTC could well be seen to have started the current rift in cross-Atlantic swaps cooperation with its 2013 cross-border guidance imposing CFTC transaction rules on swaps traded by U.S. persons even in jurisdictions committed to implementing G-20 swaps reforms. That approach alienated many overseas regulatory counterparts and squandered important American leadership and influence in global reform efforts.

And two-and-a-half-years later when I became Chairman of the CFTC, and gained the authority to direct the CFTC staff to change policies, I took further steps to acknowledge the problems caused by the CFTC's expansive approach to applying its swaps rules to cross-border activities. I laid out a detailed program to remedy the errors of such past policies[2].

This openness to honestly assess how we have worked with each other in the past is something that I hope all authorities – here in Europe and in the United States – will do. Only through a willingness to change direction, when confronted by evidence showing that we may have been wrong, will we be able to overcome the past.

**Building Trust**

The time is at hand for Europe and the United States to take steps to rebuild trust. As CFTC Chairman, I am proud of the recent series of joint announcements and commitments with my counterparts in Europe and Asia on a range of regulatory actions[3]. These joint statements are public commitments, which the CFTC has followed through on in concrete terms. They help build trust as they show we can make agreements and stand by them.

Transparency is also a key part of building trust. While at the CFTC, I have authored three detailed white papers laying out my views on the regulation of swaps execution facilities, the effectiveness of the CFTC's implementation of the Dodd-Frank Act, and cross-border policies[4].

Some people ask why I wrote these papers. There are many reasons, but one purpose was to inform global regulatory counterparts of the direction of our policies and the principles upon which that direction is set. It has enabled us to solicit thoughtful input from our global partners. In particular, it has allowed European and U.S. authorities to have substantive discussions about how to optimize global swaps reform and better calibrate it to maintain healthy financial markets across international borders. Being transparent in the regulatory course we follow encourages our overseas counterparts to anticipate and rely on the actions we take.

Moreover, I have sought to build trust by directing the CFTC to be an active, engaged and positive participant in international standards setting activities. Today, the CFTC participates in more international work streams than ever in its history. The agency is an active contributor to the International Organization of Securities Commissions (IOSCO), Financial Stability Board (FSB), and IOSCO's joint work with the Committee on Payments and Market Infrastructures and Basel Committee on Banking Supervision. More importantly, the CFTC chairs or co-chairs international working groups on market fragmentation, efficient resiliency of OTC derivatives reforms, commodity principles, cybersecurity, regulation of financial market infrastructures, international data standards, and implementation monitoring and assessment.

I am proud that CFTC leadership has made it possible to have IOSCO, the FSB and other groups produce international standards, guidance and reports that have substantially advanced the goal of a more resilient global financial system while supporting robust markets. And I am pleased to observe that often our closest partners in these groups are European authorities.

**Commitment to Shared Principles**

The last ingredient to successful regulatory and supervisory cooperation between Europe and United States is a commitment to shared principles.

First, we should share a commitment to market-based solutions. When facing common regulatory challenges, we should be looking to see how our rules and policies can help make our markets work better and more efficiently.

Internationally, the CFTC has been a strong supporter of the efforts in the FSB and IOSCO to review the effectiveness of the G20 reforms. Again, these reviews are not designed to weaken the reforms – I have always been a strong supporter of the G20 reforms – but to make sure they are implemented in ways that enhance derivatives markets, not stifle them.

At the CFTC, one of my early initiatives was Project KISS, which was a massive review of CFTC rules and regulations to make them simpler, less burdensome and less costly, but not less effective.

And consider the CFTC's approach to the development of new derivatives products on crypto-assets like Bitcoin. We have resisted calls to use our legal powers to suppress the development of crypto-assets and the underlying technologies that support them. Instead, we have favored close monitoring of market developments while not hindering the introduction of new products like bitcoin futures, which have proven invaluable in letting market forces determine the appropriate value of the bitcoin[5].

Second, we should share a commitment to open markets and competition. Both European and U.S. policymakers have a common interest to make our respective markets the most effective places to trade and to do business. They should be neither the least, nor the most, prescriptively regulated – but the best regulated for the unique characteristics of our marketplaces, balancing market oversight, health and vitality. This goal will not be achieved by setting up regulatory barriers and separating ourselves from our foreign counterparts, but by removing the barriers that stand in the way of global market participants choosing the best markets for their needs. Thus, our common approach to regulation should not be based on a crude measure of the quantity of regulation, but the quality of regulation and oversight. In this respect, regulatory and supervisory cooperation should lead to greater access to each other's markets.

Finally, we should share a commitment to outcomes-based deference. I am more convinced than ever that regulatory deference – whether it be through equivalence and recognition decisions or through substituted compliance orders and exemptions – is the only rational way to ensure that jurisdictional rules can work constructively to provide sound regulation for cross-border trade, investment and risk mitigation.

