

# Views

The EUROFI Magazine

BUCHAREST | APRIL 2019

## Eugen O. Teodorovici

European financial sector  
at the crossroads

## The Eurofi High Level Seminar 2019

Bucharest | 3, 4 & 5 April



### Mugur Isărescu

Financial integration in Europe:  
challenges and prospects



### Klaas Knot

New challenges in an evolving  
financial system

And more than 160 speakers' contributions including: B. Le Maire, P. Gramegna, H. Löger, V. Dombrovskis, H. Vijlbrief, O. Rehn, P. Hernández de Cos, B. Vujčić, P. Wunsch, J. Wuermeling, P. Callesen, H. Waiglein, T. Saarenheimo, B. Balz, E. König, S. Maijoor, G. Bernardino, F. Hufeld, M. Bayle de Jessé, L. Badea, F. Restoy, K. Kumpfmüller, M. Ross, K. Braddick, O. Guersent, S. Albella Amigo, D. Calleja Crespo, M. Ferber, O. Renaud-Basso, E. Fernandez-Bollo, L. Mörttinen, M. Pradhan, P. Heilbronn, B. Quintenz, S. Shirakawa, M. Bech, J. Lemierre, B. Thompson, C. Michaud, J.M. González-Páramo, V. Grilli, T. Book, L. van Houwelingen, M. West...

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# The Eurofi High Level Seminar

**BUCHAREST | APRIL 2019**

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# The Eurofi Bucharest High Level Seminar

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Over 700 representatives of the European and international public authorities and the financial industry are gathered in Bucharest to discuss the main policy issues impacting the EU financial sector, the main evolutions underway in the macro-economic environment and also new trends such as technology and sustainable finance.

Brexit implications for the EU financial sector and the future of global regulatory and supervisory cooperation will also provide major topics of discussion during this international Eurofi Seminar.

As the European elections are approaching, a common theme throughout this event will be the priorities of the incoming Commission for financial services. How to foster more growth, develop investment and increase capital mobility across the EU appear as major objectives going forward. As the EU investment gap widens with additional requirements due to an ageing population, climate-change and digitalisation and as financing needs are changing e.g. in the CESEE region, with more emphasis on innovation and intangible assets, the financing model in the EU needs to evolve. How to capitalize better on the significant saving surpluses generated in Europe and complete bank financing with a further development of capital markets, in line with the objectives of the Capital Markets Union, are some of the main challenges going forward in this perspective.

Most of the 200 speakers taking part in the Eurofi Bucharest Seminar have expressed their views in this Magazine, providing a comprehensive overview of thoughts and proposals regarding these issues. We thank them very warmly for their thoughtful contributions and are sure that you will read them with great interest. ●

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

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# David Wright

President, EUROFI

## Defining, agreeing and implementing an EU growth supplement for the 2019-2024 political cycle



It is an honour for EUROFI that our 29th edition takes place in Bucharest, Romania.

On behalf of all our distinguished speakers and participants, we thank the Romanian Presidency of the European Union for their cooperation, hospitality and warm welcome in Bucharest, as well as its Central Bank, Regulators and representatives of the private sector.

EUROFI is a true “rassemblement” of European Finance Ministers, European Members of Parliament, the European Commission, Central Bank Governors, Regulators - European and International - and our distinguished private sector members and sponsors whom we thank profusely for their continuous support.

EUROFI's strength lies in our open, free flowing debates. Our seminar takes pride at discussing the issues at the European financial policy frontier as well as encompassing rich exchanges of view with leading international policy makers from Japan, the United States, Switzerland and others whose attendance and participation is much appreciated.

This European political cycle is nearing its end. EUROFI Bucharest is the right time to look forward to the future and to discuss the key ideas for the next European Commission and the next European Parliament that will take office later this year. What do we think should its macro- and micro-financial priorities be until 2024 and beyond? For the EUROZONE? For European Capital markets etc?

All of us will have ideas and priorities. Some convergent, some less so. But I hope we will be able to distill a few key ones together in Bucharest which, collectively, in aggregate and if adopted, will be able to significantly ratchet up, sustainably and inclusively, the EU's long-term economic growth rate and employment levels. If we can't do this in the Union, if we fail, I see imminent, dangerous, political and economic waters ahead:

- Rising “chacun pour soi” nationalism, populism, intolerance and political fragmentation;
- Continuous slow economic growth with increasingly constrained financial markets and credit provision;
- Worsening public sector spending deficits as Europe ages;
- Growing income distribution disequilibria and deepening perceptions of societal and regional unfairness;

- Insufficient internal EU economic dynamism, sub-optimal innovation and SME development;
- Weakening EU global influence.

Formidable challenges that demand strong future leadership and clear, consensual policy priorities agreed between the European Commission, the European Parliament and Member States with firm, political dates for delivery. So, what should be on the financial policy list?

Clearly Capital Markets Union needs to be rethought, rebooted, strengthened. Will the EU opt for an inward looking approach, or an outward facing one?

European Monetary Union is incomplete - there are still cracks weakening its structure and coherence and hampering the capture of pan-EMU economies of scale;

European pension systems need reform to switch over time to far more private sector provision given the EUs aging population. The Personal European Pension Plan (PEPP) surely should be an important component.

Sustainable and inclusive finance are here to stay but how can the EU become the world leader and define the standards? What needs to be done to make these a major commercial success for the EU and to really boost long-term investment?

Data access, fintech and digitalization issues raise important competition and privacy issues. All aspects of financial crime - money laundering, terrorist financing and tax evasion - are certain to be very high on the EUs political agenda. Corporate governance and cross-border resolution frameworks remain incomplete and will need a strong impetus to be taken forward. The future economic, trade and financial relationship with the United Kingdom is also certain to be of major strategic importance given the size, depth and scope of its capital markets.

Defining the priorities and finding a balance will be hard, but not impossible. But there is a huge prize. Agreeing and delivering an economic “growth plus” plan that will ratchet up long-term economic growth in the EU will build political “appartenance” in Europe and enhance citizens belief in its institutions and procedures.

Failure, the opposite.

But on top of this we need strong leadership voices - political and economic, educationalists, trade unionists and industrial .... - to support and defend the European Union as a remarkable political project. A democratic, law abiding public project of peace, solidarity, common values, culture, decency and friendship.

We need more people like Guy Verhofstadt and others ready to stand up, take on publicly and demolish those who churn out repeated, pernicious lies about what the European Union is and what it stands for.

The European Union is a force for good. As Europeans let us say it more often, counter malicious scepticism and act decisively together to make it work better in the future. ●

# Eugen O. Teodorovici

Minister of Public Finance,  
Romania



## Q&A

### European financial sector at the crossroads

#### WHAT ARE THE PRIORITIES OF THE ROMANIAN EU COUNCIL PRESIDENCY IN THE FINANCIAL AREA?

The Romanian Presidency of the Ecofin Council faces a series of unprecedented pressures and rare opportunities at the same time. Pressures are well known: the new European budget in the context of Brexit and the new priorities, also the time pressure related to the completion of mandates of the European Commission and the European Parliament. Opportunities, on the other hand, relate to the context of economic growth and recovery.

Besides the administrative endeavors, the Presidency of the Ecofin Council wishes to raise awareness on a series of assumptions that lay beyond the regulatory system. We need to acknowledge, first of all, not just as a statement, but as a principle, that rules are means to an end, rather than a self sufficient goal. They are meant to serve the European Citizen and the European businesses.

It is said: we must close as many files as possible! – as an indicator of success for the Presidency. And the faster, the better. We say: we need to move fast to close meaningful files! And solid ones, with as few exceptions as possible. Otherwise, exceptions become a customary way to fix unperfect legislation. Where does this lead to? Rabates, when we try to get the budget right. Different Schengen area criteria, other than technical, when we rule the freedom of movement. Various ways to assess the compliance of SGP rules. And so on.

Thus, between the reflex to react under administrative pressure and the drive to move proactively towards favorable changes, our approach is based on the principles of European unity and cohesion, placing the European citizen at the core of our priorities.

We consider strengthening of the Economic and Monetary Union an important component of the roadmap developed in preparation

for the Summit of EU leaders in Sibiu of 9 May 2019. At the same time, better regulation in the fiscal field has the potential to ensure effective and fair taxation at European level and help combat fraud and tax evasion, for the benefit of Member States and European citizens.

Initiatives like risk reduction measures, the ones dealing with stocks of non-performing loans, finalized under our Presidency are meant to improve the resilience of the EU, with an impact on the prosperity and stability of the European economy as a whole.

The process of removing barriers to the development and integration of European capital markets should continue. Consequently, the Romanian Presidency strives to work on the proposals related to the capital markets union, in order to reduce the difference in terms of jurisdiction to a minimum, to optimize opportunities for investors and to ensure SMEs' access to a wider range of financial resources. The measures related to derivatives markets, prudential treatment of investment firms, cross-distribution of funds, pan European personal pension product are dossiers finalized under our EU mandate and they all create an enhanced framework for financial stability, cross border competition and a strong consumer protection.

As part of the efforts to develop the capital markets union, the Romanian Presidency considers the sustainable finance file as a very important one. We agreed with European Parliament two regulations on new categories of benchmarks and disclosure rules. We are also committed to continue the work on creating an EU classification or taxonomy for climate change, environmentally and socially sustainable activities. This process should be dynamic, evolving and take into account the specificities of the business sectors.

The balance between risk reduction and risk sharing continues to be a subject of discussion. Major steps have been taken during the past years to ensure its consistency. The Single rulebook has been implemented, as well as common supervision by the ECB and a common resolution framework, which has ensured a more uniform regulation and high-quality supervision across the EU. However, in addition to the legacy issues which are being addressed, a number of gaps may still remain relating to, for example, the discrepancies between the different insolvency regimes, or the efficiency of cross-border financing in the home-host context.

#### **WHAT ARE THE MAIN FINANCING AND INVESTMENT CHALLENGES IN THE CEE REGION?**

There are lots of challenges on financing and investment, not only in CEE region, but also at EU level. A new Multiannual Financial Framework equipped with adequate instruments could respond to some of these challenges. In the proactive spirit we are promoting, the Romanian Presidency is striving to pave the way for such flexibility of rules that will promote a quick and efficient absorption of funds.

SMEs' investment activity and their access to finance represents a major endeavor. The SMEs are one of the main pillars of economic growth, job creation and development. However, they need to be helped to access more varied and stable sources of financing, especially in the CEE region where capital markets are not yet mature and their main source of funding remains the banking sector. Moreover, the SMEs or start-up companies investing in

new technologies, innovative products and services should be encouraged and sustained in their efforts to access the market and to bring modernity, improved productivity, competitiveness and highly trained work force.

The further development of local capital markets is essential for completing Capital Market Union. The private capital is an important source of funding of the small businesses and firms in order to become more productive and to support the economic development. But this requires efforts at national, regional and EU levels. Mainly in CEE countries, the capital markets lag behind in terms of products, size, liquidity and maturity compared to Western Europe countries. Thus, for strengthening and well-functioning of the single capital market at the level of UE, these markets need to grow faster.

The local capital markets role in supporting the SMEs becomes more and more important, especially because these companies are not large enough to reach the capital available across the borders but they could access the equity markets at national level. This could help them also in terms of lower transaction costs and facilitate investors understanding of the particularities and specifics of the business they are funding.

In this context, the benefits of an integrated EU capital market are enhanced, offering both access to large group of investors and sophisticated products at EU level for the big multinational companies but also to local, developing capital markets for the SMEs and the smaller actors.

#### **ARE THERE AREAS WHERE EUROPE SHOULD BUILD AN AUTONOMOUS INTERNATIONAL SYSTEM IN ORDER TO BETTER PROTECT EUROPEAN INTERESTS?**

It is clear for all of us that these are times where we need to make EU stronger and to protect its interests globally. Euro has to strengthen its role and spread its coverage in terms of transactions or holding currency. The Euro is used today in about 60 countries in the world, either as their official currency, or linked to their national currency or are preparing to adopt it as their currency. However, we need to do more at international level to reflect EU's political and economic importance.

Euro it is not used at its full potential. We need to create a European brand regarding the payment solutions used at pan-European level. An EU-wide instant payment system will help both the customers and the businesses, would enable fast, efficient and safe transactions and cost reduction. Besides its benefits within the EU, such a system may help reducing EU dependence on the global payment providers and card schemes and waive off some of the vulnerabilities of our internal market to outside influences.

All EU member states need to work together to build an equivalence system, they need to be aware that reliance on each other's regulatory and supervisory systems is vital for the proper functioning of the common instruments and for a reinforced market infrastructure.

Our commitment is constant and consistent to face the inside or outside challenges and to make possible for every European citizen to feel at home in every Member State. ●

# Mugur Isărescu

Governor,  
National Bank of Romania



**WHAT IS YOUR OVERALL ASSESSMENT OF THE PROGRESS MADE IN FINANCIAL INTEGRATION IN EUROPE? HOW TO EXPLAIN THE DEEPENING OF THE FRAGMENTATION OF EU BANKING MARKETS ALONG NATIONAL LINES SINCE THE CRISIS? WHAT ARE THE CONSEQUENCES?**

Financial integration is an essential driver in enhancing competitiveness and redirecting available capital across Europe. Moreover, it fosters a smooth and balanced monetary policy transmission throughout the euro area, being key for completing the EU Single Market.

Space for improvement certainly exists and countries like Romania could significantly benefit from deeper financial integration, especially those having an underdeveloped capital market.

## Q&A

### Financial integration in Europe: challenges and prospects

The fragmentation of EU banking markets along national borders in the wake of the crisis is the consequence of risk mispricing during the boom: fragmentation has increased simply because market participants were not aware of or ignored the fact that the institutional architecture of the EMU was incomplete. The lacking institutional pieces could no longer be underplayed after the crisis. Completing the EMU in order to facilitate risk-sharing is the way forward to address financial fragmentation.

As regards its consequences, they concern mainly the effectiveness of the transmission mechanism of the ECB's monetary policy. Financial fragmentation hampers the functioning of the standard interest rate channel. While a reduction in financial fragmentation has been achieved 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 normalise. Having in place an institutional set-up that relies on risk-sharing too is a prerequisite for a well-functioning EMU and an effective monetary policy.

**WHAT WOULD BE THE APPROPRIATE LEVEL OF INTEGRATION OF THE BANKING SECTOR IN THE EU AND THE EXPECTED BENEFITS? IS FURTHER CROSS-BORDER CONSOLIDATION POSSIBLE IN THE EU? WHAT SHOULD BE THE POLICY PRIORITIES OF THE NEXT EU LEGISLATURE IN THIS AREA?**

The appropriate level of banking sector integration is difficult to assess, but what is obvious, in my opinion, is that pre-crisis levels may not be proper benchmarks as the 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. Additionally, the introduction of instruments that can help Member States to deal with asymmetric shocks is also needed for improving risk-sharing among them.

The reforms of the regulation and supervision of the financial industry have taken us into 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 it is now better capitalised. But much attention needs to be paid to systemic risks in non-bank financial markets.

However, one effect of more integrated financial markets may be the decline of financial intermediation in some non-euro area EU countries, Romania and Hungary in particular, as international companies opt for credit outsourcing (where it may be cheaper).

Speaking about non-euro catching-up countries, no matter how much one wishes to put single currency adoption onto a fast track, success hinges on having achieved a critical mass of real and structural convergence. The lessons of the euro area crisis remind us this reality. The more robust the euro area turns as a result of institutional and policy reforms, the better for the current and prospective members.

Fiscal discipline is straightforward for a macroeconomist. The pitfalls of a lack of fiscal discipline are obvious: a near-sighted fiscal policy translates into persistent deficits, rising debt levels, output volatility and, ultimately, a loss in policy credibility. In general, adequate macroeconomic and macroprudential policies are needed to control external imbalances, for excessive private indebtedness is no less dangerous.

In Europe, however, there may be more to the desirability of fiscal discipline than the macroeconomic argument. It may very well have a political dimension: a commitment to fiscal discipline is needed for further integration. It is difficult to imagine a 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. Among the EU Member States, as between the participants on the insurance market, one cannot expect to reach an agreement involving risk-sharing if its winners and losers are known beforehand and presumed to stay as such for ever.

Beyond any concrete policy measures, I trust that the next EU legislature will find the right balance to address key institutional and policy related weaknesses.

#### **WHAT SHOULD BE THE MAIN PRIORITIES OF THE UPCOMING COMMISSION FOR HARNESSING DIGITALIZATION DEVELOPMENTS IN THE FINANCIAL SECTOR? WHAT ROLE CAN THE EU PUBLIC AUTHORITIES PLAY IN THIS AREA?**

Without any doubt, digitalization plays a key role in enhancing productivity and competitiveness, contributing significantly to economic growth. This is also valid for the financial sector, where digitalization is needed even more than in other sectors, as it facilitates business transactions economy-wide. The impact of digitalization development on the financial system may be considerable, as technological innovation has the potential to reshape the current structure of this system. The EU authorities must stand ready to address these challenges.

The outlook on payment and settlement systems hinges on keener competition, tighter regulations and stronger customer preference for digital experiences. The sustainable development of digitalization and technology-driven innovation in financial services (FinTech) requires an adequate competitive environment, which can be ensured by introducing a set of EU-wide applicable standards and rules. Moreover, establishing a clear and comprehensive regulatory framework governing the new technological progress in the financial field is a key prerequisite for the harmonized integration of FinTech products in Europe. The new set of rules should address technological and operational requirements, from the perspective

of both the business environment and the supervisory authorities, with a view to containing the materialization of risks to financial stability. Therefore, the main priorities that EU authorities should focus on in order to harness digitalization development in the financial sector are related to: establishing a legal framework for a regulated environment; enhancing a prudential supervisory framework; promoting specific technological education along with the exchange of information security data; enhancing the security and integrity of the European financial system.

#### **IS A STRONGER LONG-TERM INVESTMENT CAPACITY NEEDED IN THE EU AND WHAT WOULD IT INVOLVE? WHO CAN PLAY THIS ROLE IN THE EU AND WHAT REGULATORY, SUPERVISORY AND ECONOMIC FRAMEWORK IS NEEDED?**

The prospect of a hard Brexit is distressing, as it entails high uncertainty, shaking the grounds of planned investment, future trade and free movement of labour. It occurs at a time of a relative economic slowdown all over Europe, an erosion of multilateralism and broadening trade conflicts.

Poor investment prospects are worrisome given that half of EU countries continue to post below pre-crisis investment levels and, on aggregate, EU capital formation barely stands on a par with that witnessed prior to the outbreak of the crisis. Many empirical studies have placed uncertainty among the main drivers of investment dynamics, and this is not surprising. Investment requires irreversible expenses, so a “wait-and-see” attitude becomes more appealing. Moreover, risk aversion most often prompts businesspeople to boost precautionary saving.

To deliver clear and credible messages that mitigate the concerns of businesses and consumers alike is a challenge that policymakers need to live up to, and they certainly know it. It is high time to strike a deal on the Multiannual Financial Framework so that the great challenges the Union is facing (protection of borders, cyber fare, climate change, conflicts in near and more remote regions) are solved in a way compatible with preserving the EU's cohesion. Having a euro area budget does make sense, but it should, arguably, stand on its own feet and not hollow out the EU budget.

As a central banker, I have to point out that monetary policy plays an essential role in ensuring an economic climate conducive to long-term investment and subsequent sustainable growth. The economic recovery of recent years has heavily hinged on non-standard measures of major central banks and very low interest rates.

There are still large public and private debts, which prove especially burdensome in the euro area – and which compound the mission of monetary policy normalisation, of unwinding the ECB's non-standard measures. Fortunately, some emerging EU economies (including Romania) are in a much better position in this respect.

Irrespective of the pace of monetary policy normalisation in Europe, keeping internal and external imbalances in check, including through the implementation of structural reforms, is essential to achieve lasting economic growth. The future might look uncertain, but we can surely try to be better prepared for it. ●

# Valdis Dombrovskis

Vice-President for the Euro and Social Dialogue,  
also in charge of Financial Stability, Financial Services  
and Capital Markets Union, European Commission



**HOW DO YOU SEE THE STATE OF PLAY OF THE BANKING UNION? CAN THE DEEPENING FRAGMENTATION OF THE EU BANKING MARKETS ALONG NATIONAL LINES BE REVERSED ON THE BASIS OF WHAT HAS BEEN ACHIEVED?**

Europe's more than 5000 banks play a crucial role in our financial system, so a strong and integrated Banking Union has been and remains one of my top priorities: first, because it is essential for ensuring financial stability and deepening the Economic and Monetary Union. Second, because it decreases the burden on taxpayers, by helping to replace public risk-sharing with more

## Q&A

## Completing the Banking Union and the Capital Markets Union for a stronger EU at home and abroad

private risk-sharing. And finally, because it helps to ensure a level playing-field for banks to expand cross-border and compete across Europe.

Thanks to the Banking Union, the euro area now has a single supervisor for large banks, a single framework for resolving failing institutions, and a single fund to finance those resolution activities. And over the past years, the European Commission has continued making important progress towards a safer and more robust banking sector.

For instance, we have completely overhauled our prudential framework for the single market. We have transposed internationally agreed prudential standards into EU law, while taking into account European specificities, and even going beyond what is required by the Basel rules. And in December, we reached a deal at EU-level on the banking package. It complements the risk reduction progress already achieved, and lays the basis for further strengthening the Banking Union.

Today, the Banking Union is steadily delivering results and lowering financial risks:

- Overall, European banks are better capitalised, less leveraged, and with higher liquidity buffers than before.
- The average level of non-performing loans in the EU is down to 3.3% as of the third quarter of 2018, according to the ECB.
- And as part of the banking package, EU lawmakers agreed to treat the Banking Union as one entity when identifying systemically important banking groups. This removes another impediment to a more integrated banking market.

Nevertheless, European banks still face major challenges. In particular, low interest rates, still high levels of non-performing loans in some countries, and competition from Fintech firms is pressuring European banks to consolidate. Despite the many systemic improvements, banking markets in the Banking Union remain more fragmented than before the crisis.

In light of the progress achieved on reducing risks in the banking sector, we should now push together to tackle the gaps in the Banking Union. These include a common backstop to the Single Resolution Fund and a common deposit insurance system. This would promote the cross-border integration of our financial sector, further improve its capacity to absorb shocks, and set Europe's banks free to compete on equal terms across the continent.

**THE COMMISSION SET OUT PLANS TO CREATE A CAPITAL MARKETS UNION IN THE EU. AS THE TERM OF THE LEGISLATURE COMES TO AN END, HAVE WE ACHIEVED THE OBJECTIVE? WHAT IMPACT MAY BREXIT HAVE IN THIS RESPECT?**

This Commission has worked consistently to put in place the key building blocks of the Capital Markets Union (CMU), so that firms and investors can access market funding on equal terms, no matter where they are located. The aim is to diversify funding for EU companies, to reduce their reliance on bank funding only.

Our determination to complete the CMU comes from the real benefits that well-integrated and liquid capital markets can bring to Europe's citizens and economy:

- For example, in terms of financial and economic stability, CMU can help to cushion country-specific shocks and mitigate overall financial risks in the Economic and Monetary Union.
- And in terms of job creation, CMU can help attract investment from abroad, and channel private funding to the most innovative and productive companies and projects here in the EU.

Today, we can look back on the substantial progress that we have made. During this Commission, the EU has adopted or agreed a range of new CMU proposals, so let me name a few of them:

- we have agreed new rules to boost the ability of investment firms to help companies tap capital markets, manage assets, and provide market liquidity;
- we have new rules on prospectuses and on SME Growth Markets, so companies can seek more funding from stock markets across the EU;
- we have a new approach to insolvency, to help viable companies restructure early, and give honest entrepreneurs a second chance;
- and we have a new pan-European personal pension product, and measures to improve the EU's investment fund market, which will provide new saving and investment opportunities for consumers;
- On top of that, there is more new Capital Markets Union legislation, which has been agreed and adopted only in the recent weeks.

Meanwhile, there are already some early positive signs of stronger integration in the EU, as firms increasingly access capital market funding to complement their bank lending. For example, the cross-border distribution of EU-labelled investment funds has grown steadily.

I hope and expect that work on CMU will continue also in the next Commission. In any event, future actions will need to reflect the impact of Brexit on capital markets, including by ensuring that all critical functions of the EU's capital markets are properly regulated and supervised. We also need to keep preparing for the fundamental and rapid changes arising from climate change, the decarbonisation of the economy, and developments in financial technology.

**ARE THERE AREAS WHERE EUROPE SHOULD BUILD AN AUTONOMOUS INTERNATIONAL SYSTEM OR, AT LEAST, STRENGTHEN ITS CURRENT MECHANISMS IN ORDER TO BETTER PROTECT EUROPEAN INTERESTS? HOW TO MOVE TOWARDS THIS OBJECTIVE?**

With recent challenges to international rules-based governance and trade, and the eastward movement of the world's economic centre of gravity, the world is clearly becoming more multipolar.

In this context, Europe should remain the standard-bearer for global cooperation, multilateralism, and democracy. But we should also recognize that to successfully promote our values abroad, we need to better protect our economic interests globally. This calls for strengthening the international role of the euro, which is the world's second most-used reserve currency, after the US dollar. And last December the Commission adopted a strategy to achieve this.

By further reinforcing the global role of the euro, we can support a more diversified and resilient international financial system. And we could lower currency conversion costs, interest rates, and exchange risk for European consumers and businesses that trade internationally.

Of course, achieving a greater role for the euro depends ultimately on the choices of market participants. But I believe having the right policies in place will help greatly:

For example, a strong currency is built on strong foundations, so we need to complete the architecture of the Economic and Monetary Union. We need to back up the euro with the full range of stable financial services and infrastructures, because deeper and more integrated markets can help businesses fund themselves at lower costs. This means we should complete the Banking Union and the Capital Markets Unions.

We should also make sure that Europe has resilient financial infrastructures, and one particularly relevant example is payment systems. With recent launches by the European Central Bank and by EBA Clearing of infrastructure solutions to process instant payments, we now have the capacity to develop a pan-European network for instant payments. This could potentially disrupt existing payment solutions - including cards. The European Commission is ready to help develop the appropriate standards in a way that is open and fair for existing and new operators.

We also need to promote the use of the euro in international energy agreements and in trade. In fact, there are a number of strategic sectors where the euro can play a bigger role, such as food commodities, aircraft building, and raw materials. But maybe most important of all is the energy sector. Today over 80% of Europe's energy imports are priced and paid for in US dollars. Therefore we are looking at policies that can increase the use of the euro in contracting and transactions in these sectors.

And finally, we should seek to develop Europe's economic diplomacy, by engaging with global partners to promote the use of the euro in payments and as a reserve currency. Europe is an important geo-political actor with real economic influence, and we could better make use of this position to reinforce the international role of the euro. ●

## Klaas Knot

President, De Nederlandsche Bank  
& Vice Chair, Financial Stability Board



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### Q&A

## New challenges in an evolving financial system

### WHAT ARE THE KEY CHALLENGES FOR FINANCIAL STABILITY TEN YEARS AFTER THE FINANCIAL CRISIS, AND WHAT ROLE IS THE FSB PLAYING?

Ten years ago, in response to the global financial crisis, the Financial Stability Forum was re-established as the Financial Stability Board (FSB). Since then, the FSB has largely focused on the implementation of the G20 financial reform agenda to create a more resilient global financial system. The reform agenda includes tightening regulation, intensifying supervision and strengthening international cooperation. Now, after ten years a significant part of the regulatory reform agenda has been completed and we are entering a new phase. The upcoming period will focus on finalizing the implementation of reforms, evaluating whether the reforms have achieved the desired effects and identifying new vulnerabilities in a financial sector which continues to evolve.

With the Standing Committee on Assessment of Vulnerabilities (SCAV) the FSB has a leading role in assessing the impact of evolving market structures and technological innovation on global financial stability. Two specific areas that would benefit from global coordination are cyber resilience and non-bank financial intermediation.

First, the financial sector is becoming increasingly technology-dependent, and financial institutions are more frequently targets of state actors and organized criminal groups. Cyberattacks are a potential threat to business models and the stability of the financial system. In close cooperation between its standing committees, the FSB will continue to work to enhance cyber resilience. The Standing Committee on Supervisory and Regulatory Cooperation (SRC) will identify and assess the best practices relating to a financial institution's response to a cyber incident. The SCAV will

continue to analyze the systemic consequences of operational and cyber incidents.

Second, as a result of regulation, risks tend to shift to less regulated areas: the 'waterbed' effect. Non-bank financial intermediaries play a growing role in the financial system and their share of the financial system is currently the largest on record. They are becoming important players in areas where banks have traditionally played dominant roles. Authorities need to remain vigilant in addressing financial stability risks that emerge as a result of non-bank financing, through enhanced data collection, improved risk analysis and implementing appropriate policy measures. This includes the FSB's policy recommendations for addressing structural vulnerabilities from asset management activities.

#### WHICH STRUCTURAL CHANGES ARE IMPORTANT?

As mentioned, the financial sector is becoming increasingly technology-dependent and there is a shift towards non-bank financial intermediation. Another topic that requires further attention in the coming years is for example the effect of energy transition risk on the activities of financial institutions and the stability of the financial sector. At DNB we have conducted several studies on this topic. Under the Paris Agreement almost 200 countries pledged to keep the global temperature rise well below 2 degrees Celsius. This pledge translates into a transition to a low-carbon economy and energy system. From a financial stability perspective, we have developed a stress test to gain insight in the potential financial stability effects. The stress test shows that a disruptive energy transition for the financial sector in the Netherlands can lead to significant losses for financial institutions. Policymakers can help avoid unnecessary losses by implementing timely, reliable and effective climate policies. Individual financial institutions should take energy transition risks into account in their risk management.

#### IS MARKET FRAGMENTATION AN IMPEDIMENT TO A RESILIENT FINANCIAL SYSTEM?

Market fragmentation is a complex phenomenon. Detecting and addressing sources of market fragmentation is important for maintaining an open and resilient financial system. Market fragmentation could for example stem from cultural differences, investor preferences, differences in the development of the financial system, as well as domestic policies, financial regulation and supervision. Market fragmentation arising from differences in regulation reflecting domestic mandates could increase the resilience of financial systems, whereas fragmentation limiting opportunities for cross-border diversification and risk management reduce the resilience of the financial system. The implementation of international standards could play a central role in harmonizing regulation and reducing negative effects of market fragmentation. To this end, enhancing the effectiveness and efficiency of international cooperation is key to ensuring new regulations are implemented consistently across the board.

#### WHICH FURTHER STEPS COULD CONTRIBUTE TO A STRONGER FINANCIAL SYSTEM IN EUROPE?

Over the years we have made progress in integration and harmonization of policy, standards and regulation in the EU. With the establishment of the Banking Union, the EU was given the responsibility for supervision and resolution of large banks. The

establishment of the Capital Markets Union constitutes a step towards further integration of capital markets of the EU Member States. I would like to make the case once again for deepening financial integration and deliver on the Capital Markets Union.

The Capital Markets Union will make it easier for savers and investors to diversify their investments within the EU, will provide business with better access to funding, can reduce Europe's strong dependency on banking intermediation and can enhance private risk sharing via cross-border integration. Finally, and maybe most importantly, a well-diversified Capital Markets Union improves the functioning of the monetary union and enhances the resilience to asymmetric shocks in the European economy and financial system.

#### WHAT IS THE WAY FORWARD TO A COMMON AND PREDICTABLE BANK RESOLUTION REGIME IN EUROPE?

With the adoption of the Bank Recovery and Resolution Directive (BRRD) for the EU as a whole and the creation of the Single Resolution Mechanism (SRM) within the Banking Union, historic steps were taken to create a common European framework for the orderly resolution of failing banks. The application of resolution tools such as bail-in or sale of business that are provided by the BRRD is however restricted to cases where a resolution action is needed to safeguard the public interest. In particular for smaller banks, the implication is that liquidation through national insolvency procedures still remains the default approach for bank failures. In my view, the challenge we are currently facing in the EU – and the Banking Union in particular – relates to the significant diversity of national insolvency regimes. Different frameworks imply different options and outcomes in insolvency for similar banks, dependent on the Member State in which they are located. And because the outcome of liquidation through insolvency can be different, it also confronts supervisors and resolution authorities with country-specific trade-offs in determining whether the application of resolution tools is warranted to safeguard the public interest in particular cases.

Taking a closer look at the Banking Union, creating a common pool of funds through a European Deposit Insurance Scheme (EDIS) would strengthen the financial capacity of national Deposit Guarantee Schemes (DGSs). For a larger group of banks, it would increase the credibility of liquidation through insolvency procedure as a resolution strategy. This is because such strategies are dependent on the capacity of the DGS to reimburse depositors. Hence, the introduction of EDIS would indeed constitute the next step in creating a common and predictable bank resolution regime for the Banking Union.

However, EDIS does not solve all issues related to the strong differences in national insolvency regimes. This relates in particular to risk sharing within EDIS, because differences in insolvency regimes lead to different recovery rates in insolvency. While this discussion is still in its early stages, there seems to be merit in studying options to harmonize the toolkit available in insolvency at the European level in order to minimize the potential for different outcomes in orderly liquidation. Furthermore, as long as differences remain between Member States in expected recovery rates, liquidity sharing could be considered as an intermediate step as this already provides the largest benefits necessary to further strengthen the bank resolution regime in the Banking Union. ●

# I. EU POLICY PRIORITIES AND INTEGRATION CHALLENGES

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## Issues at stake

The current European political cycle is nearing its end and it is the right time to look forward to the future and define the priorities for the incoming Commission.

Restoring capital mobility, favouring long term investment and supporting innovative projects with a strong immaterial content in all parts of the European Union remain major priorities going forward, in line with the objectives of the Banking and Capital Markets Unions. These major initiatives launched by the present Commission still need completing and possibly reviewing. The EU banking sector remains fragmented and oversized and the CMU action plan has so far not led to a strong development of capital markets in the EU.

Brexit makes the implementation of the Capital Markets Union even more important for Europe and calls for a thorough reflection on how to promote an efficient and competitive financial system in the EU.

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# Viability and future of the Eurozone



## Pierre Gramegna

Minister of Finance, Luxembourg

### Ensuring Europe's economic success: more sustainable, competitive and inclusive

In 2019, Europe's economy is set to expand for the seventh year in a row. This trend has led to a sizeable improvement in labour markets, with employment growing to record levels and unemployment receding markedly. Importantly, these favourable economic conditions have been widely shared, benefitting people and businesses across the entire EU.

Europe has come a long way since the crisis, thanks to determined action at both the European and national levels. A combination of structural reforms, sound fiscal policies and continued investment, improving our economies' competitiveness and raising the growth potential, has been the recipe for this success.

Throughout these past years, Luxembourg has been living by these same key principles. On the one hand, structural reforms have been implemented to enhance competitiveness: not only by strengthening the labour market, supporting private investment and redoubling investment in education and skills, but also by fully embracing the

international tax agenda. At the same time, Luxembourg carried out a comprehensive modernization and restructuring plan, which has helped the country to rebalance public finances and lower its debt-to-GDP ratio, while raising investment to record levels, with a particular focus on key areas such as mobility and digitalization to support the country's future prosperity.

Looking ahead, Europe must continue with this virtuous triangle of structural reforms, investments and sound fiscal policies to make its economies more resilient and competitive. A balanced approach is also needed to address future challenges:

First, it will be paramount to ensure the sustainability of our economies. If Europe wants to effectively address climate change and respect its commitments under the Paris Agreement, our economies need to become greener and investments must be targeted towards this objective. In this context, Luxembourg has notably developed a roadmap that establishes a comprehensive sustainable finance strategy contributing to the long-term sustainability goals through the engagement of public, private and civil-society stakeholders.

Second, the EU should build common action points fostering competitiveness. Low productivity growth was a key contributor to the slow recovery in the aftermath of the crisis. It will be key to step up efforts and improve the quality of investments, focussing on areas such as digitalization. Such a focus will be more conducive to the long-term success of our economies than yet another discussion on the perceived deficiencies of the European construction. In Luxembourg, for instance, a dedicated Ministry of Digitalization has been set up, with the focus to accelerate the digitisation of businesses, research and public services and thus to resolutely prepare the country for the future.

Third, economic resilience can be further increased by firmly embracing inclusiveness. The crisis has left scars on large swathes of the population, shaping negative perceptions and hampering trust in the successful European economic and social model. If trust is to be regained, it will be important to ensure that no one is left behind in a rapidly evolving world. The European workforce must therefore be prepared for a changing work environment. In Luxembourg, this structural change is considered a major opportunity to tap into new sources of productivity growth, notably through the so-called "Digital Skills Bridge" initiative, which aims to equip employees with the necessary skills in the digitalized workplace. At the same time, Luxembourg has recently also increased minimum wages by 100 euros to reduce inequalities and support an inclusive society.

If we collectively focus on all these key elements and develop the right solutions to address the most pressing challenges, whilst fully respecting our common rules such as those from the Stability and Growth Pact, Europe will continue to be a symbol of shared prosperity and remain a role model for others to follow. ●



## Bruno Le Maire

Minister of Economy and Finance, France

### The euro area budget will improve economic policy coordination in the Euro area

Economic policy coordination in the Euro area is essential for a well-functioning monetary union. It makes no sense over the long run for economies which share a currency to diverge too much. Although we have strengthened the Eurozone considerably since the crisis, it still has weaknesses and its biggest is perhaps that economies of the Eurozone continue to diverge. Deeper and earlier coordination of economic policies should help the Eurozone's economies converge over time.

Today, the state of public finances in Eurozone countries is extremely varied. On the one hand, some countries still have high debt levels in the aftermath of the crisis. They have little room for manoeuvre for fiscal expansion. On the other hand, other countries have more fiscal leeway and could use this space to support economic activity. It is even more the case when there also are high current account surpluses. Such surpluses reflect economic competitiveness but they also underline the weakness of domestic demand. Using this fiscal space is even more important at a time when there are clouds on the horizon and economic forecasts are more gloomy.

The differences between Euro area economies call for a genuine coordination of economic policies in the Euro area. In case of a more severe economic slowdown, such coordination could make a real difference to the speed of recovery in the Euro area. The objective should be for member states to define together an efficient and appropriate Eurozone macroeconomic policy with takes on board where countries are in the economic cycle and their specific structural situation. Four principles should prevail:

(i) continuing to reduce the high levels of public debt, (ii) pursuing the most needed structural reforms (iii) making use of fiscal space where available, and (iv) coordinating actions among European partners to maximize their benefits.

We all know that implementing structural reforms is of utmost importance as it is what makes the biggest difference to long term growth and competitiveness. France has taken decisive steps in this direction and will continue to do so. The PACTE bill, which should see its final adoption by Parliament before the summer, will overhaul the business environment to encourage business growth. It will help our SMEs to grow into mid-caps. Other ambitious structural reforms are also on the agenda: transforming our unemployment insurance scheme and our pension system to make them more resilient and fairer over the long run.

However, it is equally crucial to use fiscal space where it exists in order to support household's purchasing power as well as investment. Policies to that end include reducing the income tax for low-income households, supporting a robust wage growth and increasing public investment, where the focus should be on digital infrastructure, education, R&D and innovation. Such policies will also help to reduce Euro area macroeconomic imbalances, not by eroding competitiveness but by strengthening domestic demand. It will be a win-win approach that delivers higher growth for all Member States and lower debt for the Euro area as a whole, and in particular in today's high-debt countries.

Last but not least, our reliance on national fiscal policies in cases of downturns will be alleviated by the implementation of a budget at the Euro area level. The principle of a budgetary instrument for the Eurozone was agreed by Heads of State last December. Now we need to agree on its modalities by June 2019. It needs to be a real Euro area budget with permanent resources and a Euro area governance, which finances permanent expenditure targeted on actions that enhance future potential growth. Designing the Euro area budget in this way will ensure it supports the competitiveness and convergence of Euro area economies. When we have such a common budget, and it should be operational by 2021, this will be a key step in helping finance Ministers decide together priorities for investments and thus also a big step towards greater coordination of economic policies. ●



## Hartwig Löger

Federal Minister of Finance, Austria

### Tackling structural weaknesses in the Euro area: time to move ahead

The euro area is a political project to establish lasting peace in Europe and an economic project with the aim to improve the well-being and prosperity of its citizens. The straight line towards convergence that we have once believed to be an automatic result of the internal market and liberalisation of society has turned out to be a more tortuous path than expected. Due to the Great Recession the economic project experienced a significant setback, which sometimes is dubbed the “lost decade”. In political terms, the crisis has swept many governments out of office and populist parties emerged and play a stronger role in Europe.