And what is most critical is the manner in which we apply such deference. Deference only can work if we seek comparable regulatory outcomes. It must be based on the understanding that each market has unique rules, practices, states of development and range of market participants. Thus, it is only right that regulators accept reasonable differences suitable to local conditions, law and traditions while achieving similar outcomes.

During my tenure as CFTC Chairman, the CFTC has made a series of deference decisions for Europe, Japan, Singapore and Australia, among others. In each case, we have accepted that the relevant foreign jurisdiction has requirements different from what we have in the United States. Still, we have felt comfortable acting with deference despite such differences.

To do otherwise, would be to tell other jurisdictions that all markets are the same and, therefore, everyone needs to conform to one way of doing things. This cannot be right. If we do not embrace in a meaningful way outcomes-based deference, then tools like equivalence become not bridges to build cross-border markets but cudgels to force rule taking. Such a tactic will never be successful between Europe and the United States.

**Challenges**

Improved regulatory and supervisory cooperation, however, will require effort. We must be cognizant of the challenges that have previously undermined, and will continue to pose a threat to, future regulatory and supervisory cooperation.

I spoke earlier of the importance of being able to build trust through agreements and public commitments. As many of you know, I have been vocal in expressing CFTC concerns with EMIR 2.2. One primary reason EMIR 2.2, and the manner by which it has been presented, has created such anxiety in the United States is that, for a long time, there was an unwillingness by the European Commission to acknowledge any commitment to the 2016 agreement between the CFTC and EC on CCPs.

Does Europe have the right to decide how it wishes to supervise CCPs? Yes. Does Europe have the right to consider how third-country CCPs may pose a systemic risk to Europe? Certainly, it does. But should Europe do so without regard to past commitments to the CFTC? Not if it is serious about maintaining trust and recognizing the importance of regulatory and supervisory cooperation with the United States.

Another challenge is to insulate market regulation from politics. Market regulation must focus on objectives such as investor protection, the safety and soundness of market utilities, and the efficiency of trading markets. When, instead, domestic politics determines regulatory priorities, picks winners and losers and interferes with the operation of the market – then cross-border regulatory and supervisory cooperation is challenged. Regulatory cooperation works best when it is conducted free of political considerations.

Finally, there is the challenge of communication. Regulatory and supervisory cooperation depends on honesty between regulators. Authorities are made up of people, and there needs to be frequent and forthright communication. So much depends on the day-to-day relationship of the people who serve the different authorities. Honest brokers and truthful interlocutors are essential. When they are not present, cooperation has little chance. When they communicate, as they do here at EuroFi, regulatory cooperation is strengthened and increased.

In all of our international engagements with fellow financial regulators and related regulatory bodies, I have made it my priority for the CFTC to act in a forthright and candid manner, displaying leadership when appropriate and respect and due consideration at all times. The CFTC aims to be considered a trusted and worthy counterparty by its overseas regulatory counterparts.

**Conclusion**

As I approach the end of my time at the CFTC, I wish to express my tremendous respect for my many counterparts in Europe – from the officials in the European Commission to the staff in ESMA and the ECB and the personnel in the range of national authorities with whom the CFTC works with on a regular basis. Everyone I have encountered has been intelligent, thoughtful and professional. And I pay them my highest compliment when I say that they are dedicated public servants who work tirelessly to do what is best for European markets and European interests.

That is why I conclude on an optimistic note. Romania's great son, Ion Luca Cariagiale, told us to be thoughtful in how we look at things.

I look at a future where Europe and the United States grow markets that support prosperity and encourage innovation. I look at a future of shared principles of market-based solutions, healthy competition and regulatory deference. I look at a future where the problems we face, whether economic, social or environmental, are addressed with the help of creative entrepreneurship, free enterprise and most essentially, well-ordered and vibrant trading markets.

As I come here to Eurofi and hear talk about Capital Markets Union, digital distribution, and fintech, I know European policymakers share this vision, a vision in which US and EU markets continue to develop in their own unique ways, reflecting the different legal, commercial and social characteristics of Europe and America, while drawing on common principles and pursuing similar regulatory outcomes.

Moreover, it is a future in which our markets actively support each other with knowledge, skill and capital flowing freely between them, making both stronger and more vibrant, under the thoughtful oversight of European and U.S. regulators working cooperatively with one another.

I see a bright and prosperous future, one of courage, confidence and commonality.

I look forward to this future. With your help and leadership, we shall see it together.

Thank you very much. ■

1. See Keynote Address of CFTC Commissioner J. Christopher Giancarlo at The Global Forum for Derivatives Markets, 35th Annual Burgenstock Conference, Geneva, Switzerland (September 24, 2014), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/opagiancarlos-1.
2. See CFTC Chairman J. Christopher Giancarlo, Cross-Border Swaps Regulation Version 2.0: A Risk-Based Approach with Deference to Comparable Non-U.S. Regulation (Oct. 1, 2018), available at: https://www.cftc.gov/sites/default/files/2018-10/Whitepaper_CBSR100118_0.pdf [hereinafter Cross-Border White Paper].
3. See, e.g., Joint European Commission and CFTC Statement on EMIR 2.2 (March 13, 2019), available at https://www.cftc.gov/PressRoom/SpeechesTestimony/jointeuropeanandcftcstatement031319; Joint Statement of the CFTC and the Monetary Authority of Singapore Regarding the Mutual Recognition of Certain Derivatives Trading Venues in the United States and Singapore (March 13, 2019), available at https://www.cftc.gov/PressRoom/PressReleases/7887-19; Joint Statement by UK and US Authorities on Continuity of Derivatives Trading and Clearing Post-Brexit (February 25, 2019), available at https://www.cftc.gov/PressRoom/PressReleases/7876-19; CFTC Comparability Determination on EU Margin Requirements and a Common Approach on Trading Venues (October 13, 2017), available at https://www.cftc.gov/PressRoom/PressReleases/pr7629-17.
4. See Commissioner J. Christopher Giancarlo, Pro-Reform Reconsideration of the CFTC Swaps Trading Rules: Return to Dodd-Frank (Jan. 29, 2015), available at http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/sefwhitepaper012915.pdf; CFTC Chairman J. Christopher Giancarlo and CFTC Chief Economist Bruce Tuckman, Swaps Regulation Version 2.0: An Assessment of the Current Implementation of Reform and Proposals for Next Steps (Apr. 26, 2018) (April 2018 White Paper), available at: https://www.cftc.gov/sites/default/files/2018-05/oce_chairman_swapregversion2whitepaper_042618.pdf; Cross-Border White Paper, supra note 2.
5. See Galina B. Hale, Federal Reserve Bank of San Francisco, Economic Letter, "How Futures Trading Changed Bitcoin Prices" (May 7, 2018), at: https://www.frbsf.org/economic-research/publications/economic-letter/2018/may/how-futures-trading-changed-bitcoin-prices/.


The Eurofi
High Level Seminar 2019
BUCHAREST | 3, 4 & 5 APRIL
eurofi
H. Waiglein
T. Saarenheimo

Bucharest 2019

# INDEX OF SPEAKERS

# EUROPEAN PUBLIC AUTHORITIES

### Austrian Financial Market Authority
**Klaus Kumpfmüller**
Executive Director

### Autorité de Contrôle Prudentiel et de Résolution
**Edouard Fernandez-Bollo**
Secretary General

### Autorité des Marchés Financiers
**Natasha Cazenave**
Managing Director, Head of Policy and International Affairs

### Banca d'Italia
**Claudio Impenna**
Deputy Head of Markets and Payments System Oversight Directorate

### Banco de España
**Pablo Hernández de Cos**
Governor
**Jesús Saurina Salas**
Director General Financial Stability, Regulation and Resolution

### Banco de Portugal
**Elisa Ferreira**
Vice-Governor

### Bank for International Settlements
**Morten Bech**
Head of Secretariat, Committee on Payments and Market Infrastructures
**Denise Garcia Ocampo**
Senior Advisor, Representative Office for the Americas
**Luiz Awazu Pereira da Silva**
Deputy General Manager
**Fernando Restoy**
Chairman, Financial Stability Institute

### Bank of England
**David Bailey**
Executive Director, Financial Market Infrastructure, Financial Stability
**Sarah Breeden**
Executive Director, International Banks Supervision

### Bank of Finland
**Päivi Heikkinen**
Head of Payment Systems Department
**Olli Rehn**
Governor

### Bank of Greece
**Kostas Botopoulos**
Advisor to the Governor

### Bank of Lithuania
**Vilė Urbonienė**
Director of International Relations Department

### Banque de France
**Nathalie Aufauvre**
Director General Financial Stability and Operations
**Denis Beau**
First Deputy Governor
**Sylvie Goulard**
Second Deputy Governor
**François Villeroy de Galhau**
Governor

### Basel Committee on Banking Supervision
**William Coen**
Secretary General

### Central Bank of Ireland
**Gerry Cross**
Director of Financial Regulation - Policy and Risk

### Commissione Nazionale per le Società e la Borsa
**Giulia Bertezzolo**
Secretary General
**Carmine Di Noia**
Commissioner
**Nicoletta Giusto**
Director of the International Relations Office

### Council of the European Union
**Hans Vijlbrief**
President of the Eurogroup Working Group and the Economic and Financial Committee

### Croatian National Bank
**Boris Vujcic**
Governor

### Danish Financial Supervisory Authority
**Jesper Berg**
Director General

### Danmarks Nationalbank
**Per Callesen**
Governor

### De Nederlandsche Bank
**Klaas Knot**
President & Vice Chair, Financial Stability Board

### Deutsche Bundesbank
**Burkhard Balz**
Member of the Executive Board
**Jochen Metzger**
Director General, Directorate General Payments and Settlement Systems
**Joachim Wuermeling**
Member of the Executive Board