It is to remember that the crisis led to the immediate emergence of solidarity and risk sharing in the euro area by establishing the EFSF and then the ESM, with significant firepower alongside the IMF, which got more resources from Europe. The principle of the ESM is solidarity, shelter and buying time in order to fix the structural problems of a country in times of severe economic distress. Fixing structural problems does not go without some pain, but ten years after the start of the crisis no country continues to be under a programme and all have regained access to financial markets. Notably, all former programme countries have much more resilient and fit-for-the-future structures than before the Great Recession.

This is not to say that structural problems in the economies are a thing of the past. While citizens tend to evaluate progress by their immediate surroundings, little seems to be known about the big leaps forward at the European and euro area level.

The new European architecture of the banking system and the financial markets is certainly a major achievement since the past crisis. Under the headings of “banking union” and “capital markets union” many of the weaknesses of the past could be resolved. In the second half of 2018, the Austrian EU Presidency made significant progress concerning financial services, including such complex issues as the banking package on risk reduction measures or the pan European pension product. Deepening financial integration in the Eurozone is an important contributor to economic growth. Protecting taxpayers’ money and reducing risks in the EU banking system will lead to a more resilient euro area. By establishing a stronger and more unified European capital market we will bring together investors and innovators, including on new financial services such as FinTechs, and thereby lay the ground for higher productivity growth in Europe.

We have not yet resolved all problems and legacy issues of the crisis put a burden on the debate. But these sometimes lengthy, repetitive and emotional debates allow us to develop a better mutual understanding and visions about the future of the euro area. I’m deeply convinced it is a path that is worth following, an effort that is absolutely required from us in order to build a better Europe.

Populist movements tend to question basic institutions of Europe. One topic in this field is central bank independence. For us it is a core value of institutional stability, which must never be put into question. Without any doubt a well-functioning state has to guard and protect central bank independence and it is a matter of concern to us that this appears to be coming under threat even in Europe.

In the absence of a political union, the rule of law forms the basis of the European project. It is necessary for all European Member States to stick to our common rules. As a minister of finance and from a European perspective this first and foremost applies to our common fiscal rules. These rules are not only needed to avoid negative spill-overs to other Member States, but are essential for not excessively burdening the national future generations, as those are at the same time the future generations of Europe.

This brings me to the euro area budget. With the same argument in place, it cannot be based on extra credit-financing and it should finance structural reforms of euro area Member States. Austria is willing to contribute to lessening the pain of structural reforms by means of a euro area budget.

The Treaty on the Functioning of the EU has left many important competences at the national level. There is no lack of ideas on reasonable and useful structural reforms. With the European Semester, Europe has developed a useful device to detect structural problems in the Member States. Let’s reinforce this instrument via the euro area budget. ●



## Tuomas Saarenheimo

Permanent Under-Secretary, Responsible for  
International and Financial Affairs,  
Ministry of Finance, Finland

### A fiscal union would not complete EMU

The present debate presents the EMU as an incomplete structure. Lacking independent monetary policy, and absent the stabilizing effect of a true federal budget, Member States are vulnerable to asymmetric shocks, leading to higher risk of economic and financial instability. Deeper fiscal integration within the Eurozone is regularly proposed as key remedy for this shortcoming. A Fiscal Union would entail mechanisms of fiscal risk-sharing between Member States and —as a prerequisite for such risk-sharing— stronger controls over Member States' fiscal and macroeconomic policies.

It is easy to agree that EMU is, in some ways, incomplete. In particular, the Eurozone's fragmented financial landscape remains a clear source of instability. While on the regulatory side, the Banking Union has taken important steps forward, the same cannot be said about progress on cross-border integration of the banking industry. European banking continues to be largely national, making financial sectors overly exposed to the same asymmetric shocks as their domestic sovereign. Further, compared with the US and other well-developed monetary unions, the role of European capital markets in cross-border risk diversification

remains small. Consequently, asymmetric shocks are absorbed primarily nationally, and the coincidence of sovereign distress and financial instability remains high. Fixing this is by far the most important part of creating a stable EMU.

In contrast, the significance of fiscal integration for the stability of EMU is much less clear. Contrary to the popular perception, evidence from major federations consistently shows that the role of the federal budget in smoothing state-level fluctuations is actually small, and even that small contribution tends to deal primarily with symmetric (ie. federation-wide) shocks. For state-level asymmetric shocks, the primary focus of the European discussion, the federal role tends to be almost nonexistent. On this evidence, it is difficult to see how the lack of federal level fiscal stabilization could be the missing element from a complete EMU.

There is another, deeper reason why a fiscal union alone might not only fail to stabilize EMU but could instead add new fragilities to it. Compared to other dimensions of integration that are part of EMU, such as monetary and financial regulatory integration, fiscal integration is fundamentally different. Whereas monetary policy and financial supervision are, in all developed countries, administrative tasks delegated to non-elected experts, fiscal policies remain everywhere in the hands of elected politicians. In national elections, budgetary programs constitute a key part of parties' electoral platforms. They are what mobilize people to vote.

This is a key difference. Common monetary policy and the Banking Union shifted responsibilities from national expert bodies to European expert bodies and thus had little if any effect on the democratic politics of the participating Member States. In contrast, fiscal integration would shift responsibilities from national elected bodies to the hands of European non-elected bodies, thus narrowing the scope of democratic decision making. The risk here is hollowing out of national democratic life. Taken too far, the outcome could be alienation and apathy among voters and, eventually, voter backlash with unpredictable consequences.

A stable EMU cannot stand on unstable political foundations. An effective and democratic fiscal union is only possible together with a much stronger political union. This is not about symbolic changes such as a European Finance Minister but about far more fundamental reforms. It is about creating a true European political space, with true European political parties with complete political programs, a true European media that can hold European politicians accountable, and a deep European civil society to channel citizen participation. Such a political union remains a long-term prospect, at best. Therefore, steps towards deeper fiscal integration should be taken with caution. ●



## Mahmood Pradhan

Deputy Director, European Department,  
International Monetary Fund (IMF)

### Getting financial integration back on track

Euro area financial integration has been derailed since the crisis. We need to get it back on track. Cross-border interbank lending amongst euro area banks is back to 2005 levels. Cross-border private sector risk sharing through the capital markets remains low, partly because institutional investors in the euro area, such as pension funds and insurers, exhibit significant home bias in their asset holdings. And euro area households concentrate over 80 percent of their financial assets in bank deposits and deposit-like instruments.

This is a far cry from the integrated financial union that the euro area was envisioned to become—a currency zone where private sector risk sharing across countries would flourish to the benefit of all. In this vision, the creation of the economic and monetary union was meant to facilitate a diversification of risk exposures by financial intermediaries in all member states, across both national borders and economic sectors. That was to become a financial union where equity capital in one jurisdiction could support prudent risk-taking in another jurisdiction; where deposits in one country could fund sound lending in another; and where financial and nonfinancial firms alike could issue equity and debt into a single and integrated European capital market, to a single European investor base.

We need a renewed push to achieve this vision of finance without internal frontiers. In practice, this means completing the banking union, pressing forward to build a capital markets union, and ensuring seamless integration between the two.

While we have seen a lot of progress on unified supervision with the creation of the Single Supervisory Mechanism, gaps in supervisory powers—in the ability to impose fines, to name just one example—need to be filled. While there has been some progress on bank resolution with the creation of the Single Resolution Mechanism, here too there is much work still to be done. Steps such as creating a common backstop to the Single Resolution Fund are certainly positive, yet the banking landscape is riddled with loopholes, with countries able in some cases to resort to national bank insolvency frameworks that still vary considerably.

Moreover, the third pillar of the banking union—a single European deposit base—is still missing. The European Commission has put forward concrete proposals to ensure that greater cross-country risk sharing through common deposit insurance be accompanied by further risk reduction in banks with higher nonperforming loans and concentrated risks. But there is still much resistance in many quarters, and we have yet to see material progress on this front.

Taken together, all of the missing elements in the banking union superstructure mean that national ring fencing of bank liquidity and capital remain the norm, not the exception, limiting cross-border risk sharing and—ultimately—a more uniform cost of intermediation and funding for the real economy.

Creating a true capital markets union is no less of a challenge. Reducing the costs of cross-border portfolio flows through more uniform standards across national capital markets and incentivizing a shift in the investment behaviors of both professionals and households is a long-term project. Here too, policymakers will eventually have to tackle difficult hurdles, such as modernizing and harmonizing national corporate insolvency regimes. Yet meaningful progress is possible. There are some obvious wins—take a fully portable European pension product, for example, which would also support labor mobility.

Euro area policymakers need to identify the less contentious reforms, where faster progress is within reach, and spend scarce political capital on pushing those through now. Because achieving the envisioned degree of financial integration in the euro area will be a long journey, it is all the more urgent that we do not let progress simply stall, that we keep trudging toward the final destination. ●

# The Eurofi High Level Seminar

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# Priorities for the upcoming Commission



## Jean Lemierre

Chairman, BNP Paribas

### It is now urgent to complete Banking Union, revitalize CMU and ensure security and fair competition in digital banking

As the current EU legislature comes to a close, it will be over a decade since the sub-prime crisis burst. In the intervening years, Europe has made very considerable progress in strengthening its financial system. The Single Supervisory Mechanism, the Single Resolution Board and the Single Resolution Fund represent important achievements. Even though the foundations for further integration have been laid, Banking Union has not progressed yet. In fact, it is now amply evident that fragmentation in the European banking industry has increased. 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 today less concentrated than that of the US. What are the implications of this? For the economy, a non-optimal allocation of savings (which do not circulate within European countries) to the detriment of investment and a loss in the potential economic growth in Europe.

At the same time, the low interest rate environment that has prevailed in Europe for a number of years has put strong pressure on banks' net interest margins. When taken together with the cumulative impact of new regulatory requirements and increased fragmentation, it has led to low profitability of European banks ever since the crisis.

Contrary to the US, European banks finance 75% of funding needs and markets only 25%. In addition, EU banks will be confronted in the years to come with the implementation of "the new Basel III" capital and liquidity requirements which will force them, in a context of low profitability, into a deleveraging.

To avoid this worrying scenario, decisive action will be needed from the next Commission. Rebalancing the financing of the European economy towards more market driven financing is an overriding policy priority too. A first priority of the new Commission should be to take stock of CMU with a view to refocusing it, recalibrating notably the securitization framework, which given its excessive complexity and cost will not succeed in allowing banks to reduce their balance sheets through quality securitizations. In this respect it is important to recall that securitization has declined in Europe, from € 819 bn in 2008 to € 235 bn in 2017, while during the same period American issuance nearly doubled, from € 967 bn to € 1713 bn. Relaunching securitization would also further the objective of increasing private risk sharing which is key to absorbing economic shocks and will contribute to overcoming obstacles to the completion of Banking Union.

A second priority area of focus for the next Commission's work should be completing the Digital Single Market and making very significant structural investments to ensure Europe's digital autonomy and competitiveness in the world economy. Regarding financial services

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>>> specifically, the digital transformation can greatly benefit European consumers and spur economic growth. The application of new technologies can reduce operating costs and improve access to financial services, often through new business models offered by both incumbent institutions and new entrants to the market. This increased competition is a stimulus for the industry, but ensuring a level playing field among all actors including Tech Giants and start-ups is essential to avoiding systemic cyber risks arising from the weak regulations applied to some actors. An equal footing will also enable banks to compete effectively and to make the very significant technology investments required. In this regard, it is important EBA supports the deduction of software investments in relation to capital requirement calculations, which US banks can avail themselves of. Two other essential areas in the digital policy agenda of the next Commission will be ensuring maximum cyber risks protection and prevention as well as appropriate European data regulations and governance in a context of continuous technological evolution. ●

1. Source: ECB (BSI)
2. AFME Securitization Data Report Q4 2017



## Hans Vijlbrief

President of the Eurogroup Working Group and the Economic and Financial Committee, Council of the European Union

### EMU and integrated financial markets need each other

Integrated financial markets are crucial for the smooth functioning of the Economic and Monetary Union. They serve a dual purpose. They should contribute to an efficient allocation of resources and thereby spur innovation, productivity and competitiveness. Europe cannot afford to lag behind if it is to meet the challenges of globalization and technological change. They should also help smooth asymmetric economic shocks and thus contribute to macroeconomic stability through private sector risk sharing. This is an integral part of mature currency unions, and it is particularly relevant for the EMU where the scope for public risk sharing is more limited due to political constraints.

In fulfilling this double role, financial market integration would foster upward convergence in the EU. However, one of the key lessons learned from the financial and sovereign debt crisis is that sudden stop and reversals of financial flows come at a high cost. In other words, financial market integration needs to be put on a sustainable footing.

Since the crisis, major steps have been taken to improve the framework conditions for sustainable, financial integration thanks to the establishment of the banking union and to the capital markets union initiative. Both these unions are still incomplete, but progress continues being made. There are for instance, the recent agreements on the banking package of risk reduction measures and on the European Stability Mechanism providing the common backstop to the Single Resolution Fund. The latter is part of a broader use of the ESM, which notably includes more effective precautionary credit lines. In addition, under the auspice of the Eurogroup, a renewed push is being made to unlock the discussions on a European Deposit Insurance Scheme, which remains an indispensable, yet missing third pillar of the banking union. EDIS needs to be embedded in a broader discussion on what is still needed to arrive at a completed banking union. This can include legacy issues, cross-border banking, home-host issues, the prudential, insolvency and supervisory frameworks. The capital markets union is a more wide-ranging project, touching upon many aspects of the single market.

The above-mentioned strengthening of the EMU's architecture, including new elements of public risk sharing, will enhance the resilience of the euro area economies and

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>>> should therefore pave the way for more private risk sharing. At the same time, sustainable financial market integration requires more than improvements in the institutional framework. For financial flows to be directed across national borders, investors need to have confidence in the recipient countries' long-term growth prospects. This implies that countries have a self-interest to put in place high-quality domestic institutions, well functioning product and labour markets, and of course sound public finances, which have the fiscal space to react to economic downturns without putting public debt and financial sustainability into question. Convergence in these areas is essential for private risk sharing to take hold and to ultimately move to a more ambitious degree of public risk sharing. An effective implementation of the EU's economic policy coordination instruments - the European Semester, the Stability and Growth Pact, and the Macroeconomic Imbalances Procedures - plays a key role in this respect. Moreover, the decision of the Euro Summit of 14 December 2018 to establish a budgetary instrument for convergence and competitiveness in the euro area, is a recognition by the Heads of State or Government that countries that share a single currency have a specific and collective interest to support building sound economic structures. Work is underway by the Eurogroup, to develop this budgetary instrument.

In conclusion, the EMU will be stronger and more prosperous if it can rely on well-integrated financial markets. In some areas, this requires a centralised enforcement of common rules combined with public risk sharing, whereas in other areas, this requires decisive national action to lay the ground for increased convergence. Appropriately sequenced reforms that take account of the synergies and complementarities in these areas, have been and are being taken to this effect at European and national level. ●



## Odile Renaud-Basso

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

### Finance for the common good

At its core, the financial sector's function is to help households and firms across Europe realizing their projects while adequately handling risks. Stated like this it can sound easy, but for the financial sector to fully play its role European institutions should remain mindful of two strings of facts. First and foremost, the global financial crisis has exposed weaknesses, in global finance generally, and within the Eurozone financial architecture more specifically. Besides, the European financial sector is at the heart of several important mutations: (i) the transition towards a greener economy; (ii) the broad digitalization of our economies; (iii) the potential reshaping European linkages following Brexit.

Regarding the vulnerabilities exposed during the global financial crisis, much has been done since 2009 to make the financial system safer. The regulatory framework has been overhauled to strengthen financial players' resilience and the institutional framework has been completed to improve systemic risk supervision. In particular, there is a broad consensus to say that the banking sector is today more able to withstand a market downturn than 10 years ago; banks are better capitalized, their holding of high-quality liquid assets are much higher; their funding significantly more resilient. Nevertheless, to foster a robust financing of European economies much progress remains to be accomplished, and efforts to further integrate our economies will be key:

- Regarding Banking Union, our priority during the next regulatory cycle should be to make it deliver on its expected benefits in terms of cross border integration. A geographical diversification of assets would allow banks to better absorb local shocks while keeping their lending activity stable. Such an enhanced private risk sharing capacity would improve the resilience of the EU as a whole. A strong Banking Union also means strong, profitable and internationally competitive financial institutions. Concrete steps to lift cross border barriers are desirable and possible now. The Banking Union must deliver on its promise of an integrated banking market, otherwise support for the project risks fading away.
- But the efforts of the upcoming Commission in this regard cannot solely focus on the banking sphere. A strong European Union will necessarily have to rely on deep, integrated >>>

>>> capital markets. Their benefits would be twofold. By channeling the high savings of European households toward the real economy, they would on the one hand contribute to reducing the cost of capital for European corporates and to funding innovation. On the other hand, deeper capital markets would also provide firms with an alternative to bank credit; thereby diversifying their sources of financing and improving the resilience of their operations. In this regard, it is worth mentioning that changes of the prudential framework applicable to insurance companies are needed to foster long-term equity investment and deeper markets.

With respect to the deep transformations of our economies, European institutions role must be to set the right conditions for the financial sector to fully play its part. This is particularly important in triggering the necessary investments to finance the transition towards a low-carbon economy. In my mind, achieving this objective hinges on two complimentary set of policies:

- Chiefly, it will rely on setting ambitious climate policies, and providing the private sector with a transparent, stable, and credible transition trajectory. In turns, this entails on the one hand making sure that the environmental impact of economic activities is reflected in their costs. On the other hand, EU institutions should lead the way and ensure that their investments and policies are consistent with the objectives of the Paris agreement.
- Moreover, it is important to keep working at the European level toward developing a framework so that investors (and savers) can better assess the environmental impact of their investments and the risks they are facing. We fully support the Action Plan on Sustainable Finance and we are working intensively on the Taxonomy proposal, as it is an essential tool for market participants. ●



## Harald Waiglein

Director General for Economic Policy and Financial Markets, Member of the Board of Directors, ESM & EFC, Federal Ministry of Finance, Austria

### CMU – have we already reached the landing zone?

In 2015 the European Commission launched a comprehensive programme to put in place the building blocks for the Capital Markets Union (CMU) by 2019. Since that time quite a lot of legislative acts have been passed or are currently finalised. None of them delivers the vision of a fully integrated market which leads to the optimal allocation of capital within the internal market by itself, but they shall all contribute incrementally to improving and developing capital markets in the Union. So, any single measure does not carry much weight, but cumulatively they have the potential to turn fragmented pieces of legislation into a cohesive regulatory framework “to mobilise capital in Europe”. The CMU is also a different concept than the Banking Union where focus is laid on integration by shifting competences from the national to the European level. The CMU is more about creating a supportive framework for market participants by reducing barriers and offering new possibilities.

Whether the steps currently taken and suggested by the Commission in its Action Plan are sufficient remains to be seen. It is too early to assess whether the new regulatory framework is able to live up to expectations and contributes effectively to job creation and growth or whether further initiatives are needed. CMU is a long-term project, and it will be some time before the benefits of the implementation of the Action Plan are fully realised.

It is not only transposition into national law that takes some time. It is mainly the behaviour of market participants that needs to adapt to new possibilities. You cannot expect these behavioural changes to fully occur in the short run. Retail clients will continue to focus on products offered by national industry and SMEs will not immediately get listing in other countries. CMU is about offering possible and affordable alternatives to the financial products offered on the respective national markets. The search for alternatives can be seen as >>>

>>> the main driver for changes in behaviour. In order to start this search a certain level of discomfort by investors but also by enterprises must be reached to take on the burden for the search and for the resulting change. It can be induced by costs, quality aspects or even shortages and it is facilitated by technical progress. And the new CMU framework will slowly get the ball rolling to facilitate this behavioural change.

In the near future a lot of traditional family-owned SMEs will mainly rely on local debt financing, partly to avoid external influence by equity owners on their business strategy, even if all barriers were to be removed. But financial innovation as well as the need for a transition to a low-carbon and more resource-efficient economy will have implications for business strategies. The future generation of market participants is likely to be more open to these opportunities, but they are also under more pressure to face the new challenges. And it is up to the regulator and supervisor to provide for a stable and reliable environment when the rolling ball is increasing its speed.