### Dutch Authority for the Financial Markets
**Gerben Everts**
Member of the Executive Board

### European Bank for Reconstruction and Development

**Pierre Heilbronn**
Vice President, Policy and Partnerships

### European Banking Authority

**Olli Castrén**
Head of Unit, Economic Analysis and Impact Assessment
**Adam Farkas**
Executive Director
**Jo Swyngedouw**
Interim Chairperson

### European Central Bank

**Marc Bayle de Jessé**
Director General, Market Infrastructure and Payments
**Philipp Hartmann**
Deputy Director General, Research
**Korbinian Ibel**
Director General, DG Micro-Prudential Supervision IV
**Klaus Löber**
Head of Oversight

### European Commission

**Benjamin Angel**
Director, Economic and Financial Affairs, DG ECFIN
**Daniel Calleja Crespo**
Director General for Environment
**Valdis Dombrovskis**
Vice-President for the Euro and Social Dialogue, also in charge of Financial Stability, Financial Services and Capital Markets Union
**Olivier Guersent**
Director General for Financial Stability, Financial Services and Capital Markets Union
**Mario Nava**
Director, Horizontal Policies, DG FISMA
**Stephanie Pamies**
Head of Sector, Sustainability of Public Debt, DG ECFIN
**Artur Runge-Metzger**
Director, Climate strategy, Governance and Emissions from Non-trading Sectors, DG CLIMA
**Felicia Stanescu**
Head of Policy Definition and Coordination, DG FISMA
**Gerassimos Thomas**
Deputy Director General, Energy
**Pēteris Zilgalvis**
Head of Unit, Digital Innovation and Blockchain, Digital Single Market Directorate, DG CNECT & Co-Chair of the FinTech Task Force

### European Court of Auditors

**Rimantas Sadzius**
Member

### European Insurance and Occupational Pensions Authority

**Gabriel Bernardino**
Chairman
**Fausto Parente**
Executive Director
**Dimitris Zafeiris**
Head of Risk and Financial Stability Department

### European Investment Bank

**Eric Perée**
Associate Director, General Secretariat
**Debora Revoltella**
Director Economics Department

### European Parliament

**Pervenche Berès**
MEP, ECON Committee
**Markus Ferber**
MEP, ECON Committee
**Wolf Klinz**
MEP, ECON Committee
**Lavan Thasarathakumar**
Policy Advisor

### European Securities and Markets Authority

**Steven Maijoor**
Chair
**Verena Ross**
Executive Director

### European Stability Mechanism

**Rolf Strauch**
Chief Economist, Management Board Member

### European Systemic Risk Board

**Francesco Mazzaferro**
Head of the ESRB Secretariat

### Federal Financial Supervisory Authority, Germany

**Frank Grund**
Chief Executive Director of Insurance and Pension Funds Supervision

### Federal Ministry of Finance, Austria

**Harald Waiglein**
Director General for Economic Policy and Financial Markets, Member of the Board of Directors, ESM & EFC

### Federal Ministry of Finance, Germany

**Levin Holle**
Director General, Financial Markets Policy
**Jörg Kukies**
State Secretary

### Financial Conduct Authority

**Nausicaa Delfas**
Executive Director, International
**Lee Foulger**
Head of International Department

### Financial Services and Markets Authority, Belgium

**Jean-Paul Servais**
Chairman

### Financial Supervisory Authority, Finland

**Hanna Heiskanen**
Senior Advisor on Fintech and Policy

### Italian Insurance Supervisory Authority

**Alberto Corinti**
Member of the Board of Directors

### Ministry of Economy and Finance, France
**Lionel Corre**
Deputy Director Insurance Division
**Bruno Le Maire**
The Minister
**Sébastien Raspiller**
Assistant Secretary
**Jérôme Reboul**
Deputy Assistant Secretary for Banking Affairs, DG Trésor
**Odile Renaud-Basso**
Director General of Treasury

### Ministry of Economy and Finance, Italy
**Alessandro Rivera**
Director General of the Treasury

### Ministry of Finance, Finland
**Leena Mörttinen**
General Director, Financial Markets Department
**Tuomas Saarenheimo**
Permanent Under-Secretary, Responsible for International and Financial Affairs

### Ministry of Finance, Latvia
**Liga Klavina**
Deputy State Secretary on Financial Policy

### Ministry of Finance, Luxembourg
**Pierre Gramegna**
The Minister

### Ministry of Finance, Republic of Estonia
**Märten Ross**
Deputy Secretary General for Financial Policy and External Relations

### Ministry of Public Finance, Romania
**Eugen Orlando Teodorovici**
The Minister

### National Bank of Belgium
**Guillaume-Pierre Wunsch**
Governor

### National Bank of Estonia
**Madis Müller**
Deputy Governor

### National Bank of Romania
**Florin Georgescu**
First Deputy Governor
**Mugur Isărescu**
Governor
**Liviu Voinea**
Deputy Governor

### National Supervisory Authority for Personal Data Processing, Romania
**Simona Şandru**
Head of Complaints Department

### Oesterreichische Nationalbank
**Andreas Ittner**
Vice Governor, Financial Stability, Banking Supervision and Statistics

### Permanent Representation of the Slovak Republic to EU
**Peter Palus**
Head of the Financial Unit

### Romanian Financial Supervisory Authority
**Leonardo Badea**
President

### Single Resolution Board
**Antonio Carrascosa**
Member of the Board
**Elke König**
Chair

### Spanish Securities and Exchange Commission
**Sebastián Albella Amigo**
Chairman

## GLOBAL AND INTERNATIONAL PUBLIC AUTHORITIES

### Bank of Japan
**Yuko Kawai-Yamada**
General Manager for Europe

### Financial Services Agency, Japan
**Shunsuke Shirakawa**
Vice Commissioner for International Affairs

### International Association of Insurance Supervisors
**Jonathan Dixon**
Secretary General

### International Monetary Fund
**Gaston Gelos**
Assistant Director & Chief, Monetary and Macroprudential Policies Division
**Mahmood Pradhan**
Deputy Director, European Department

### U.S. Commodity Futures Trading Commission
**J. Christopher Giancarlo**
Chairman
**Eric Pan**
Director, Office of International Affairs
**Brian D. Quintenz**
Commissioner

# INDUSTRY REPRESENTATIVES

## Allianz SE
**Tobias Bücheler**
Head of Regulatory Strategy

## American Express
**Brett Loper**
Executive Vice President, Global Government Affairs

## Amundi Asset Management
**Frédéric Bompaire**
Head of Public Affairs, Finance and Strategy

## AXA
**Stéphane Janin**
Head of Global Regulatory Development
**Patricia Plas**
Head of Public Affairs
**Arnaud Tanguy**
Group Chief Security Officer

## Banca Comerciala Romana (BCR - Erste Group)
**Sergiu Cristian Manea**
Chief Executive Officer & President of the Council of Banking Employers in Romania

## Banco Bilbao Vizcaya Argentaria
**Eduardo Arbizu**
Global Head of Supervisors, Regulation and Compliance
**José Manuel González-Páramo**
Member of the Board of Directors, Chief Officer, Global Economics & Public Affairs

## Banco Sabadell
**David Vegara**
Chief Risk Officer

## Bank of America Merrill Lynch
**Alexander Batchvarov**
Head of International Structured Finance Research
**Andrei Magasiner**
Treasurer
**Bruce Thompson**
Vice Chairman

## Barclays Bank
**Rhian-Mari Thomas**
Global Head of Green Banking

## BlackRock
**Joanna Cound**
Head of Global Public Policy, EMEA

## BNP Paribas
**Philippe Bordenave**
Chief Operating Officer
**Laurence Caron-Habib**
Head of Strategy, Market Intelligence and Public Affairs, BNP Paribas Securities Services
**Jean Lemierre**
Chairman

## BNY Mellon
**James Cunningham**
Senior Advisor, Public Policy and Regulatory Affairs, BNY Mellon's European Bank
**Mariano Giralt**
Global Head of Tax and Regulatory, BNY Mellon Asset Servicing
**Leonique van Houwelingen**
Chief Executive Officer, BNY Mellon's European Bank

## Bolsas y Mercados Españoles
**Antonio J. Zoido Martínez**
Executive Chairman

## Bucharest Stock Exchange
**Lucian Anghel**
Chairman

## Caisse des Dépôts
**Laurent Zylberberg**
Senior Executive Vice President, Public Affairs and International Relations & President, European Association of Long-Term Investors (ELTI)

## CaixaBank
**Jean Naslin**
Executive Director, Head of Public Affairs

## CLS Group
**Alan Marquard**
Chief Strategy and Development Officer

## Crédit Agricole S.A.
**Alban Aucoin**
Head of Public Affairs
**Clément Michaud**
Chief Financial Officer, Crédit Agricole Assurances
**Carlos Molinas**
Global Head of Business Compliance, Crédit Agricole CIB

## Credit Suisse
**Manuel Rybach**
Global Head of Public Affairs and Policy

## Deutsche Bank AG
**Sylvie Matherat**
Chief Regulatory Officer and Member of the Management Board

## Deutsche Börse Group
**Thomas Book**
Member of the Executive Board
**Alexandra Hachmeister**
Chief Regulatory Officer

## Deutscher Sparkassen- und Giroverband
**Karl-Peter Schackmann-Fallis**
Executive Member of the Board

## Euroclear
**Guillaume Eliet**
Head of Regulatory, Compliance & Public Affairs

### Euronext
**Stéphane Boujnah**
Chief Executive Officer and Chairman of the Managing Board

### Federated Investors (UK) LLP
**Dennis Gepp**
Senior Vice President, Managing Director and Chief Investment Officer, Cash

### Fidelity International
**Hank Erbe III**
Global Head of Strategic Relationship Management and Public Policy
**Natalie Westerbarkey**
Head of EU Public Policy

### Goldman Sachs International
**Martine Doyon**
Managing Director, Head of Government Affairs EMEA
**Dermot McDonogh**
Chief Operating Officer for EMEA

### Google (London)
**Richard Radley**
Head of Customer Engineering, Financial Services

### Groupama
**Cyril Roux**
Group Chief Financial Officer

### Groupe BPCE
**Jacques Beyssade**
Secretary General

### HSBC Holdings plc
**William Morgan**
Financial Crime Policy, Group Public Affairs

### ICE
**Timothy J. Bowler**
President, ICE Benchmark Administration Limited
**Finbarr Hutcheson**
President, ICE Clear Europe,
ICE Intercontinental Exchange, Inc.