For the near future you need to ensure that different instruments to boost investment and programs at EU level are available to support equity financing and risk capital. The right incentives need to be set so that these EU funds are tapped and create the expected added value. ●



## Roberto Gualtieri

MEP & Chair, Committee on Economic and Monetary Affairs  
and Member of the Brexit Steering Group, European Parliament

### Priorities of the upcoming Commission in the financial sector

The completion of the Banking Union and the relaunch of the Capital Markets Union should be at the centre of the next Commission agenda. A well regulated financial integration is essential to promote growth and convergence and to enhance the resilience of the Economic and Monetary Union and of the European economy, and while in this legislature we have made important step forwards in that direction we all know that we still miss some indispensable elements of a well-functioning Financial Union.

In the area of banking regulation and supervision we have achieved positive results. With the adoption of the banking package and the NPL prudential backstop we have achieved overall a balanced compromise, which will allow a further reduction of risks while avoiding unintended negative consequences on the lending capacity of banks. We also paved the way for the agreement on the backstop to the resolution fund, and I hope that the final negotiations will be concluded soon and the outcome will be consistent with the nature of an instrument which has to be credible and quickly deployable.

As far as future legislation in this field is concerned, I am confident that the work still to be done on the finalisation of Basel III will be conducted efficiently, and I do not see major difficulties in concluding positively the long cycle of necessary improvements of our prudential framework. Where we must absolutely break the deadlock is in providing a third pillar to the banking union and removing the regulatory limitations that prevent cross-border institutions from managing own funds and liquidity requirements more efficiently. The traditional distinction between risk sharing and risk reduction is not accurate, because backstop and common deposit guarantee contribute also to reducing risks, and because some so-called risk reduction measures, if badly conceived and implemented, might actually result in enhancing the risk, as in my view it would be the case with the introduction of risk weight and of concentration limits of sovereign exposures, especially without the presence of a common risk free European asset. >>>

>>> Having said that, it is clear that the credibility of the process of risk reduction is essential in order to make progress on EDIS and hence to make possible the removal of some impediments to banking integration. In this respect, I think that the supervisory action on legacy assets is already providing clear indications that we are moving in the right direction. We will follow carefully the work of the high-level working group established by the Eurogroup, and we hope that a credible and sustainable way forward towards the completion of the Banking Union will be defined. Let me turn to CMU. I do not need to stress its importance and the reasons behind this project: diversification, resilience, investments. We have said these things many times. I would like to focus on the ongoing work and on the political indications that come from it.

We have adopted basically all the legislation proposed by the European Commission: securitisation, prospectus, PEPPs EMIR refit and 2.o, SME growth markets, covered bonds, cross border distribution of investment funds, investment firms, disclosure and benchmarks for sustainable finance, ESAs review. This is positive, and it will have lasting and deep consequences in enhancing our financial integration, diversifying source of funding, increasing proportionality and protecting consumers. However, we have to acknowledge that despite the profession of faith that we have all heard about CMU, Member States have currently very limited appetite on a fundamental component of CMU that is a more European supervision.

I understand some of the concerns and their reasons, but still I believe that we will not make the necessary decisive progress in CMU without more supervisory convergence and more European supervision. Building on the partial achievements of this mandate, we should therefore in the next years realize a gradual trade-off between ownership and europeanisation of supervision of financial markets which remains fundamental. Second, we should work on the basis of three priorities: fostering the long-term dimension of the financing, including in the Solvency2 review, focusing on the funding of the real economy, specifically of the Small and Medium Enterprises, and fully embedding the sustainable finance project into our legislative framework. A financial integration based on common rules, strong supervision and aimed at more and better quality investments is the challenge of the next legislature, and the European parliament will continue to play a key role in order to achieve this goal. ●



## Vittorio Grilli

Chairman of the Corporate and Investment Bank EMEA, J.P. Morgan

### How can EU institutions drive progress towards more private risk-sharing through capital markets?

Amidst a challenging global economic and political outlook for 2019, it is imperative for Europe to be a credible leader for the global financial system. The opportunity to drive a policy agenda which deepens and broadens Europe's financial markets should remain a priority in a year of significant change for its institutions, providing the economies of scale for Europe to compete globally.

A key barrier to cross-border investment remains the complex web of European insolvency laws. I have previously discussed that insolvency reform is long overdue. The divergence and inconsistency of national insolvency rules makes it challenging for investors to pre-empt the credit risk of transactions, whilst proceedings can be costly and inefficient.

The most recent iteration of the Insolvency Directive is a promising start for companies to continue operating and protect jobs. It includes measures to increase the efficiency of restructuring, the provision of second chance, and preventive restructuring frameworks. A focus for the next Commission should be the harmonisation of rules across Europe to build on the Directive, leading to better cross-border investment and trade facilitation in a more >>>

>>> integrated single market. A cultural shift towards the acceptance of firms' insolvency is necessary, as capital reallocation leads to a more efficient economy. As we have seen in financial markets, there should be a constant drive towards (supervisory) convergence. In many ways, the work is only starting now. We should also tackle post-trade reform. The process began with the Giovannini Group which in 2001 identified key barriers to an efficient and resilient single post-trade market. Notable initiatives and regulatory changes have been introduced since, however post-trade remains segmented and processes continue to be delivered at a national, not pan-European, level. Policymakers should look for a sound legal basis for cross border settlement, and an efficient method of reclaiming withholding taxes; to ensure open access and interoperability for European CCPs, and that collateral management is harmonised and unencumbered by unnecessary restrictions; and to continue embedding T2S as a low cost, pan-European settlement platform.

Legislators should also follow their commitment to set up a single reporting source for consolidated tape by 2020 to help boost Europe's ETFs market. In the area of sustainable finance, Europe has demonstrated strong leadership and can steam further ahead of the US in the next Commission.

We estimate that ESG assets under management across retail and institutional investors currently stand at around US\$2.5 trillion and that 81% of global ESG-labelled fund assets are domiciled in Europe, compared to 16% in North America. European corporates are at the forefront of green bond (37% vs 26% US) and loan (78% vs 12% US) issuance. Luxembourg is home to the first green exchange, whilst the first stock exchanges to create dedicated green bond lists were Oslo, Stockholm and London. We welcome the Commission's efforts to develop a comprehensive sustainable finance roadmap. The aims of that agenda, building on the financial sector's ongoing work, should remain a continued focus.

Finally, deepening European markets will only be possible if they remain open to the rest of the world. For example, third country delegation of portfolio management allows investors to access centers of excellence globally; we are concerned that certain legislative proposals could lead to restrictions on well-established market practices and the openness of European funds. There is also a risk of fragmented approaches by Member States, on areas such as innovation and ESG, which could lead to a less efficient and integrated CMU. To avoid globally divergent approaches, the Commission should continue to play an active role in international fora. Global agreements, such as Basel, should be implemented nationally or regionally and, in case of deficiencies, amended at a global level. A year of institutional change offers vast opportunities for European leadership in the global economy. The new Commission and Parliament should focus on prevalent issues such as insolvency reform, global connectedness and internationalising Europe's ESG leadership in order to inspire a sense of openness and a positive outlook, not just for the continent but the rest of the world. ●



## Leonique van Houwelingen

Chief Executive Officer, BNY Mellon's European Bank

### Sustainable finance and Capital Markets Union – Moving from myth to reality

Mircea Eliade, the famous Romanian philosopher and historian of religion, once wrote (I paraphrase) that a myth is a story that never happened but that is nonetheless true.

In financial services policy discussions, there are two topics that are close to achieving mythical status. These are topics that everybody supports, that dominate discussions as to what should be done, but for which there is so far little progress towards a satisfactory outcome. These two topics are sustainable finance and the Capital Markets Union.

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>>> It goes without saying that these two topics should be high on the agenda of the next Commission. But it will be necessary for the European Commission to find a way for these topics to move beyond the status of myth to that of tangible achievements.

One challenge for the topic of sustainable finance is that it is burdened by a set of high expectations for which it cannot by itself deliver. By itself, the sustainable finance agenda cannot prevent the misallocation of resources that result from the existence of negative externalities in the underlying economic activities.

A second challenge is that the current flagship measure of the sustainable finance agenda, the taxonomy proposal, is conceptually very difficult. The Capital Markets Union agenda also faces major challenges.

The dominant feeling with respect to the work of the current Commission on the CMU project is a sense of frustration. There have been a lot of initiatives, some of which have been brought to a conclusion, but there is little evidence that these initiatives have so far had a significant effect.

A challenge in the morass of CMU initiatives and ideas is to find those ideas that can really have a transformational effect. A second challenge is Brexit. Brexit has clearly had an impact on the CMU project. The prospect of Brexit has made more apparent the need for the EU27 to develop its own capital market capabilities. Yet at the same time, different parties have had very different views on the impacts of Brexit, and on the need for specific EU27 public policy steps.

The ECB has pointed out that only about 5% to 15% of equity and debt issued by euro area companies is issued on UK capital markets and has argued that the increases of financing costs for such companies are likely to be modest. At the same time, London is dominant in many specific trading areas. AFME has pointed out that UK-based entities intermediate about 60% of equity turnover on EU27 exchanges, and 43% of global trading in the euro (spot, swaps, options and forwards) takes place in London, while only 22% takes place in the euro area. This has certainly driven a call for the EU27 to increase its autonomy in the provision of financial services.

There are a number of practical suggestions that can help the European Commission to move forward on the twin agendas of sustainable finance and Capital Markets Union. The first is to tie the two agendas together, as the climate-change mitigation aspect of sustainable finance is critically dependent on an increase in long-term private sector investment, and on the development of capital markets as a means to channel private sector savings into that investment. The second is to focus on long-termism in financial markets, and to tackle the biases in fiscal and regulatory rules towards short-termism. The third is really to focus on capital markets, and on the real problems of those markets. The problem today is not that some global financial markets are based in London, but that in many EU27 countries the local capital markets lack critical mass, and issuers and investors are constrained in their access to those markets.

In the same way that “all politics is local”, it is probably fair to say that most “capital markets are local”. What this means is that a critical dimension of the CMU project is the local, member state dimension.

But this is all probably not enough. In order to succeed in moving sustainable finance and CMU from myth to reality, we must also ensure that all the dimensions of the sustainable finance agenda – environmental, social and governance – are taken fully into account. ●

# Developing a stronger European investment capacity



## Pablo Hernández de Cos

Governor, Banco de España

### Fostering investment and economic growth in the EU

The euro is celebrating its 20th anniversary in a critical moment. The global economic slowdown, the protectionism threat, structural and technological transition in significant sectors, Brexit; they all create a very challenging scenario. Enhancing our overall capacity to resist shocks and fostering long-term potential growth are, in my view, the major challenges facing the EU. Long term growth has followed a downward trend during the past two decades - ranging around 1.5% in the euro area, well below figures close to 2% in the US-. This development has been driven by different factors including low productivity, demographics and particularly the persistent weakness of business investment.

Investment conditions improved in recent years, helped by the economic expansion, favorable financial conditions and public initiatives such as the Investment Plan for Europe. However, according to the European Commission estimates, the investment gap is far from having been closed particularly in higher risks activities, such as research and innovation and infrastructures, crucial for long term growth and competitiveness. In net terms, the investment rate in the euro area is still below 5% of net value added, while the average during 1999 to 2008 was above 7%.

Two factors represent important obstacles for investment activities. The first one is economic policy uncertainty, at record highs in 2018. Global trade policy, Brexit and the lack of decisive steps to further increase integration in Europe, play a role in this result. The second important factor is private and public indebtedness, which remains on average above pre-crisis levels.

At the EU level, both the Investment Plan for Europe launched in 2015 and its successor, the InvestEU Programme, as well as the project of a Capital Markets Union (CMU), could partially address low investment. The Investment Plan has contributed to mobilize resources and to remove regulatory and non-regulatory barriers, but it is hard to think that it will be enough to close the investment gap. In addition, some recent analysis suggest the need to scrutinize projects in a more demanding way, to increase additionality.

The proposals put forward by the European Commission regarding a Capital Markets Union, in parallel with the completion of the Banking Union, are crucial to enhance investment. CMU can complement Banking Union by increasing the volume of available resources and fostering alternative sources of funding, thereby reducing the high reliance of the Euro area on banking intermediation. Increasing depth, liquidity and

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>>> integration in equity markets, will contribute to diversify financing sources and reduce funding costs, offering borrowers and investors a greater variety of instruments and the possibility to channel savings to investment more efficiently.

CMU proposals can be especially relevant for small and medium-sized enterprises, which typically face more difficulties accessing finance, especially when bank credit is scarce or expensive. Measures aimed at helping startups and technological innovation by fostering venture capital and creating an EU framework for crowdfunding are highly relevant. In addition, CMU can aid in raising higher volumes of funds for large investment projects, such as energy and infrastructure, sourced from long-term investors such as pension funds or institutional investors. Finally, developing European-wide markets for ABS and covered bonds can help banks securitize loan portfolios, freeing up regulatory capital and increasing the supply of funds for new loans.

Proposals facilitating cross-border distribution of investment funds are particularly welcome. Greater diversification through capital markets can enhance cross-border risk sharing and alleviate risks of financial fragmentation, and thus mitigating risks of sharp drops in investment. A more coordinated or unified European supervision of capital markets could contribute to achieve this goal.

At the country level, we should keep in mind the vast literature that shows that the highest barriers to investment are related to the domestic business environment: rigidities in labor and product markets, administrative burdens, inefficient judicial systems and insolvency frameworks, the complexity of tax systems and the debt bias in corporate taxation tend to be associated with less investment. ●

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## Markus Ferber

MEP, Committee on Economic and Monetary Affairs,  
European Parliament

### Strengthening the EU's capacity to invest

Investments are key to ensure long-term economic growth and the long-term competitiveness of the economy and also in the short run, it pays off following investment figures closely as investments help to create jobs and to boost growth. Therefore, investment levels are figures policymakers and industry are paying very close attention to. During the financial crisis, investment levels all over the world took a severe hit and at least within the European Union, they still have not sufficiently recovered to reach pre-crisis levels again, this is particularly true for private investment. Therefore, policy makers across Europe and beyond have been pondering the question of how to lift investment levels back to or above pre-crisis levels.

When we think about investments, we have to make a distinction between public investments and private investments. While both might have similar effects on the economy at large, public authorities only have a limited and indirect ability to stimulate private investments. Nonetheless, there has been a vivid debate about how to stimulate both public and private investments following the crisis. The most prominent effort was certainly the European Fund for Strategic Investments and its successor vehicles.

While the European Fund for Strategic Investments certainly created a fair degree of media buzz, it is at least questionable if it has so far fulfilled its lofty ambitions of creating more than 300 billion euros in additional investments by leveraging the initial capital stock 15-fold. If you believe the European Court of Auditors' assessment, this endeavor was not entirely successful and it is more likely that most EFSI projects were those >>>

>>> that had been in the final stages of planning and were basically shovel-ready. That means that many of the projects that now bear the EFSI label would have been realised regardless of the EFSI's involvement. Arguably, that means that most investment did not fulfil the criterion to be truly "additional".

What can we learn from this subpar result for future investment funds? Well, after all, EFSI has primarily financed projects that were not too risky and that were ready to implement, i.e. it has financed projects that would have found financing on the market anyway. Probably, in doing so, it has even crowded out potential private investors. Hence, for the next instalment we should make sure that a vehicle such as EFSI can take on a little more risk in order to focus on projects that would otherwise not getting any market financing - that would automatically ensure that we get projects that truly fulfil the objective of being truly additional.

Looking beyond elaborate guarantee schemes, we should also consider how we can empower public authorities to make investments as they see fit. If Member States want to invest, they need fiscal space to do so. The rules of economic governance and in particular the fiscal rules enshrined in the Stability and Growth Pact aim to do just that: providing Member States with enough fiscal space in order to keep up with the regular investment schedule and to be able to react in case of an economic downturn. Arguably, the rising debt levels in the aftermath of the financial crisis have severely constrained Member States' ability to act. Therefore, bringing down public debt levels by rigorously enforcing the current fiscal rules would be a substantial and welcome contribution to increase Member States' capacity to make public investments when needed.

Lastly, when looking at the mere numbers, private investment is clearly where the biggest impact can be made. The key to unlock private investments is removing barriers and obstacles that currently hinder corporations to take calculated risks by providing a high level of regulatory predictability, by deepening the Single Market and by facilitating access to finance, in particular by completing the Capital Markets Union, which would also be a hedge against the impact of Brexit.

There is no silver bullet to strengthen the European Union's capacity to invest. Instead, what we need is a multitude of coherent and coordinated measures. The biggest issues are arguably to improve the enforcement of the fiscal framework thereby creating the fiscal space for Member States to invest and to finish the Capital Markets Union. ●



## Cyril Roux

Group Chief Financial Officer, Groupama

### Regulation is turning European insurers away from listed equities

Insurance is a long-term business subjected to regulation focused on short-term risk. As a result, insurance companies are led to underinvest in listed equities.

Insurers should choose their assets' duration and expected return in line with those of their (long-term) liabilities. In so doing, insurers would play their natural supporting role in the long-term growth of the economies in which they operate.

A number of factors interfere with this ideal scenario. Since 2016 the

first impediment to long term investment is the structure of European solvency requirements. Europe measures solvency exposure to asset risk under a one-year horizon. Investment in long dated assets subject to greater short-term volatility is thus structurally disadvantaged. The long-term guarantee package was meant to counteract this fundamental design flaw of Solvency II. It proved insufficient, so more shock recalibration measures are being added. These measures come with conditions, caveats, and complexities which limit the scope of the relief they provide. Unfortunately, EIOPA fights against these improvements, limited as they are, intends to advocate against such measures during the 2020 Solvency II review.

Other impediments to long term investing derive from well-meant consumer protection measures. PRIIPs requires that retail investors are fully informed of the risks they take when investing in volatile asset classes. >>>

>>> However, the greater long-term risk for savers of eschewing equities, i.e. lower net returns, isn't as visible. Investing in equities is costlier than in other asset classes. Finally, 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. However, they may lead retail savers to under invest in equities for their retirement, whether the vehicle to do so is unit linked insurance contracts, pension products, with profit life policies or UCITS.

Other regulations hamper equity investing. Inventories of equities on bank balance sheets have dried up with the combined effect of liquidity requirements, the quest for collateral and the discouraging of proprietary trading.

*"Insurance is a long-term business subjected to regulation focused on short-term risk."*

- CYRIL ROUX

Mifid2 has reduced research on small and middle caps. Insurers face European equity

markets with surprisingly low depth at times, except for the largest caps. And accounting changes, on IFRS 9 and IFRS 17, will exact an increased toll on the volatility of net results for those insurers ready to invest in equities.

In France, measures enacted to protect renters have turned insurers away from investing in residential housing, which has become for them a residual asset class. Europe would be well advised to weigh the risk that the combined effect of regulation of market research, proprietary trading, financial reporting, insurers' solvency and consumer protection do the same to most listed equities, notwithstanding the lofty aims of the Capital Markets Union. ●



## Gérard de La Martinière

Chairman, Long-Term Investment Task Force of the Paris Marketplace

### Betting on the long-term: rebuilding investment for the Europe of tomorrow

The Green Paper published by the European Commission five years ago highlighted the importance of long-term investment both for growth and financial stability. A set of initiatives was adopted in the framework of the Capital Markets Union (CMU) project in order to transform modes of corporate financing, mobilise financial markets and exploit

and allocate inflows of long-term savings. However, such structural measures could not produce significant results in the very short term. Decades would be required to shift the intermediated financing models that have traditionally reigned supreme in Europe in the direction of a market finance model. Yet in terms of international competition, stimulating long-term investment represents a much more immediate issue.

Until the market finance model becomes the norm, it is essential to better consider the long-term intermediation because it is today the main part of the resource: it is therefore essential not to limit the capacity of financial institutions to transforming stable resources into long term investment. From this point of view, Europe can rely on powerful intermediation entities that, in a post-Brexit context, could be relevantly combined with the development of market financing to favorably revisit the CMU.

The report recently published by the "Long Term Investment Task Force" of the Paris Marketplace<sup>1</sup> shows that adjustments adopted to modify at the margins the succession of grand post-crisis regulations (sometimes detrimental to investment) only partially mitigate the pitfalls of a regulatory system too heavily focused on the very short term, and which ignores the characteristics of their LTI 'business model'. They are just "patches" which limit the damage to some extent, but do not constitute an effective response to the major political imperative of stimulating private investment in the wake of the Juncker plan.

One of the merits of the first generation of European regulation of

the financial sector (banking, insurance, etc.) was to leave those responsible for these activities free to choose in the public interest which asset allocations were best suited to client requirements, to the circumstances and the economical context.

*"EU must globally address the LTI issue in order to establish an appropriate reference framework."*

- GÉRARD DE LA MARTINIÈRE

The principle of asset managers' freedom and responsibility is of even greater critical importance today given the diversification of investment instruments, the heightened financial instability and the enhancement of saver protection. To confront its current economic and financial challenges, Europe has no other choice than to address the issue of long-term investment in a global manner in order to establish an appropriate reference framework.

Finally, it is necessary to reinforce financial literacy and information regarding LTI. Indeed, levels of financial literacy in the different member states are generally low. The reinforcement of financial literacy vis-à-vis both the general public and decision makers is crucial if we are to improve the allocation of savings and should occupy a central position within LTI. ●

1. [https://www.caissedesdepots.fr/sites/default/files/medias/en\\_-\\_liti\\_report.pdf](https://www.caissedesdepots.fr/sites/default/files/medias/en_-_liti_report.pdf)



## Pierre Heilbronn

Vice President, Policy and Partnerships,  
European Bank for Reconstruction and  
Development (EBRD)

### Pensions matter for capital markets development

In my last contribution to EUROFI, I made reference to a 2016 OECD study which concluded that unfunded government pension liabilities in its 20 member countries exceeded USD 78 trillion – most of these in Europe. These unfunded pension liabilities are growing and if left unaddressed will place a large strain on future budgetary processes and pensions alike. Why do we then observe a recent trend where in some jurisdictions existing funded Pillar II arrangements are being nationalised rather than extended? And why do countries pursue an unfunded state system when Pillar II acts as an active institutional investor with a positive impact on capital market development?

In fact, funded pension arrangements have been criticised for the following reasons:

- High fees charged by private sector asset managers and advisors that undermine returns;
- Pension risks are borne solely by the individual without regard to the capacity

of the individual to assess risk and take complex investment decision;

- Pension funds' overinvestment in government securities creates a financing circularity – the state allocation to private pensions increases the need to issue debt which is bought by pension funds;
- Onerous investment restrictions by regulators mean that returns are highly unlikely to keep pace with inflation;
- Offshore investments by state pension funds (largely due to the absence of domestic capital market investment products) mean that a country's long-term infrastructure financing needs are not funded by long term national savings.

*"Viable solutions rest in constructively addressing the identified shortcomings."*

- PIERRE HEILBRONN

Yet, rather than throwing out the notion of a funded pension system altogether, viable solutions rest in constructively addressing the identified shortcomings:

- High management fees can be partially addressed by the establishment of low-cost default funds which would outsource the investment function to asset management firms as an institutional mandate, attracting lower management fees in this way. A large percentage of contributors are likely to favour such funds until they build familiarity with other investment products with different risk profiles.
- Pooling of risks in so-called 'collective defined contribution' plans in which assets (and risks) are managed on a pooled basis could also ameliorate the risks related to the individual taking all the investment risk and choices over how much to contribute.
- Over-investment in government bonds and offshore investments can be partially addressed by a comprehensive capital market development strategy that leads to an expanded array of investment products. This can be a desirable outcome for economies with potentially

large infrastructure funding needs, particularly in local currency. Regional initiatives such as Capital Market Union also target the expansion of financial products. Nevertheless, pension funds must have an allocation to safe annuity instruments such as government bonds, although some jurisdictions set maximum investment limits for that asset class.

- Some jurisdictions subject pension funds to UCITs style investment guidelines favouring investments that can be valued daily rather than instruments of a longer duration that can mirror a funds contribution profile and potentially may not keep pace with inflation. Ideally, there should also be an allocation to high growth potential sectors such as venture capital and even commodities. However, some balance of safety and return is advisable.
- Soft compulsion incentives may provide a powerful incentive for wealthier contributors to boost their retirement savings, leaving room for the public pension system to provide improved coverage to the less well-off retiree.
- Finally, any unfunded pension liabilities should be prominently published as an integral part of the national accounts, including year on year positional change according to an agreed standardised methodology. Evidence of this lies in the powerful private sector precedent where disclosure of unfunded pension liabilities in the company accounts, following the recommendations of the Myners report (2001), led to an expansion of defined contribution schemes in the United Kingdom.

In conclusion, funded pension schemes will appear economically efficient and politically desirable compared to unfunded pension promises if and only if such initiatives are implemented with determination. This is the deep belief that guides the operations and policy engagement of EBRD across Central and South-Eastern Europe and beyond. ●

1. Pillar II arrangements are funded pension systems where future recipients and employers pay into. This includes pension funds and defined contribution accounts/plans with a wide array of design options.

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# Addressing ring-fencing issues in the Banking Union



## Olli Rehn

Governor, Bank of Finland

### It is time to complete EMU financial architecture

We still have plenty of work to complete the financial architecture of the Economic and Monetary Union. Following the launch of the euro, financial markets in the euro area steadily integrated and led to the assumption that enhanced private risk-sharing would act as a shock absorber and a source of systemic stability. However, as we now well know, this turned out to be unsustainable. In the wake of the global financial crisis, the euro area financial market quickly started to disintegrate. It was not until the ECB's determined actions to embark on non-standard monetary policy measures that the negative market developments were halted.

Despite the subsequent strong policy response, first and foremost by strengthening the regulatory and supervisory framework and, second, by enhancing the institutional setup to deepen risk-sharing, euro area financial integration has remained weak. There are some positive signs in the post-crisis reintegration trend in prices but not in quantities. In particular, there has been very little what can be called deep banking integration, and the share of cross-border bank loans to and cross-border bank deposits from end-customers has remained stubbornly low. Banks' efforts have focused on safeguarding profitability and solvency and less on cross-border activities, with few exceptions.

There is broad agreement that fragmentation is suboptimal and comes at a cost for banks and the efficiency of the financial system. So why does the progress towards a more integrated euro area financial market remain so difficult? Briefly, as long as the EMU financial architecture is incomplete member states' have legitimate concerns and incentives to protect the interests of domestic stakeholders and engage in ring-fencing activities. The underlying reasons include information asymmetries, desire to protect credit supply, protection against financial stress in foreign jurisdictions, and additional safeguards due to domestic systemic importance.

With the establishment of the Single Supervisory Mechanism SSM and the Single Resolution Mechanism SRM, significant steps to enhance banking integration have already been taken. However, we need to complete the EMU financial architecture to overcome the remaining obstacles. With regard to the Banking Union, we must implement the remaining measures to ensure an effective and credible resolution framework. This, in turn, requires making sure that banks have issued adequate amounts of bail-inable liabilities and, as a second line of defence, ensuring a proper fiscal backstop for the Single Resolution Fund with sufficiently flexible decision-making

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>>> procedures. Furthermore, the common deposit guarantee scheme, built on appropriately designed risk-based insurance premia and medium-term fiscal neutrality, is needed to ensure uniform confidence in secured bank deposits throughout the euro area.

These risk-sharing mechanisms need to be carefully designed to ensure that incentive compatibility and greater risk-sharing will go hand in hand with greater risk-reduction. In this respect, two areas in particular would facilitate further progress. First, efforts to further reduce banks' non-performing loans need to be continued – cleaning banks' balance sheets will increase trust between banks and facilitate cross-border business. Second, banks' exposures to their home country sovereign risks must be reined in – banks are less able to absorb country-specific shocks as long as they are overly exposed to their home country.

It needs to be underlined that while the completion of the Banking Union is crucial, it is not enough. An equally important priority is the Capital Market Union. Recent research has shown that while a banking union is efficient at sharing demand shocks, a capital market union is necessary to help absorb supply shocks. Hence, to ensure efficient private risk-sharing in the euro area, banking and securities market integration need to complement each other.

A more fully integrated financial market will contribute towards a stronger EMU by improving the efficient allocation of capital, smoothing out temporary economic fluctuations, and making the transmission of monetary policy more effective. To take this agenda forward, we need to be able to carefully balance further risk-reduction with further risk-sharing. ●



## Pierre Wunsch

Governor, National Bank of Belgium

### Ring-fencing is a symptom, it's time to cure the disease

One reason which led to the creation of the Banking Union was the necessity to sever the doom loop between banks and sovereigns. To do so, the European legislators restricted the conditions for bail-out and introduced, in parallel, a single supervisory authority as well as a brand-new single resolution mechanism. There is, however, a potential tension between the action of the single supervisor, which focuses on ensuring the safety and soundness of European banking groups, with a policy choice of promoting cross-border integration through the free flow of capital and liquidity and the objective of resolution authorities tasked to solve the too-big and too-complex-to fail issues. This tension is exacerbated by the inconsistent treatment of groups in life and death.

Indeed, while supervisors tend to consider a group as a single entity, the group is treated as a collection of legal entities in bankruptcy. To overcome the absence of a group insolvency framework, the resolution framework introduces the concept of Single Point of Entry (SPE). The SPE approach implies coordinated resolution actions at parent company level and establishes a different hierarchy of creditors: the creditors of the parent company always absorb losses first and irrespective of where losses initially materialized.

BRRD2 clarifies that the SPE only works if certain conditions are met:

- a sufficient buffer – the external MREL – should be constituted at parent level, calibrated to absorb losses of the entire group. BRRD2 acknowledges that the SPE strategy is only credible if the group's external MREL buffer amounts to at least 8% TLOF on >>>

- >>> a subordinated basis. The current SRB MREL policy is not yet in line with this condition and deviations from the 8% TLOF floor are sometimes material.
- a mechanism to upstream losses and downstream capital should be set up. BRRD2 clarifies that the prepositioning of fully subordinated internal MREL instruments is, at this stage, the only robust way to implement such a transfer mechanism.

The internal MREL mechanism, however, constitutes an imperfect solution to the absence of both a group insolvency framework and a formal legal instrument modelling the parent support for SPE groups in case of failure. The differences in hierarchies of creditors in resolution and liquidation imply that resolution authorities, at the point of failure, might be forced to make an arbitrage between the interests of the creditors of the parent company (expected to be the first to suffer losses in resolution) and those of its subsidiaries (expected to be the first to suffer losses in insolvency when losses materialise locally). Facing this trade-off, authorities might prefer to intervene at the level of a subsidiary rather than resolving the group. This possibility to deviate from the SPE approach is recognized in both BRRD1 and 2. In absence of enough MREL buffer at legal entity level, such a deviation may lead to financial instability and severely disrupt the local real economy. This, in turn, might reintroduce a potential need for national bail-out – in contradiction with the objective of the Banking Union.

This is the reason why a delicate balance between the interests of home and host Member States needs to be preserved. The newly adopted banking package introduces a series of checks and balances necessary to preserve the interests of all Member States. Given the existing gaps in the legislation, the conditions to achieve a more ambitious framework are currently clearly not satisfied. It would not be consistent to implement a more permissive framework allowing free flows of capital and liquidity in going concern without simultaneously addressing the legitimate concerns which result from an incomplete framework to deal with gone concern issues.

However, the new banking package does not constitute a steady state. Reaching the steady-state requires developing a holistic approach of banking groups rather than progressing step by step and stopping in an uncomfortable midstream position. The establishment of the three pillars of the Banking Union is necessary but will not solve the issues raised above. Rather, it requires addressing several fundamental questions which have been left aside up to now, including the question of group insolvency, of the formalisation of parent support, and of the optimal governance of the Banking Union. ●



## Sylvie Goulard

Second Deputy Governor,  
Banque de France

### We must keep up the momentum towards further banking integration in the European Union

Banking integration allows for economies of scale, reduced exposure to asymmetric shocks through enhanced risk-sharing and better allocation of resources. Indeed, having geographically diversified loan book and deposit base makes banks less vulnerable to negative shocks and thus helps reduce the volatility of their lending and income streams.

Decisive steps towards a more integrated banking sector in the European Union were taken soon after the Great Financial Crisis broke out. Financial integration was indeed a key motivation for the launch of the Banking Union. Important measures were also implemented to reduce risks. European banks were made more resilient through gradual increases of their capital and liquidity buffers. According to the 2018 Q3 ECB Supervisory Banking Statistics, the stock of non-performing loans on banks' balance sheets declined from €trillion in 2014 to €694billion today.

Yet, the European banking sector remains fragmented, this lingering banking fragmentation having multiple causes.

First, national ring-fencing policies applied to capital and liquidity requirements continue to hinder the management of banks at group level. While such policies reflect obvious and understandable concerns of host countries, they are significant >>>

>>> impediments to the creation of genuine pan-European banking groups. A potential avenue to address these concerns is the safeguarding of the financial position of European subsidiaries in both normal times and crisis situations, through credible cross-border guarantees provided by the parent company, based on European Union law and enforced by European Union authorities. Such guarantees, which could also be collateralized subject to a supervisory authorization, would indeed pave the way for lower capital, MREL and liquidity requirements at the subsidiary level, while providing the local supervisors with the proper assurance they can legitimately expect. In addition, the level of capital, MREL and liquidity requirements to be posted at the subsidiary level could be regularly and jointly assessed by the home and host supervisors, taking into account the situation of the whole banking group.

A second obstacle lies in the insufficiently harmonized, consistent and predictable liquidation regimes for credit institutions across the European Union. While the directive on the reorganization and winding up of credit institutions may provide a legal basis conducive to further progress, it does not actually consider the situation of banking groups. Here again, setting rules for more robust group ex ante financial support to upstream losses, especially in the case where subsidiaries face difficulties whereas the group or the parent does not, could help bolster the confidence of host authorities.

Finally, further efforts should also be devoted to the implementation of an effective and harmonized deposit insurance scheme. Such a scheme would help indeed mitigate the potential impact of a bank failure on national public finances. Discussions on this subject are continuing but the devil is of course in the details. A design to meeting liquidity needs seems to be a sensible approach to achieve

the main objective pursued, namely covering potential funding gaps.

All in all, to address these key but politically sensitive issues and complete the banking Union, a pragmatic approach accounting for the concerns of host countries seems preferable.

*"A pragmatic approach accounting for the concerns of host countries seems preferable."*

- SYLVIE GOULARD

There is no doubt that the rewards make the effort worthwhile because at the end of the day, in a completed Banking Union, genuine pan European banking groups would be able to operate more effectively and be better prepared to face and resist foreign competition. ●



## Diony Lebot

Deputy Chief Executive Officer,  
Société Générale

### Addressing fragmentation in the EU banking sector

In order to foster competition, optimum capital allocation and stability of the EU banking markets, banks should be able to offer their services across borders within the Banking Union with as few undue impediments as possible. This calls for banks being able to freely allocate required capital and liquidity within their institutions, which ultimately will provide stability at group level.

Since the 2008 crisis, fundamental improvements in financial stability through the CRR/CRD framework alongside the ramp-up of the Banking Union have made the European financial system safer. However, little has been done to address ring-fencing measures and fragmented prudential requirements, as the recent failure of the overhaul of capital waivers in the CRR II showed it.

To tackle this problem in a way that is consistent with the free movement of capital principle, it remains essential to consider the Banking Union as a single jurisdiction when applying certain prudential requirements (solvency, leverage, liquidity, large exposures).

Countries within the Eurozone not only share the same currency and a single monetary union, but also benefit from having a Single Supervisory Mechanism and a Single Resolution Authority. However, capital and liquidity requirements stemming from the current legislative framework (CRR II/CRD V) are still at odds with these two pillars.

In this context, the priorities should be:

- To change the existing regulatory framework whereby capital and liquidity requirements in the EU need to be met both at consolidated and solo level. Unfortunately, no cross-border waivers have been secured in the last revision of the CRR. Moreover, we are concerned by the possibility granted to the host authority of a subsidiary to impose an

additional MREL buffer up to 2% above the group MREL's level (the so-called "safe harbour").

- To capitalise on the progress made in the Banking Union by removing restrictions that isolate capital and liquidity along national lines. Practically, we recommend a zero weighting for intra group loans between two institutions based in two different countries of the Banking Union but belonging to the same group. For Single Point of Entry models, fragmentation or ring-fencing of loss absorbing capacity at sub-consolidated level can increase the risk of bank failure due to "misallocation risk", the risk that banks have enough capital resources overall but cannot mobilise them to the right subsidiary.
- To achieve a European Deposit Insurance Scheme through the establishment of the third pillar of the Banking Union, aiming at underpinning stability in the banking sector. It is aimed to provide strong and uniform insurance coverage for all such depositors, independent of their geographical location in the Banking Union.

Achieving all these reforms will lead to a more effective and safer Banking Union, in which resources flow where they are most in demand by businesses and households. In this regard, we welcome the recent exclusion of intra-EU exposures of cross-border exposures in the review of the calculation of the G-SIB score by the CRR II: this is another crucial step towards the build-up of a fully-fledged Banking Union. ●



## Vitas Vasiliauskas

Chairman of the Board,  
Bank of Lithuania

### To scale up our banks, let us complete and expand the Banking Union

The presence of intra euro-area ring-fencing practices is one of the root causes of fragmentation in the European banking sector. As much as I would like to see this hindrance removed, consolidation of the banking markets should not come at the expense of host jurisdictions. In my view, the surest way to eliminate the need for domestic ring-fencing is both the completion and expansion of the banking union.

To complete the banking union, we must establish a fully mutualised European Deposit Insurance Scheme (EDIS). Should we scrap the solo approach and apply the prudential requirements at a group level, EDIS could solve an unsatisfactory asymmetry in which the engagement of the national host supervisor recedes but the national Deposit Guarantee Scheme must still bear the financial burden when a subsidiary fails. Ultimately, EDIS could help mitigate the sovereign-bank loop, paving the way for consolidation of geographically diversified banking groups.

In finalising the banking union, another key element is clarity concerning liquidity in resolution. The 'Monday Morning Problem', whereby the financial entity may not have adequate access to liquidity after the adoption of the resolution scheme, is one of the main gaps in the current resolution framework, which further reinforces the sovereign-bank nexus. I thus welcome the agreement on the common backstop to the Single Resolution Fund and hope that current policy discussions will continue, including the debates on how to best design a European-level public-sector guarantee for the ECB/Eurosystem liquidity provision in resolution.

Finally, in addition to a complete banking union, I would like to see an EU-wide banking union. Until this is established, we cannot turn a blind eye to the circumstances in countries such as the Baltic States, where the parent companies of the majority of the largest banks reside outside the euro area and are not supervised by the SSM. If such banking groups were to consolidate and

start operating in an integrated way, the hosts must be made sure that the domestic subsidiaries receive enough funds in times of market distress. A banking union which spans across the entire EU could help solve this problem. It would allow for the host jurisdictions to sit across the same table as the home jurisdictions, making collective and well-informed decisions.

*"A complete and EU-wide banking union will allow us to suspend ring-fencing practices."*

- VITAS VASILIAUSKAS

We should therefore put more effort into communicating to non-euro-area countries the benefits of joining the banking union through the 'close cooperation' regime. These include an intensified supervisory scrutiny on the back of the SSM resources and analytical capacities, information sharing, influence on European rule-making, and a strong basis for enhanced competition. Furthermore, if the banking union further develops its depositor protection and resolution tools, membership will substantially decrease the likelihood of a public bailout, which distorts expectations of both consumers and investors.

Overall, a complete and EU-wide banking union will ultimately allow us to suspend ring-fencing practices and unleash the full potential of pan-European banking. This goal could well become one of the top priorities on the European agenda in the new legislative term. ●

## Burkhard Balz

Member of the Executive Board,  
Deutsche Bundesbank

### Banking Union - More integration needs less risks

The Economic and Monetary Union has so far been the most courageous step towards strong economic integration with all its progress and setbacks over the past more than 20 years. The growth effects of deeper economic integration in Europe are considered to be positive with

estimations of contributing approximately to an increase in GDP of 5% to over 25%. With regard to financial integration the Banking Union is about to follow in terms of courage, but, in order to ensure that progress prevails, the positive elements have to be reinforced. While we created the Economic and Monetary Union in times of relative economic stability, the Banking Union has been set up during the most tremendous financial and debt crisis of recent history. It has been a challenging environment for the Banking Union, but the environment also offers the opportunity to make the legislation already more resilient from the start.