### ING Groep N.V
**Tanate Phutrakul**
Chief Financial Officer

### J.P. Morgan
**Vittorio Grilli**
Chairman of the Corporate and Investment Bank EMEA
**Michael Percival**
EMEA Head of Regulatory Affairs

### KPMG in the UK
**Joe Cassidy**
Partner

### La Banque Postale
**Florence Lustman**
Chief Finance and Public Affairs Officer

### LCH Group
**Daniel Maguire**
Chief Executive Officer

### MetLife, Inc.
**Joseph L. Engelhard**
Senior Vice President, Head of Regulatory Policy Group

### Mitsubishi UFJ Financial Group
**Tomo Ishikawa**
Head of Global Regulatory Affairs

### Mizuho Bank, Ltd.
**Simon Miller**
Managing Director, Head of Legal and Compliance

### Moody's Investors Service
**Colin Ellis**
Chief Credit Officer EMEA
**Michael West**
Managing Director, Global Ratings & Research

### Nasdaq Nordics
**Lauri Rosendahl**
President

### Nordea
**Jarkko Syyrilä**
Head of Public Affairs, Asset and Wealth Management

### Nykredit
**Søren Holm**
Group Managing Director, Chief Risk Officer

### PricewaterhouseCoopers Auditores, S.L.
**Carlos Ignacio de Montalvo Rebuelta**
Partner, EMEA Insurance Risk and Regulatory Leader

### Raiffeisen Bank Romania
**Steven van Groningen**
President and Chief Executive Officer

### Romanian Association of Banks
**Sergiu Oprescu**
Chairman of the Board

### S&P Global Ratings Europe Ltd.
**Sylvain Broyer**
Chief Economist EMEA

### Société Générale
**Diony Lebot**
Deputy Chief Executive Officer

### Standard Chartered Bank
**Chris Allen**
General Counsel, Clients and Products

### State Street Corporation
**Noel Archard**
Global Head of SPDR ETF Product, State Street Global Advisors
**Stefan M. Gavell**
Global Head of Regulatory, Industry & Government Affairs

### Sumitomo Mitsui Banking Corporation
**Ian Jameson**
Managing Director, General Counsel and Chief Legal Officer, EMEA Region

### SWIFT
**Stephen Lindsay**
Head of Standards

### Swiss Re Management Ltd
**Nina Arquint**
Head of Group Qualitative Risk Management

### The Depository Trust & Clearing Corporation
**Andrew Douglas**
Managing Director, Government Relations (EMEA & APAC) and Chief Executive Officer of DTCC's European Trade Repository

### Tradition
**Vincent Remay**
Advisor to the Chairman

### UBS
**Angus Graham**
Global Head of IBOR Transition

### UniCredit S.p.A.
**Fabrizio Saccomanni**
Chairman

### Visa Europe
**Pia Sorvillo**
Director of European Affairs

### Western Union
**Tristan van der Vijver**
Global Head of Risk & Compliance

### Zurich Insurance Group
**Eugenie Molyneux**
Chief Risk Officer of Commercial Insurance

## OTHER STAKEHOLDERS

### Banque de France (Formerly)
**Christian Noyer**
Honorary Governor

### Better Finance
**Guillaume Prache**
Managing Director

### Deutsche Bundesbank (Formerly)
**Andreas Dombret**
Member of the Executive Board

### EUROFI
**Jean-Marie Andrès**
Senior Fellow
**Jean-Jacques Bonnaud**
Treasurer
**Didier Cahen**
Secretary General
**Marc Truchet**
Senior Fellow
**David Wright**
President

### Euro 50 Group
**Edmond Alphandéry**
Chairman

### European Money Markets Institute
**Jean-François Pons**
Chairman, Board of Directors

### Long-Term Investment Task Force of the Paris Marketplace
**Gérard de la Martinière**
Chairman


The Eurofi High Level Seminar 2019
BUCHAREST | 3, 4 & 5 APRIL

Bucharest 2019

# POLL RESULTS

These polls were conducted during the Bucharest event on the Eurofi mobile website

## EMU

### Main priority for ensuring a viable EMU?

| | |
|---|---|
| Optimizing the Banking Union and advancing the CMU | 28% |
| Implementing structural reforms within each Member State | 26% |
| Creating a Euro-area governance and budget with permanent resources | 16% |
| Creating an EU safe asset | 12% |
| Implementing debt rule of Stability and Growth Pact (60% of GDP) | 11% |
| Addressing symmetrically excessive current account deficits and surpluses | 7% |