Financial integration will be facilitated when the credibility >>>



>>> in the long-term viability of the European banking sector and its credit institutions is restored. This was the working assumption of the Banking Union. The comprehensive set of banking legislation that has been adopted over the past decade has helped to achieve enhanced credibility. The direct supervision of significant European banks has been brought under the roof of the SSM, the resolvability of banks has been tackled, the rules on deposit guarantee schemes have been harmonised and the ESM has been established. In total, much work has already been accomplished. The more recent agreement on the Banking Package and the prudential backstop for non-performing loans adds positively up to the achievements. What is missing in terms of credibility and facilitating financial integration?

Credibility is also about the awareness and transparency of existing risks. Financial integration can be hampered, when risks are not sufficiently disclosed or not adequately priced. Risks won't disappear when they are shared. Where risks are further reduced, there is an opportunity to advance with financial integration in Europe.

*"Where risks are further reduced, there is an opportunity to advance with financial integration in Europe."*

- BURKHARD BALZ

Credibility is also about the application and enforcement of existing

legislation. The best legislation won't be effective, when its application is not equally ensured and monitored across the European Union. Where legal certainty across borders prevails, integration across borders becomes more and more attractive.

Finally, the goal of facilitating financial integration is not only a matter of integrating banking markets in Europe, but also a matter of integrating capital markets. Advancing the CMU will contribute to mitigating risks in the financial markets and shall therefore be part of any future considerations on financial integration. A Brexit risks to bring more financial fragmentation to Europe, however it can also be an impetus for the Europeans to succeed better in the integration of their markets. ●

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# Cross-border bank consolidation prospects



## Felix Hufeld

President, Federal Financial Supervisory Authority,  
Germany (BaFin)

### Cross-border mergers are no panacea

It is said that lawyers respond to any question with a firm “It depends”. And if one were to ask me whether increased cross-border consolidation between banks in the EU were necessary, that is precisely the answer I would give: because with mergers in particular, we must always consider the individual case. Where the aim is to turn two ailing banks into one strong institution overnight, mergers certainly do not provide all the answers. Besides, big is not always beautiful. Germany’s banking industry, for example, with its unique structure developed throughout its history, also has many small institutions that are nonetheless strong and economically sound. Often this success is due to a focus on a particular customer segment or business model. Apart from that, the bigger the institution, the greater the challenges for regulators and supervisors. The too-big-to-fail issue comes to mind here.

For each individual case, one must once again ask whether the planned merger will actually result in a business model that is viable over the long term and, consequently, yield a sustainable improvement in the companies’ financial position and results of operations in the foreseeable future. Within a reasonable period of time the synergies must balance out the expenses associated with the merger in addition to the weaknesses present in both institutions before their merger. And we are not talking about issues of competition law yet. Experience gained across numerous sectors suggests that the benefits of a merger are often overestimated ex ante, while the risks are underestimated. And this is seen regardless of whether the merger takes place at the national or European level.

Are cross-border mergers between banks in the EU possible? This question I can answer with a clear “yes”, and there are historical examples to prove it: in 2016, the French private bank Oddo acquired BHF Kleinwort Benson for around EUR 600 million and at the end of 2008, the French bank Crédit Mutuel took over Citibank Deutschland from the Citibank group for around EUR 5 billion. Similarly, the takeover of the Hypovereinsbank by the Italian bank UniCredit in 2005 in addition to the takeover of the BfG Bank by the Swedish SEB Group in 2000 can also be regarded as cross-border mergers.

When it comes to cross-border mergers, the phrase coined by German writer Erich Kästner is fitting: “Good only exists if good is done.” Decisions regarding possible mergers are the responsibility of the owners and responsible managers of the individual institutions. If the decision-makers reach the conclusion that a merger makes economic sense, nobody will stop them from going ahead with it. Not least financial supervisors. Structural policies in the financial sector are not our responsibility.

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>>> Some experts are of the opinion that the legal and regulatory framework is key to cross-border mergers. This raises some interesting questions. On the one hand, it is quite clear that with greater harmonisation of EU law, cross-border mergers would more closely resemble domestic mergers and would therefore be easier to manage. On the other hand, I doubt that a bank in country A would decide not to merge with another bank in country B simply due to regulatory issues if the bank truly believed it had a good business case for proceeding with the merger.

It is the task of supervisors to monitor the market and, where necessary, adjust supervisory practice. Individual mergers only become a focus of supervisory activities when the plans are relatively concrete. Of course, supervisors primarily consider concrete plans to initiate a merger from the perspective of the supervisory requirements. This includes, next to many other considerations, an assessment of whether the business model is stable over the long term and whether the capital resources are adequate. But that is only the second or third step. Institutions must take the crucial first step themselves. ●



## Elke König

Chair, Single Resolution Board (SRB)

### Banking Union financial integration: time to consolidate trust

Extensive literature exists on the benefits of financial integration and consolidation of banks. From the perspective of the Single Resolution Board, whose mandate focuses on achieving banks' resolvability, having strong European banks is a natural aspiration. Where there is a solid business case, consolidation can bring economies of scale and increase profitability. It can improve diversification of risks within banking groups. It can also increase banks' access to capital markets and decrease their funding cost, ultimately facilitating their build-up of loss absorption capacity to meet the so-called Minimum Requirement of Eligible Liabilities (MREL).

Moreover, like cross-border capital markets, cross-border banks can play the important role of reducing risks through private risk sharing within the Banking Union. Indeed, cross-border banks are better equipped to withstand and absorb idiosyncratic shocks that may affect one or another Member State. Beyond the perspective of banks and Member States, it is important to look at this topic from the perspective of the investor too. Financial integration could lead to more efficient markets and provide financial services users with better choices.

This being said, consolidation within the banking sector should not be seen as a panacea or a short cut to avoid necessary reforms. In this sense, it is crucial for a resolution authority that consolidation facilitates rather than hinders the resolvability of a bank, in line with the Single Resolution Board's resolvability expectations.

Overall, the advantages of banks' consolidation seem therefore evident. In addition, the establishment of the institutional infrastructure of the Banking Union can also be seen as a favourable element: although the third pillar, common deposit insurance, is yet to be built, a single supervisory mechanism and a single resolution mechanism are up and running.

In spite of all of this, financial integration within the Banking Union is still lagging behind. Several studies have found multiple causes behind this trend. Market

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>>> factors surely play a prominent role. However, there are also challenges that could be addressed by policy-makers and regulators.

Among these, EU legislators and regulators should keep up the momentum on the clean-up of banks' balance sheets. The harmonisation of relevant legislation, such as insolvency proceedings, could also contribute to remove barriers for the cross-border consolidation of banks.

Finally, yet importantly, rule-makers and regulators should resist the temptation of ring-fencing capital and liquidity resources, as this can lead to suboptimal location and rigidity in the deployment of such resources. Regrettably, the recently agreed banking package does not mark a step forward on this aspect. Rather, it runs the risks of, first, fragmenting decision-making within the Banking Union on external MREL, and second, ring-fencing of internal MREL.

The Single Resolution Board already invests and will continue to invest significant resources to reach joint decisions with national authorities on resolution plans, calibration and location of MREL, and bail-in playbooks. Such day-to-day cooperation should increase mutual trust within the Banking Union, and ultimately be reflected in a future revised regulatory framework.

In a word, Rome was not built in a day. Just like in the United States, where financial integration took decades, it is not surprising that the road for Banking Union integration is still long and winding. However, the direction of travel should remain clear, and the need to consolidate trust along the way should be high on everybody's agenda. ●



## Fernando Restoy

Chairman, Financial Stability Institute,  
Bank for International Settlements (BIS)

### Lack of banking integration: is it all regulation?

At least so far, the existence of the SSM and the SRM have not had any marked impact on the banking industry's structure. For example, the share of cross-border loans to and deposits from non-banks in the euro zone remains low – around 8% and 6%, respectively – and has fallen slightly over the last few years. In the same vein, the share of domestically owned banks in the national banking systems remains high, at 83%, roughly the same as in 2014, before the SSM's establishment.

The first set of obstacles is related to Europe's lack of a comprehensive single rulebook. Much EU banking legislation is still in the form of Directives, rather than Regulations. More importantly, European banking law includes options and discretions for national authorities, again leading to different rules across countries (Nouy 2018).

The second group of impediments relates to the general regulatory treatment of internationally active banks. Typically, those institutions are subject to stringent capital requirements associated with the complexity and greater systemic importance arising from their interconnectedness. At the same time, regulations (under Pillar 1, Pillar 2 or stress tests) fail to fully acknowledge the potential prudential benefits associated with the geographical diversification of exposures.

The third category of regulatory obstacles relates to the treatment in European banking legislation of cross-border groups. In particular, pan-European banks that control subsidiaries in different member states must, in principle, satisfy liquidity and loss absorption requirements at the level of both the subsidiary and the consolidated balance sheet. Since economic integration is far from satisfactory and financial

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>>> stability remains largely a national policy objective, prudential safeguards in host jurisdictions seem unavoidable.

In any event, even if regulation may not provide sufficient support for the integration of the banking market – and some adjustments could be helpful in that regard – it may be the case that the main obstacle preventing faster and deeper integration is the genuine absence of significant profit opportunities for banks in other European jurisdictions.

Overbanking should, in principle, make the industry ripe for some consolidation. However, this is more likely to take place at the domestic rather than a cross-border level. In fact, the excess capacity in domestic banking sectors in the euro zone acts as a natural barrier to the entry of new (foreign) competitors.

Another obstacle to cross-border merger activity is the banking sector's structure. In the euro zone, many banks operate under only limited market pressure. For example, only 30% of the significant banks in the euro zone (those directly supervised by the SSM) are publicly traded companies. Most of the non-listed banks in the euro zone are savings, regional or mutual (cooperative) banks. A large portion of those banks do not typically follow standard profit-maximising objectives and cannot be taken over by ordinary commercial banks through ordinary M&A activity. Under those conditions, European banks typically see little scope for entering foreign retail markets where well established incumbents can sustain competitive pricing policies.

It is possible that, over time, technological innovations could facilitate the provision of cross-border banking services and enhance competition in the deposit and credit market as well as in the provision of payment and other ancillary services. Yet, at least in the short term, the incentives for traditional banks to expand their operations abroad are likely to be further eroded by uncertainty as to the scope and nature of the disruption that new fintech and big tech companies will bring.

As a consequence, significant cross-border consolidation of Europe's banking industry would probably need to be preceded by domestic consolidation to reduce overcapacity and help restore sustainable profitability. But even if that were achieved, any significant integration may first need a substantial reorganisation of the domestic banking sectors with the aim of trimming the market presence of mutual and savings banks to levels more comparable with those seen in other jurisdictions. ●

Reference: Restoy, F (2018): "The European banking union: what are the missing pieces?", public lecture at the ICMB, Geneva, 16 October.



## Jean Lemierre

Chairman, BNP Paribas

### What are the impacts of bank fragmentation in the EU?

European banking has been going through a massive transformation since the financial crisis. Capital and liquidity buffers have been considerably increased, strengthening financial stability. European Supervisory Authorities have been created for banks, markets, and insurance. Over the last five years, the Banking Union has further transformed the landscape, with harmonized supervisory practices and a single resolution authority and a resolution fund to deal with distress situations. Europe now has common stress-tests, more credible internal models via TRIM, harmonized deposit insurance and ambitious common approaches on subjects such as >>>

>>> NPL reduction or Sustainable Finance. No doubt that such an achievement is commendable.

However, Banking Union is still not there. Financial integration has reversed, compared to the trend observed during the first decade of the Euro:

- Direct cross border loans and deposits are minimal, as banking remains a “multi-local” business, based on local laws and tax rules, even if digitalization may challenge this.
- The interbank market has dried-up. Pre-crisis, the main source of cross-border flows was simply that deposit-rich banks with limited lending opportunities were lending to low-deposit banks with higher lending opportunities. This natural reallocation of savings to investments has been eliminated, not only because “banks did not trust each other”, but mostly because regulators, to cut the contagion risk, dis-incentivized banks to lend to each other, through the LCR rules. The structural mismatch between loans and deposits is now intermediated by the ECB, as a “first resort” lender. Even intragroup cross-border flows are constrained by large exposure limits and the solo application of LCR.
- Cross-border M&A could also foster private risk sharing and diversification. But the GSIB buffer and solo application of capital and liquidity ratios (a major EU gold-plating, as the BCBS only requires application at consolidated level), cancel the potential synergies in a cross-border deal. The solo application of NSFR will worsen this situation.

Such reduction of cross-border flows should be seen as a source of vulnerability for the common currency, and urgently addressed.

From the banks’ point of view, the negative consequences are clear:

- Lack of economies of scale to invest in technology and risk management.
- Lack of competitiveness vs non-euro zone players and with new entrants, not submitted to similar constraints.
- Poor profitability and lower capital formation to comply with ever increasing regulatory requirements.
- As a result, low attractiveness for investors, with all EU listed banks having Price to Book below 1.

Even more the ring-fencing of capital and liquidity prevents the market to find a proper equilibrium and translates into excessive discounts on asset values in weaker States.

The recent talks about the need for another TLTRO illustrate the difficulty in which the Euro-area finds itself. A TLTRO is certainly needed, especially given the considerable shortfall to be created by the implementation of NSFR and the need for banks to comply in a short period of time with the MREL SRB policy. But it will only kick the can further down the road, with cheap liquidity putting pressure on loan margins and maintaining bank profitability low.

To exit this trap, Europe has to effectively rebalance the share of banks and capital markets in the financing of the European economy. This was the aim of the CMU project, not delivered so far. Its main pillar, the relaunching of securitization, is not going to materialize given the excessive complexity of the “Simple, Transparent, and Standard” framework.

Europe should quickly revisit its rules as the CMU is the only way to reduce the banks’ reliance on Central Bank liquidity and restore proper asset pricing and risk mutualisation.

In this time of European elections, we should all remember the four freedoms at the core of the European Union, including the free movement of capital. A strong and integrated European economy needs a strong and integrated financial sector to support its growth and competitiveness. ●



# Korbinian Ibel

Director General, DG Micro-Prudential Supervision IV,  
European Central Bank (ECB)

## Further harmonisation needed to overcome financial fragmentation

One of the founding aims of the banking union was to overcome the fragmentation of the financial sector, aiming to restore financial stability and lay the basis for economic recovery after the recent crises. Since the establishment of the Single Supervisory Mechanism, substantial progress has been made to ensure a level playing field among euro area banks and to promote the integration of the European banking sectors. It is clear that there is still some way to go, however. As the ECB report on Financial integration in Europe (May 2018) shows, integration measures have not moved substantially, in particular for retail banking, despite collective efforts by regulators and supervisors to harmonise the framework.

In a more integrated European banking market, savers have more options when investing their money and companies can tap more sources of funding. Risks can be shared across borders, smoothing idiosyncratic shocks to individual Member States and allowing banks to better balance the needs of customers in different locations and stages of the economic cycle. This helps the EU economy to become more stable and more efficient. At the same time, enhancing market integration – where suitable – can also support a more robust banking sector. While it must be left to market forces to determine which corporate operations make sense economically, European legislators and supervisors need to ensure that the framework does not unnecessarily impede market developments, enabling banks to operate and grow across borders: both organically and by merging across borders.

While some of the factors leading to fragmentation may be due to differences in preferences for service provision across member states, other factors lie in the hands of regulators. The current regulatory framework still imposes a number of impediments to cross-border consolidation in the EU – complicating the management of bank capital and liquidity within cross-border groups and hindering the prospects for cross-border mergers.

Many of the regulatory impediments can be addressed by further harmonisation, including unwarranted Member State options and discretions, such as the treatment of intra-group exposures under large exposures rules. Other impediments would need to be addressed by policy changes, such as the absence of cross-border capital waivers within the EU; or the lack of recognition of the banking union in the international G-SIB methodology framework. Of course, any such policy changes need to be coupled with appropriate prudential safeguards. Additionally, more work is required on other policy areas that differ across the euro area and may discourage further integration, but are outside of the scope of banking regulation. For example, tax codes and legal systems, including insolvency law.

Going forward, it is also important to make efforts to cut down the uncertainties in banks' business environment. This means banks need to continue the work on legacy assets and on the reduction of NPLs, which will reduce uncertainty around banks' assets and make, for example, cross-border mergers more attractive. But this also means ensuring regulatory certainty and consistency. Here, the full, timely and consistent implementation of the Basel III reforms into the EU framework is crucial.

In summary: a more integrated European banking sector will be beneficial for the real economy as well as for banks' resilience. While much progress has been achieved already in reforming conditions, the level of integration of euro area banking markets still remains limited. We should continue to move towards a more harmonised framework and in particular towards completing the banking union, helping to create conditions to reap benefits from the single market. ●

# Developing an EU bank resolution approach



## Elke König

Chair, Single Resolution Board (SRB)

### Resolution and liquidation: closing the gaps

As the mandate of the current European Commission and Parliament draws to an end, it is worth reflecting on the progress made, as well as the priorities on the resolution framework for the next EU legislature.

From the perspective of the Single Resolution Board (SRB), the finalisation of the Banking Package represents a milestone in further strengthening the framework. The partial harmonisation of the creditor hierarchy was another step forward. Building on these achievements, the SRB is hopeful that the next legislature will deliver on the implementation, review and completion of the resolution framework.

The lingering asymmetries between the EU resolution regime and national insolvency frameworks are one of the areas where further progress is needed. The problems are well known and the SRB, as well as other authorities, academics and the industry, have made their case more than once.

To recall, the assessment of the no-creditor-worse-off principle (comparing the treatment of creditors in resolution to the one they would have received under insolvency proceedings) is complicated by the co-existence of nineteen different insolvency frameworks in the Banking Union. This results in diverging outcomes depending on where a bank entity is located.

Moreover, the conditions to determine that a bank is 'failing or likely to fail' are not necessarily aligned to the criteria for liquidation at national level, which also poses challenges.

Furthermore, the requirements for burden sharing under the European Commission's 2013 Banking Communication, which apply in cases of precautionary recapitalisation and liquidation aid, are not entirely in line with those for bail-in under the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR), potentially giving wrong incentives when compared to resolution.

Finally, the ranking of creditors in insolvency was only partially harmonised: Directive 2017/2399 focused only on unsecured debt instruments in the hierarchy, while national differences remain on the ranking of the rest of the creditors, leading also to divergences in the protection of creditors and uneven loss absorption.

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>>> In the next mandate, legislators could focus on these issues to complete the framework. This could be done gradually: the review of Directive 2017/2399 could be an opportunity to fully harmonise the creditor hierarchy, while BRRD/SRMR and the 2013 Banking Communication could be revised to align incentives and close the gaps between the EU resolution framework and the insolvency rules for banks. In this sense, the set up and experience of the Federal Deposit Insurance Corporation in the US offers a number of lessons, as recently highlighted by a study from the European Parliament Think Tank.

It is not only authorities and credit institutions – particularly the ones less likely to pass the public interest test and therefore be resolved – that would gain from a common and upgraded insolvency regime. Investors and creditors (including households) would also greatly benefit from a stable underlying legal framework that provides the same degree of certainty in liquidation as in resolution.

It is often emphasised that deepening the EU's Economic and Monetary Union requires the completion of the Banking Union and of the Capital Markets Union. A common framework for banks' insolvency would constitute a significant advance on both paths. In turn, both the Banking Union and a strong, truly European capital market can play an important role in the creation of the needed liquidity for capital instruments and MREL. Therefore, work on those files must continue to progress in the new EU legislature. ●



## Boris Vujčić

Governor, Croatian National Bank

### Without EDIS credibility of both SSM and SRM is at stake

We have witnessed tremendous progress in establishment of now operational SSM and SRM frameworks since the last EU elections. This is a clear guidance not to stop at the final phase of this historical effort but to give more “thrust” to efforts for completion of a common, transparent, predictable and, most importantly, credible supervisory and resolution regime. Upcoming election of new EU legislature is another opportunity for further step in establishing a common, transparent and predictable supervisory and resolution regimes in the EU and especially in the Banking Union, to which Croatia intends to join during the 2020.

For big, systemic banks there is little alternative other than robust and transparent MREL framework which, I believe, is achieved to a largest extent possible as a result of agreement reached for new Banking Package. Now, it will be primary responsibility for the SRB to ensure that during transitional phase adequate MREL build-up by banks will happen, which would imply that at the end of the transitional phase (2024) both SRF and agreed resolution strategies should become fully credible and operational for all, or vast majority, of significant banks and groups in the Banking Union. Therefore, it seems obvious that MREL build-up is a cornerstone of common EU resolution regime for significant institutions and groups. But, MREL build-up envisaged for significant institutions would not solve the issue of smaller or medium sized banks whose business model relies on providing services for retail and SME clients because the need for additional MREL requirement for such institutions should be rare and improbable scenario. This issue, combined with the importance of SMEs in the EU economy, makes finalization of Banking Union as a priority for EU leaders and regulators. >>>

>>> Only with the establishment of the European Deposit Insurance Scheme (EDIS) will Banking Union be complete and credible. Otherwise, in the absence of such a mechanism, full responsibility for depositor and client protection, as well as protection of public funds in thousands of small and medium sized banks, where conditions for resolution do not exist, will remain at the national level. In an environment where key decisions (licence withdrawal, public interest etc.) in that process are made at the EU level.

Such a concept, where ultimate responsibility lies at the national level (although all LSI are under supervisory and resolution frameworks developed by the ECB and SRB), risks undermining the credibility of the common regime in the eyes of citizens, politicians and regulators. National authorities in such circumstances might be tempted to use tools designed for big systemic banks in order to tackle the issues in smaller institutions without critical functions, combined with demands for less stringent supervisory oversight, which prolongs decisions that would make pressure on their national DGS or public funds. This problem has a viable solution: harmonising of national insolvency proceedings. Their main feature must be a clear legal framework for withdrawal of failing institutions from the market in a swift and efficient manner with no cost to public funds nor, equally importantly, “cost” of losing public confidence in the financial system.

EDIS mechanism would ensure that ultimate responsibility for actions is addressed at the level where decisions are made. Of course, we are all aware that credibility of EDIS itself stems from a number of factors. One is a further risk reduction in a significant number of remaining vulnerable institutions, which itself is a broad issue. However, the credibility also depends on the recovery rates achieved from insolvency estate. If they could be high and comparable thru though the whole banking union, the establishment of EDIS would be much easier.

Ultimately, common, secure, transparent and credible supervisory and resolution framework accompanied with such an insolvency framework, and with EDIS as a common provider of depositor protection will lead credible solution for LSI entities. ●



## Edouard Fernandez-Bollo

Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

### Funding resolution and harmonizing liquidation: challenges of the next European legislator

Less than two months are left before the elections of the new European Parliament and – despite substantial and recent breakthroughs – additional steps forwards are still needed to deepen the Banking Union (BU). A common framework is in place from the supervision side but the second pillar, resolution, remains incomplete. Harmonization is also pending regarding liquidation rules and the third pillar related to the deposit protection. Ensuring a continuum between supervision and resolution will be the key issue for the new European lawmakers.

First, we shall be pleased as regards the agreement reached by the 4 December Council on the establishment of a common backstop to the Single Resolution Fund. Such a safety net was long overdue. The second pillar is now aligned with the highest international standards. Indeed, in the United States, the United Kingdom and Japan, the firepower of resolution funds has already been backstopped by the fiscal authorities or central banks. The credit line provided by the European Stability Mechanism (ESM) will boost the confidence in the BU.

Nevertheless, the features of this new instrument shall be finalized. In 2019, the technical discussions will be pursued and substantial issues remain to be tackled. A swift decision-making process and simple triggering conditions to deal with emergencies are now expected. The current voting rules of the ESM Board should be softened in order to substitute the current unanimity requirement for a qualified-majority procedure. In addition, the recovery of backstop resources after resolution should be deepened for the purpose of establishing a gradual burden-sharing at a BU-level. >>>

>>> Beyond the backstop, another funding source is on the agenda. A liquidity provision scheme implemented by the Euro-system and compliant with European-Union monetary policy rules could be supplied by a high-quality guarantee from the European public sector to the banks whose financial situation has been restored following the resolution process. This Emergency-Resolution-Liquidity would ease the way out from resolution to return to a stabilized financial situation.

Besides, the treatment of bank failures out of resolution scope could also be further harmonized. The liquidation regimes across the Union are not sufficiently consistent and predictable. The directive 2001/24/EC on the reorganization and winding up of credit institutions is a beneficial legal basis for further progress. At this stage, it does not consider the

situation of banking groups. Additional improvements could be put in place such as credible cross-border guarantees, based on European law, enforced by European authorities and granted to their subsidiaries by parent banks. Ex-ante group support arrangements would be a suitable tool to upstream losses, especially in the case where subsidiaries face difficulties, but the group/parent does not.

These are the most credible option to increase confidence between home and host authorities. Such guarantees should address the question of group support not only in going-concern but also in resolution and liquidation. Single-Supervisory-Mechanism and Single-Resolution-Mechanism should take into account these arrangements by lowering prudential constraints. Unfortunately, we have missed one chance to accordingly upgrade our

legal framework through the revision of the Capital Requirement Regulation. Another window of opportunity will open soon: cross-border guarantees should be inserted in the priorities of the new Commission.

Finally, EDIS is another objective to keep in mind to achieve a fully-fledged Union. The 4 December 2018 Council did not manage to reach an agreement. The finalization of the third pillar urges to start now negotiations at political level. To break the deadlock, the design focused on liquidity needs – as proposed by the Commission with its 11 October 2017 communication – seems to be a pragmatic approach and should meet the main objective of EDIS, namely covering the financial gaps of domestic schemes in case of large shock. The new lawmakers will timely take office to build a consensus: substantial risk reduction has already taken place and risk-sharing greatly helps risk reduction. ●



## Jose Manuel González Páramo

Member of the Board of Directors & Chief Officer Global Economics & Public Affairs, Banco Bilbao Vizcaya Argentaria (BBVA)

### EDIS & harmonization of insolvency laws: necessary steps to complete the BU

It is hard to disagree with the fact that in the last few months there has not been tangible progress about the pending reforms to complete the Banking Union. The advances made in banking regulation, supervision

and resolution will not form a credible Banking Union (BU) until fiscal backstops for the private insurance instruments (Single Resolution Fund and the future European Deposit Insurance Scheme-EDIS) are adopted, but their legislative development is being much slower than expected. Furthermore, two other steps should be taken: a single insolvency regime for banks and a funding-in-resolution mechanism (as the SRF backstop is not enough).

The debate on risk reduction versus risk sharing is a false one. Europe has taken important steps towards risk reduction over recent years, the last one the endorsement of one of the main elements of the risk reduction banking package (the so called CRD V). It is time to unlock the current legislative hiatus and move ahead in the field of risk sharing.

Setting up an EDIS is the logical complement after elevating responsibility for banking supervision and resolution to the European level. As the guarantee of depositors moves to a supranational level, rather than at national level, depositors' confidence would increase. This would in turn promote deposits stability and therefore reduce the risk of deposit runs in stressed conditions. Moreover, this would help limiting possible contagion effects within a country and across borders, fostering financial stability. Besides, it could enhance both competition among European banks and cross-border capital flows, deepening the Single Market. Finally, EDIS would favor the elimination of the bank-sovereign link and it would help reducing financial fragmentation in the Banking Union.

EU legislators should now focus their efforts on the creation of a single insolvency regime for banks instead of relying on the current step-by-step harmonization approach. The way recent bank failures have been dealt with shows that the framework is not complete as each case revealed new and unforeseen problems. In some cases, creditors were better off under insolvency procedures and taxpayers worse off. In others, national authorities refused to apply decisions taken by Eurozone authorities. A common insolvency regime would correct these issues, reduce the opportunities for regulatory arbitrage and provide much needed clarity for investors, customers and the public in general regarding how a bank failure will be treated in the future, who should absorb losses, when and in what order. That regime should be led by a single administrative authority but with the participation of judicial authorities. Resolution authorities should be granted a set of liquidation powers similar to those included in their resolution toolkit. Creditor hierarchies and triggers should be completely harmonized in order to activate insolvency proceedings in a coordinated way.

Together with the establishment of a funding-in-resolution mechanism and the creation of the EDIS, a single insolvency regime for banks in Europe would be a decisive step towards finalizing the Banking Union. It will not be easy to agree on all the outstanding key elements before Parliament elections, but it is crucial in order to avoid putting in question the compromise of European countries on the Banking Union. ●



## Karl-Peter Schackmann-Fallis

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

### EDIS – still many stumbling blocks to overcome

The EU's motto "United in Diversity" is well displayed in the EU's banking sector. In fact, diversity is one of its main features, offering EU citizens a wide array of financial services suited to their needs. In this context, Institutional Protection Schemes (IPS) enable several

thousands of locally active banks to bring those services to their clients. IPSs safeguard their members' solvency and liquidity, providing an overarching element for groups of independently governed credit institutions. According to the European Central Bank, there are currently a dozen IPSs in Europe, covering about 50% of all euro area credit institutions. Crucially, several of them are also recognized as Deposit Guarantee Schemes (DGS) by the Deposit Guarantee Scheme Directive (DGSD).

The DGSD has ensured a harmonized level of deposit protection up to 100,000 Euro in all Member States. In addition, by providing enough room for national discretion as well as allowing DGSs to use their funds for alternative measures, the DGSD is recognizing the diverse banking sector in the EU. In contrast, the European Deposit Insurance Scheme (EDIS) does not take into account these differences, as Member States will in many ways be deprived of their discretions. It has been argued that EDIS has no negative effect on IPSs as they could be set up as a voluntary scheme next to a European DGS. Consequently, members of an IPS would be faced with a double burden, extinguishing IPSs in the end. This would have far-reaching consequences for financial stability as well as for local banking. It is, therefore, imperative to ensure the incorporation of IPSs recognized as DGSs into any form of an European deposit protection system.

A fully fledged EDIS would also uncouple risk and accountability. Since higher-risk banking sectors would be backed by EDIS, they would be prone to favor riskier business models altogether. Banking sectors with lower-risk business models – such as the German savings banks – would implicitly support their competitors in other Member States.

Apart from the potentially severe implications of EDIS for diversity and for networks of smaller, low-risk banks, the issue of legacy risks remains largely unaccounted for. Neither is this issue limited to the predominantly discussed levels of Non-Performing Loans (NPLs) in some parts of the EU banking sector. Without neglecting recent progress in addressing NPLs, their total volume still remains far too high. In the same vein, it is of crucial importance to address the sovereign-bank nexus as reflected in the persisting home-bias present in banks' sovereign risk portfolios. Deteriorations of sovereign debt have the potential to exercise severe pressure on banks' capital positions, particularly when they are already faced with a high NPL ratio.

A fully mutualized EDIS will not prevent bank crises. This can only be achieved via sound and sustainable business models, the effective clean-up of distressed balance sheets and a clear path to dealing with the risk weighting of sovereign exposures. In the meantime, breaking up established and well-functioning deposit guarantee schemes will only be detrimental to financial stability. ●

## Klaus Kumpfmüller

Executive Director, Austrian Financial Market Authority

### EDIS – The European way of burden sharing

The Banking Union remains incomplete without the European Deposit Insurance Scheme (EDIS). Each of the Banking Union's three pillars were conceived to make specific, mutually reinforcing contributions towards its overall goal of breaking the vicious circle between banks and sovereigns. Deposit insurance is essential for a stable banking system. Yet, in difficult times, it can become a burden for sovereigns. Only

EDIS, with much deeper funds than any national system, can minimize reliance on a sovereign backstop.

It is therefore unfortunate that EDIS is mired in the debate around banks' legacy risks and home bias in sovereign bond holdings. Arguably, risks in the Euro area banking sector are not yet aligned, and risk-sharing through EDIS cannot encourage moral hazard. Yet, at this juncture extreme positions will not bring us any closer to completing the Banking Union.

De-coupling banks from sovereigns will take time. Neither EDIS nor the alignment of banking risk will be achieved overnight. Instead of arguing over a revolution, we should embrace an evolutionary approach towards EDIS: by starting off both processes in parallel, and proceeding in smaller, mutually reinforcing steps. In fact, risk-alignment



is already on its way. The SSM has devised tough NPL guidance for tackling legacy risks. EU co-legislators >>>

>>> have followed suit with the RRM package in the review of the CRD / CRR as well as the BRRD / SRMR. We must not lose this momentum. Co-legislators should now take up the Commission's proposal for a gradually phased-in EDIS.

Tackling home bias in sovereign bond holdings is another essential step towards completing EDIS and the Banking Union. Regulatory limits, however, are not the only conceivable way to do this. Sovereign bonds are, and will remain, an important asset class in banking. A more effective way forward might be to positively incentivise banks to hold a well-diversified sovereign bond portfolio. Dynamic risk weights, contingent on the degree of diversification, could be introduced.

*"Until EDIS is fully established, we should broaden our understanding of the European public interest."*

- KLAUS KUMPFMÜLLER

Finally, there is still room for the European resolution framework to contribute more towards risk alignment. Currently, 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 national level, leaving the door wide open for divergent courses of action to be pursued along national lines. In recent cases, ailing banks, having been turned down by the SRB, were subsequently found to be of public interest by national authorities. National fiscal means were once again used to prop them up, despite the existence of the Banking Union. The right to decide lies with whoever is prepared to foot the bill.

Until EDIS is fully established as a backstop for insolvent banks, we should broaden our understanding of the European public interest, by also integrating national public interests. For this, national authorities should have a greater say in SRB resolution decisions. In exchange, as many decisions as possible should be taken under the SRB umbrella. This requires SRB governance to be temporarily adapted, as well as a willingness to use the SRF. Doing so would pave the way to finally leave the national level of burden sharing and move forward to the European level. ●



**Elisa Ferreira**

Vice-Governor, Banco de Portugal

## Enabling the orderly management of failing locally systemic relevant banks

Remarkable progress has been made in the setting-up of the first pillars of Banking Union. However, its incompleteness poses renewed challenges that policymakers need to address. Absent stabilisation mechanisms – a fully-fledged EDIS, the provision of liquidity in resolution, etc. – in the short to medium term, banks will continue to be 'European in life but national in death'. While supervisory and resolution decisions are mostly European, the ultimate guarantor of financial stability remains national. This unstable balance prevents economic agents from fully reaping the expected benefits of economic integration via a single market for wholesale and retail financial services.

*"Principles to be agreed by all Member States and applicable at national level."*

- ELISA FERREIRA

As stressed, among others, by Fernando Restoy, whereas MREL and bail-in requirements may work for larger banks, it is not clear whether such requirements are suited for a middle class of institutions that operate on a more traditional business

model and which may be of no public interest at EU level but still have systemic relevance at local level.

Solutions thus need to be found for the orderly exit of traditional medium-sized deposit-taking banks without disrupting financial stability. Otherwise, Member States will continue to be accused of circumventing the existing rules when adopting solutions whose ultimate objective is to safeguard financial stability and mitigate the economic impact of potential disorderly liquidations or resolution actions.

Recent experience has shown the current framework might not be appropriate to address such cases. As an alternative, the topic of harmonising EU banks' liquidation regimes has been put on the agenda. But what does bank liquidation mean? And do we have the tools to ensure its orderliness in the current context? Let us acknowledge that this is not a silver bullet. In the absence of an appropriate legal framework, liquidation might imply the immediate interruption of lending support, as well as the suspension of payments; it may have disruptive effects for creditors, depositors and other stakeholders, with the ensuing impact on the real economy, ultimately reinforcing the sovereign-bank doom loop.

Instead of moving immediately towards the harmonisation of EU banks' liquidation regimes, efforts must be made towards the establishment of an enabling framework for the orderly management of failing locally systemic relevant banks, combining elements of the resolution and liquidation frameworks – akin to the FDIC approach in the USA – while minimising losses and protecting relevant creditors and non-financial borrowers. Such enabling framework should include the definition of high level principles to be agreed by all Member States and applicable at national level. Possible paths might include:

- The establishment of special insolvency proceedings, with recourse to administrative options, assigning to a liquidating authority some of the instruments currently envisaged in the BRRD, as an alternative to the court-led liquidation regime. The liquidating authority and the funding sources available would need to be identified.
- The use of DGSs for deposit transfers abiding by the least cost principle. For that, a revision of the applicable State aid rules and of the national transpositions of the DGSD would be required.
- The liquidating authority having the option to offer guarantees or enter into profit and loss sharing regimes. ●

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



## Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

### The CMU: looking back and looking ahead

The Capital Markets Union (CMU) has been one of the most important projects of the outgoing European Commission – for several reasons. The economies of the Member States as well as the European Union (EU) as a whole would benefit greatly from deeper and more integrated capital markets, to complement a resilient banking system. After almost five years since the launch of this initiative, it is the right moment to look back at what has been achieved as well as looking ahead at what is needed to bring the CMU to fruition.

Firstly, the CMU has been designed as a combination of legislative and non-legislative initiatives. The legislative part contains a number of proposals from the European Commission, and the co-legislators diligently assessed them, and have concluded negotiations on a large number of these proposals.

Moreover, a number of regulatory enhancements in the area of financial infrastructures has been agreed (EU Benchmarks Regulation, EMIR refit and EMIR 2.2). In addition, several proposed regulatory measures on Sustainable Finance have been brought forward, including ESMA's consultation on the applicable Level 2 measures. Further, a complete framework for Level 1 and Level 2 measures under the Prospectus and Securitisation Regulations have been developed and ESMA will soon move forward with additional supervisory tasks regarding securitisations.

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*"The CMU has been designed as a combination of legislative and non-legislative initiatives."*

- STEVEN MAIJOOR

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However, these new legislative acts alone cannot achieve a successful CMU with a more diverse and robust funding of the real economy. What the EU has needed and will continue to need is effective and convergent supervision of existing laws and regulations throughout the Union. In this important aspect of making the CMU a real success, the ESAs could and should play a decisive role. However, progress has been held back due to a lack of strong tools and sufficient resources to effectively ensure convergence. >>>

>>> Looking ahead, a key question is what Brexit will mean for the CMU. To my mind, the departure of the biggest financial centre creates the need to build up the required expertise and capabilities in the EU27: whatever the long-term outcome, access to the UK financial market will be less than in the current situation whereby the UK is part of the single market. Brexit also means that the EU27's capital markets should remain attractive for overseas market participants, including the UK. Equally, it will require that financial stability and investor protection would need to be assessed and addressed from an EU27 perspective.

Brexit will not only be the driver for the – much needed – further development of the CMU in the EU. As outlined above, greater efforts of a primarily non-legislative nature, aiming particularly at enhancing supervisory convergence, will be necessary to achieve a truly single capital market in Europe. ●



## Olivier Guersent

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

### The future of the CMU project

Building a Capital Markets Union has been a key priority for the Juncker Commission. At the heart of the Single Market, this project strengthens the Economic and Monetary Union, fosters the international role of the euro and promotes access to capital markets for firms and citizens. This is most relevant for smaller countries, through links between their local capital market ecosystems and deeper pools of capital across the EU. Deeper integration of capital markets, together with more integrated banking systems, can also help maintain cross-border capital flows and sustain investments in Member States suffering large asymmetric macroeconomic shocks.

*"The new Commission will find a solid base, on which to decide the next steps."*

- OLIVIER GUERSENT

The European Commission has delivered what it promised. It has tabled all the legislative proposals envisioned in the Capital Markets Union Action Plan and Mid-term review and has called on the co-legislators to conclude their work on these key building blocks before the European Parliament elections in May 2019. The Commission has also delivered on a large number of non-legislative actions related to the Capital Markets Union that will provide key contributions towards deep and liquid capital markets by addressing areas such as distribution of retail investment products, drivers of institutional investment and corporate finance for entrepreneurs and start-ups.

Provided that the co-legislators manage to conclude their work on as many as possible of the pending proposals currently under negotiation, the new Commission will find a solid base, on which to decide the next steps necessary to put in place a vibrant Capital Markets Union in the EU.

It will be for the future Commission to decide on future policies but there is no doubt that Capital Markets Union will continue to feature prominently on the agenda. CMU is a long-term single market project entailing an EU-wide structural reform that can deliver more economic growth through funding of innovation and better use

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>>> of new financial technologies, financial stability through greater private risk sharing, and more efficient EU-wide markets through greater access to capital markets services for businesses and citizens across the European Union.

The United Kingdom's departure from the single market calls for a thorough reflection on how to promote an efficient, competitive and integrated financial system underpinned by strong supervision ensuring investor protection, preserving market integrity and financial stability. Brexit makes the implementation of Capital Markets Union even more important for Europe, building on a large and developed banking sector and with segments that are already well developed in the EU-27, such as private placement, covered bonds, investment funds, and insurance. It requires a full implementation of the Action Plan to ensure that the impact on the ground is felt as soon as possible and will allow starting work on new priorities.