## BANKING UNION

### Key priority for optimizing the Banking Union?

| | |
|---|---|
| Achieving a political agreement on EDIS | 40% |
| Removing domestic ring-fencing practices (capital, liquidity) | 28% |
| Solving remaining NPL issues | 18% |
| Ensuring a common liquidation regime for transnational banking groups | 7% |
| Facilitating the transformation of subsidiaries into branches | 7% |

## CMU

### What is the way forward for the CMU?

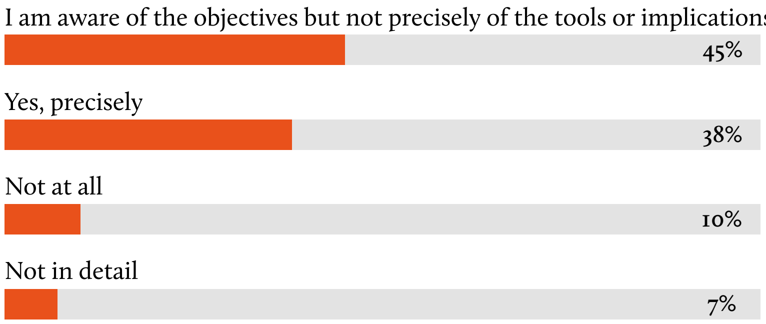
| | |
|---|---|
| Refocus on some key objectives | 63% |
| Complete redesign | 16% |
| Continuation of the existing action plan | 8% |
| Enough has been done on the CMU already | 7% |
| It depends on the outcome of Brexit | 6% |

**CMU**

### Should synergies between the CMU and BU be further developed?

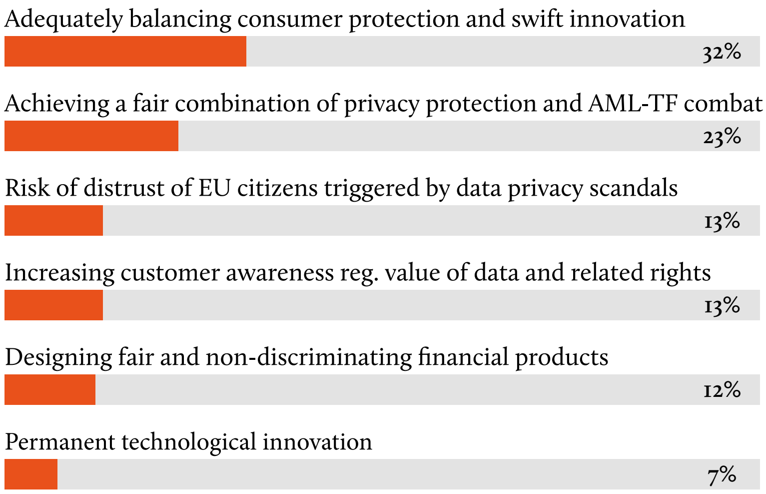

**MACRO-PRUDENTIAL**

### Do you know what macro-prudential approaches involve?




**DATA PRIVACY**

### Main challenges ahead regarding data privacy?



These polls were conducted during the Bucharest event on the Eurofi mobile website

BREXIT

## Is the UK-based financial sector ready for a potential no-deal?


BREXIT

## Expected impacts of Brexit on the EU economy?

**BREXIT**

## Is the UK going to leave EU by 22 May at the latest?

| | |
|---|---|
| No, a longer extension (one year at least) will be obtained | 31% |
| No idea | 25% |
| A short extension beyond 22 May is most probable | 19% |
| Certainly | 17% |
| The UK won't leave the EU in the end | 8% |

**AML-TF**

## Initiatives to more effectively detect and stop suspicious financial flows?

| | |
|---|---|
| Improved information exchange among supervisory / AML authorities | 24% |
| Fully harmonized regulation in the EU | 24% |
| Comprehensive AML approach in EU supervisory actions | 23% |
| Institutional changes e.g. creation an EU AML authority | 18% |
| Improved governance of EU financial institutions reg. AML-TF risk | 11% |

**SUSTAINABLE FINANCE**

## Policy priorities to further mobilise EU sustainable investment?

| | |
|---|---|
| Clarification of EU environmental and sustainability policy objectives | 30% |
| Complete the definition of an adequate taxonomy | 29% |
| Adapt regulation and accounting standards to long-term investment | 19% |
| Increase public resources for EU environmental investments | 14% |
| Focus public resources mainly on long-term risk mitigation | 8% |


WELCOME

Bucharest 2019

# PORTFOLIO


A. Rivera
H. Waiglein


F. Grund
J. Dixon


J. Berg
A. Farkas


F. Restoy


O. Guersent

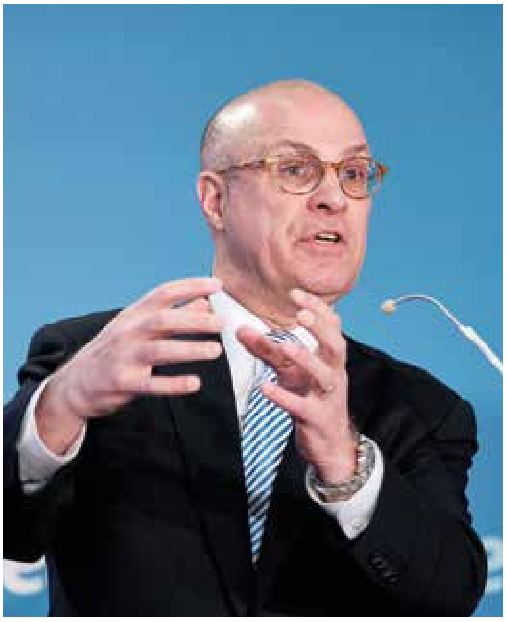

eurofi
A. Dombret


eurofi
K-P. Schackmann-Fallis
J. M. González-Páramo
B. Vujčić


eurofi
B. Balz


eurofi
L. Mörtt

eurofi
K. Knot
A. Magasiner



F. Saccom
eurofi

eurofi
BBVA
J. Kukies
V. Grilli
L. Van Houwelingen




L. Caron-H
eurofi

G. Evert
eurofi


eurofi
Lemierre
E. König


C. Noyer


eurofi
J. Wuermeling


eurofi


eurofi


eurofi
A. Runge-Metzger
D. Calleja Crespo


eurofi
J. Saurina Salas


eurofi
P. Zilgalvis
L. Holle
M. Ross
H. Heiskanen


eurofi
F. Parente


eurofi


P. Berès


eurofi


The Eurofi High Level Seminar 2019
BUCHAREST


key topics



M. Percival




W. Klinz

H. Vijlbrief
O. Renaud-Basso


M. Müller

R-M. Thomas
S. Goulard
L.A. Pereira da Silva

**Authors:** Jean-Marie Andrès & Marc Truchet
**Publisher:** Didier Cahen
**Design & Production:** Virginie Denis, Initial Production
**Photographers:** François de Ribaucourt & Philippe Molitor

# About EUROFI

## The European think tank dedicated to financial services

- **A platform for exchanges between the financial services industry and the public authorities**
- **Topics addressed include the latest developments in financial regulation and supervision and the macroeconomic and industry trends affecting the financial sector**
- **A process organised around 2 major international yearly events, supported by extensive research and consultation among the public and private sectors**

### *Our objectives*

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

### *Our approach*

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user standpoint.

We organise our work mainly around two yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow to structure effective debates and offer extensive input. The output of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proven over time to be an effective way for moving the regulatory debate forward in an objective and open way.

### *Our organisation and membership*

Eurofi works on a membership basis and comprises a diverse range of more than 65 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

### *Our events and meetings*

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends.

These events assemble a wide range of private sector representatives, EU and international public decision-makers and representatives of the civil society. More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan...) and international organisations. The logistics of these events are handled by Virginie Denis and her team.

These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

### *Our research activities and publications*

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (technology, sustainable finance...).

3 main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance.... These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net :

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 150 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of the conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

Eurofi would like to thank very warmly
**the sponsors** of this seminar for their support

## LEAD SPONSORS

Bank of America Merrill Lynch

BNP PARIBAS

CRÉDIT AGRICOLE S.A.

## SUPPORT SPONSORS

BBVA

BNY MELLON

DEUTSCHE BÖRSE GROUP

J.P.Morgan

Moody's

## REGIONAL PARTNER

UniCredit

## EUROFI MEMBERS

Allianz
American Express
Amundi Asset Management
AXA
Bank of America Merrill Lynch
Barclays
BBVA
BlackRock
BME Spanish Exchanges
BNP Paribas
BNY Mellon
Groupe BPCE
Caceis Investor Services
Groupe Caisse des Dépôts
CaixaBank
cbp
CLS trusted market solutions
CNP Assurances
Covea
Crédit Agricole S.A.
Credit Suisse
Deka
Deutsche Börse Group
DNB
DTCC
Erste Group
euroclear Post-trade made easy
Euronext
European Investment Bank The EU bank
Federated
Fidelity International
Finanzgruppe
Goldman Sachs
Le Groupe Groupama
HSBC
ice
ING
J.P.Morgan
KPMG
La Banque Postale
LCH The Markets' Partner
MetLife
Mizuho
Moody's
Morgan Stanley
MUFG
Nasdaq
Nomura
Nordea
Nykredit
pwc
Raiffeisen
Sabadell
Santander
SMBC
Societe Generale
Standard Chartered
S&P Global
State Street
SWIFT
Swiss Re
Tradition
UniCredit
UBS
WesternUnion WU
Zurich

# eurofi

The European think tank dedicated to financial services

www.eurofi.net