These include strong market infrastructures, based on the ongoing proposals in the post-trading landscape. Capital Markets Union will have the strength of multiple and diverse financial centres, which will provide opportunities for innovation and specialisation and will require strong supervisory convergence actions.

There are three key reasons why Capital Markets Union will stick with us for a long time:

1. Cross-border capital markets and banking activities are a formidable risk absorption tool, when it comes to economic shocks. There is still much potential for greater capital flow diversification and private risk sharing.
2. Building a CMU is crucial to make our EU economy more innovative and open to new digital trends. Market-based funding is best suited for high-risk-high-return projects, whose innovative nature can boost economic growth via the productivity channel.
3. The free movement of capital and services is an essential element of the EU's Single Market. The Capital Markets Union seeks to make progress on the functioning of the Single Market, by ensuring that all companies and investors have access to capital markets across the EU on equal terms.

The Commission can only put in place building blocks to restore the intermediation channels, but it will be for supervisors and market participants to use these blocks to build a functioning and integrated Capital Markets Union. ●



## Sebastián Albella Amigo

Chairman, Spanish Securities and Exchange Commission (CNMV)

### Integrated and efficient supervision does not mean centralised supervision

From the outset, the supervisory component has been considered an important part of the Capital Markets Union (CMU) project. Moving towards a more coherent and harmonised supervision across Europe contributes to greater integration and efficiency of the European capital markets. The June 2017 European Commission statement on the Mid-Term review of the CMU Action Plan

emphasised this, highlighting the priority of the reform of the European Supervisory Authorities (ESAs).

Accordingly, in September 2017 the European Commission (EC) presented a proposal for the reform. Almost a year and a half later, it is still being discussed by the European institutions and it is currently (March 2019) in the phase of trilogue negotiations between the EC, the Council and the Parliament.

The debate on the issue has moved between two “extreme” positions or attitudes (obviously both very civilised and legitimate):

- a) The first one, inspired by the ultimate objective of creating a single securities supervisor in the EU, a kind of European SEC that centralises all relevant supervisory functions of EU capital markets.
- b) The second approach considers ESMA only as a “members-driven organisation”, that is, a kind of club or mere association of supervisors. >>>

>>> In my view, the most appropriate stance is a mid-point between the two approaches.

*"Robust national supervisors help ensure a plurality of financial centres with a critical mass."*

- SEBASTIÁN ALBELLA AMIGO

It is essential to strengthen ESMA in the context of the CMU action plan, especially in light of Brexit. ESMA should have more power (should use more proactively tools such as the breach of EU Law, have the power to set up common supervisory priorities, play a greater role in peer reviews, etc.). However, ESMA should remain essentially a body that

coordinates the Competent National Authorities (NCA) and promotes supervisory convergence.

The debate, by the way, concerns a fact that is rarely explicitly referred to: the different realities in Europe. On the one hand, the large countries and some medium-sized countries; and on the other hand, the many countries with a much smaller size in terms of population, GDP and the importance of their markets. The NCAs of the large countries are at an appropriate distance to supervise effectively. Quality supervision requires certain proximity but also a minimum distance from the market participants. In addition, NCAs in these countries are equipped to supervise any type of situation and supervise markets with a critical mass and a significant number of retail investors.

The EC stressed in its proposal the importance of an integrated supervisory system. I agree completely. But integrated supervision does not necessarily mean more centralised supervision. The direction and the objectives of the reform are compatible with respecting what I like to call the supervisory factor at the national level.

The Member States must continue to have robust supervisory bodies, with relevant powers, which will help ensure that we continue having in Europe a plurality of markets and financial centres with a critical mass. In addition, this will enable us to achieve a European capital market with greater penetration that really helps to improve the financing of the companies, not just the large ones, and reduce their level of dependence on bank financing, one of the main objectives of the CMU. ●



**Thomas Book**

Member of the Executive Board,  
Deutsche Börse Group

## The European Growth Case

Over the last two years, the world has been rapidly changing. Regulation, technology and investment behaviors continue to shape the way markets work, impacting economic growth and the resilience of the financial system. In this context, two projects are of special importance: the Capital Markets Union (CMU) and the initiative around the international role of the Euro.

While the CMU looks at how to develop a competitive and attractive EU landscape to enable future growth opportunities, the Euro initiative aims at assessing the role of the common currency and its potential. From a market infrastructure perspective, both are vital when it comes to fostering economic growth.

We need to attract foreign investment flows into the Eurozone. A true Single Market in the EU is a precondition for meeting this objective. We need to further reduce barriers across Member States, finalize the stability agenda and embrace financial innovation. At the same time, we need to ensure that foreign investors find an attractive and efficient market infrastructure and the right investment vehicles.

This is where market infrastructure providers like Deutsche Börse Group come into play. As a natural partner to the regulator, we build safe, strong and resilient markets and we innovate to offer tailor-made products and services. Current examples are our market-led solution that allows banks, asset managers and pension funds to clear their Euro denominated business in the EU27 and the extension of our trading hours to the Asian time zones. From China to Korea, investors can now hedge their euro exposure in their own time zones.

Both initiatives meet the market's needs. On the Euro clearing side, we gained 10 percent market share in one year. And in only three months, 1 million contracts were traded during the Asian

trading hours. With these successes, we support the regulatory agenda by providing the infrastructure that is needed for economic growth.

2019 will be an important year to bring a new life to the CMU with the upcoming elections in the European Parliament and the renewal of the top leadership positions across the EU institutions. It will not only be important for the EU internally but also externally in light of recent global challenges.

*"The future of the CMU should tie in a more strategic vision of the EU."*

- THOMAS BOOK

The future of the CMU should tie in a more strategic vision of the EU. Last year, President Juncker declared in his State of the Union speech that "the Euro must become the face and the instrument of a new, more sovereign Europe and the geopolitical situation makes this Europe's hour: the time for European sovereignty has come." We support this vision and have already started to embrace it by developing liquid commodities markets (gas, electricity and emission allowances) that settle in Euro.

This shows how regulation and market-led initiatives can work hand in hand to support competitive and sovereign EU financial markets to create growth while ensuring financial stability. ●



## Stefan Gavell

Global Head of Regulatory,  
Industry & Government Affairs,  
State Street Corporation

### An EU Capital Markets Union needs permanent capital

Ahead of the next European Commission's mandate, and with the UK's departure from the EU approaching, it is a good time to consider what's next for the EU Capital Markets Union project. In order to ensure we continue to further deepen Europe's capital markets policy makers should focus less on intermediation activities, which are mobile

and increasingly technology enabled, and worry more about the underlying sources of long-term risk capital.

Whilst the EU and US are roughly equivalent in GDP, the EU still lags far behind the US in sources of long-term risk capital. PensionsEurope membership data indicates that the total of European 2nd and 3rd pillar assets represent only 21% of the US equivalents (2nd pillar and IRAs), insurance assets are more heavily orientated towards government debt with twice the allocation as in the US, and UCITS assets are less slightly less than half the size of the equivalent in the US.

Further to this, while banks play a more important role in financing the EU economy relative to the US, they also have difficulty in securing capital from EU indigenous investors. As such, approximately 40% of Tier 1 and Tier 2 European bank capital issuance (by volume) was able to be targeted at US investors in 2018.

*"In order to have a viable EU capital market, we need deeper sources of long-term risk capital."*

- STEFAN GAVELL

In order to have a viable EU capital market, we need deeper sources of long-term risk capital. This includes the further development of Member State pensions markets, including removing barriers to cross-border investments, the

realisation of the Pan-European Personal Pension Product and the better alignment of initiatives to promote investment in infrastructure with pension fund needs. Consideration should also be given to adjustments to insurance regulation that encourages diversification of holdings away from government debt.

This rise of index funds presents another opportunity to tap permanent capital. These funds have been growing steadily in Europe, and are expected to grow from 14% of total assets under management in 2017 to between 22-27% by 2025. Unlike actively managed funds, index funds are required to maintain their investments as long as the underlying instrument comprises part of the index. This results in low turnover of investments as compared with active funds and as a result index fund managers focus on creating the conditions for long-term value creation at the companies in which they invest. Index funds managers do not seek to micromanage corporate decisions but rather, given their long-term perspective, seek to establish high level governance standards at the companies they invest in, to ensure that company boards and management have the framework to make good decisions, and do not ignore long-term factors that may impact their viability.

In addition to these benefits, index funds provide European investors with diversified portfolios at low cost, resulting in a win-win situation for both investors as well as for the development of a self-sustaining European Capital Markets Union. ●

## Xavier Larnaudie-Eiffel

Deputy Chief Executive Officer,  
CNP Assurances

### 2020 Solvency II review is opportunity for EC to deliver on CMU objectives

The European insurance industry very much welcomed, at the end of 2014, the European Commission's ambitious Investment Plan for Europe and the Capital Markets Union (CMU) project, with the

overarching aim of supporting growth and jobs in Europe.

The EC rightly recognised from the beginning that the insurance industry would be at the centre of the CMU project, given the important role that insurers play as the largest European institutional investors with more than €10trn of assets under management. In fact, through the long-term and savings products insurers provide, the industry has a strong duty to policyholders to provide returns. This has become increasingly challenging over recent years due to low interest rates and a very conservative prudential regulatory framework (Solvency II).

The CMU was therefore welcomed by insurers as a way to remove the regulatory barriers in Solvency II that prevent them from investing optimally. A few years down the line, we can confirm



that there have been positive changes in the areas of infrastructure and securitisations. Solvency II capital requirements >>>>

>>> and their calibrations have been investigated and revised in a way that better reflects insurers' risk exposure. One cannot, however, ignore the fact that these assets represent less than 5% of our portfolios, so — while positive — the changes have a limited impact.

For the past two years, insurers have been calling on the Commission to use the 2018 review of Solvency II to do more to support the CMU objectives; for example, to review both the capital requirements for long-term investment in equity and the risk margin. The latter is an extra capital buffer of around €200bn that particularly affects long-term products and negatively impacts insurers' capacity to invest long-term. At the time of writing, the EC's final proposals for the 2018 review are still not known, but are not expected to propose material changes that would

support the CMU. This makes the 2018 review a missed opportunity.

*"Fixing the challenges Solvency II creates for long term business would make a real difference to the economy."*

- XAVIER LARNAUDIE-EIFFEL

Looking ahead, the insurance industry continues to fully support the objectives of the CMU to remove regulatory barriers and support investment, and strongly believes this should remain an objective of the next Commission. A wide review of Solvency II is due by the end of 2020. The EC should use it to investigate the concerns raised by the industry and

propose changes where these are justified. It should not shy away from asking some essential questions, such as whether the current Solvency II assumption that insurers would be forced to sell their entire portfolio at a huge loss in a time of stress is reasonable and backed by evidence.

Answering this question requires a thorough approach and joint effort from supervisors, regulators, academia and the industry. Fixing the challenges Solvency II creates for long-term business, while maintaining it as a strong risk-based system, would make a real difference to the economy.

Policymakers need to recognise that requiring insurers to hold too much capital can be as damaging for consumers and the economy as requiring them to hold too little. Finding the right balance is not easy, but it is definitely worth the effort. ●



**Sébastien Raspiller**

Assistant Secretary, Ministry of Economy and Finance, France

## Financing the future of the European Union

The Capital Market Union (CMU) corresponds to the profound necessity to complete the single market in a vital area of the European economy: that of its financing. Without a doubt this explains why the ambition of this project has not been derailed by Brexit. If anything, this makes the CMU all the more urgent, as it is supposed to answer some fundamental questions: how does Europe project itself

as a financial player? how do we ensure that our businesses find enough funding? that our retail investors are offered a wide choice of saving opportunities?

Despite its initial ambition, the outcome of CMU is usually said to have been disappointing. Figures show that financial markets are still fragmented in many areas, ranging from the distribution of funds or insurance products, to the possibility for innovation to easily spill over from one member state to the next.

Brexit challenges the European economy in two ways. Locating the main pools of liquidity outside the Union implies that the Union's dependence on external financing will increase, as well as its reliance on foreign supervisory decisions, which may be of more concern especially in times of crisis. With regard to the financial relations with third countries, it is paramount to ensure none of our regulation core principles will be defeated. Thus, third country equivalence regimes need to safeguard level playing field, market integrity and curb systemic risks.

The prospect of the withdrawal of the United Kingdom of course is expected to lead to more fragmentation as far as the financial services concentrated so far in this country are concerned. The coming CMU 2.0 will have to factor in an increasingly multipolar landscape.

The review of the European supervisory agencies launched by the Commission in 2017 was meant to be a cornerstone of the CMU. The principle of harmonized regulation for the nationally-supervised activities and European

supervision for transnational activities must be a driving principle for the CMU - but it is not enough. In this matter one can sometimes measure the distance between the posturing and the concrete actions to which we are ready.

The CMU project must strive to build a financial system in order to gear towards enhanced market performance and a competitive European financial sector. Following this objective, "tech for finance" offers new avenues for consumers and professionals alike: not only do these technologies allow significant cost savings, but they as well increase competition, market liquidity and broaden market access. France will pioneer a new framework for blockchain-based financial solutions. We now want to work at the European level in order to ensure that we collectively seize those opportunities though flexible and open-minded regulatory approaches, as long as investor protection and financial stability are preserved.

Sustainable finance is also now more than just a trend in the European financial landscape. Though financial regulation cannot be a substitute for an ambitious climate agenda, finance flows shall be made consistent with a pathway towards low greenhouse gas emissions and climate-resilient development, as set out by the Paris Agreement - and Europe can be at the forefront of this adventure. We believe it is important to take adequate time to reach a well-functioning regulation, it will be one of our main priorities in the early months of the forthcoming term of the European Commission. ●



## Rimantas Šadžius

Member, European Court of Auditors

### Looking beyond numbers – EU auditors' focus on European financial sector

Checking numbers, balance sheets and accuracy of annual reports of financial institutions – this is how “audit in the financial sector” is commonly perceived by people, even by professionals. Yet, the European Court of Auditors (ECA), the EU’s official external auditor based in Luxembourg, aims at much wider perspective. This is in line with our strong EU Treaty-based mandate, permitting us to audit also the performance of any European funds and EU policies and give respective recommendations to institutions.

In the aftermath of the 2008-2009 crisis, the ECA recognised that much more is needed to promote efficiency and adequate accountability in the EU financial and economic governance, where EU institutions can and should add significant value, and convergence of national actions at Member States level is vital. In recent years we conducted a number of interesting audits focused in these fields, e.g. on Banking Union (SSM and SRM); implementation of the Stability and Growth Pact; performance of the European Supervisory Authorities (ESAs). **Systemic challenges in insurance supervision in Europe**

Recent audit of the European Insurance and Occupational Pensions

Authority (EIOPA) manifestly showed how EU financial market fragmentation stood on the way of reforms undertaken to secure financial stability, harmonize regulation or improve supervision. We looked in detail at cross-border insurance business supervision and found that despite EIOPA clearly took a significant – and often informal – co-ordination effort, the current EU legal framework itself features systemic weaknesses. It creates a situation where supervision (or lack of it) of the entities depends solely on the legal form of a business rather than on its nature.

So, there appear wrong incentives for some insurers to take advantage of freedom of establishment or services in jurisdictions with less stringent standards of supervision; and national authorities lack tools to counteract this. Clear for us: in genuine single market, its shortfalls call for Europe-wide solutions. Our recommendation to address in the European law these detrimental cross-border effects, I think, came just in time, given ongoing debate on revision of legal mandate and powers of the three ESAs.

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*“Clear for us: in genuine single market, its shortfalls call for Europe-wide solutions.”*

- RIMANTAS ŠADŽIUS

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#### Looking forward to a comprehensive CMU assessment

The ECA is now starting another big journey: an audit of the progress in the European Capital Markets Union (CMU) project. Our intention is to check whether the EU has in reality delivered on its promise to diversify business financing and ease access to non-bank resources within and across national borders, in particular for smaller entities.

We will also reflect on whether, by going in this direction, the EU has managed to maintain a level-playing field and sufficiently protected market participants on both – demand and supply – sides.

Applying our audit evidence collection tools and scrutinizing action of EU authorities, we at the same time will keep close contact with European business associations and public financial institutions, to ensure our final recommendations are relevant and practical for agility of the evolving CMU. ●

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# CMU and Banking Union: complementary or antagonistic?



## Philipp Hartmann

Deputy Director General Research,  
European Central Bank (ECB)

### A primer on the inherent complementarity of banking and capital markets

Financial systems play a key role for growth and stability. Notably, they offer agents with surpluses of funds means to invest them profitably and use the proceeds for consumption or real investment in the future. Agents with shortages of funds they offer means to acquire what they need and engage in consumption or real investment immediately. In other words, a well-functioning financial system supports re-allocating resources over time and across agents or sectors.

The relevant services are typically provided through a mixture of financial intermediaries and markets, the so-called financial structure. The economic literature emphasises the distinction between banks and capital markets. This terminology is also picked up for some policy initiatives, such as the European Banking Union and the European Capital Markets Union. For example, traditional banks are regarded as providing particularly intertemporal insurance to borrowers and depositors, whereas equity markets are regarded as providing particularly cross-sectional diversification to investors. The broad-brushed labelling is certainly useful for effective project management, communication purposes and some research. But it should not mask the wider variety of intermediaries, markets and services needed in a modern financial system and their different complementary roles.

There are many more examples of such complementarities. One is the ability to switch funding sources, sometimes referred to under the headline “spare tyre theory”. Empirical research has shown that in financial systems with well-developed loan, corporate bond and equity markets if one of these funding sources for non-financial corporations dries up then one or both of the others compensate for it, at least partly. Another example relates to which funding channel is best for which type of real investment. Recent research suggests that public and private capital markets, notably equity markets, tend to be better in funding highly risky investments and investments in frontier technologies. Bank lending tends to be better in funding medium-to-low-level risks and more traditional industries. A third example concerns different forms that financial integration can take across regions or countries. Cross-border holdings of equity claims are found to be particularly effective in fostering private financial risk sharing, i.e. smoothing aggregate consumption of countries or regions. But also cross-border retail lending and borrowing can contribute to it materially. Whereas the equity holdings can probably be achieved through various forms of investment funds, it is hard to see how the credit channel can operate without significant cross-border bank consolidation. Finally, the ability to securitise loans creates complementarities between banks and capital markets. The possibility to distribute >>>

>>> the securitised products via capital markets allows banks to create space on their balance sheets for the origination of new loans (obviously, securitisation should be of the simple, transparent and standardised type that avoids the problems experienced in the financial crisis).

In a case like the euro area, in which banks still play a very strong role and capital markets need to develop more, also transitional dynamics need to be taken into account. If banks would not adjust their business models, competition from capital markets could undermine their already low profitability. Part of the banks will remain competitive for lending on a relationship basis (e.g. in local markets), whereas other banks would have to develop their business models, e.g. incorporating stronger investment banking services. The latter will require, inter alia, a certain scale and distribution channels for multiple countries, which could also be achieved through more cross-border bank consolidation in the euro area. All this, and also different starting positions of different countries, may meet some resistance and would have to be accompanied by banking supervisory vigilance and a level playing field between banks' and other intermediaries' regulations. My overall conclusion, however, is that the European Banking Union and the Capital Markets Union are strongly complementary. ●



## Felix Hufeld

President, Federal Financial Supervisory Authority,  
Germany (BaFin)

### CMU and Banking Union are complementary

The mere fact that a broad and liquid capital market in the EU may create opportunities for banks shows that the Capital Markets Union (CMU) and the Banking Union are in fact complementary. Not only do banks grant loans, they also have expertise as structurers and advisors, on both the credit and equity side. However, in the current environment, the abilities of banks and capital markets to fuel the economy vary largely. In addition, there are considerable national differences in the ratios between market capitalisation and GDP. While capital market penetration is around 250 percent in the UK and 260 percent in the US, the figures for the EU-27 average around 150 percent. Roughly speaking, 80 percent of corporate loans in the EU are bank loans, whereas in the US the opposite is true: around 80 percent of loans stem from the corporate bond market. A slowdown in the securitisation market due to the financial crisis has contributed to this environment. Despite the concept of the "European Passport", capital markets tend to be fragmented. The typical retail investor, alongside many institutional investors, still primarily invests in national markets ("home bias").

At first glance, a shift away from credit financing for companies in the real economy towards more capital market-driven forms of financing may seem like a migration between two different worlds. Capital market financing and raising funds via bank loans are largely seen as antagonistic. A shift to more market financing is often considered a threat to banks' business models with their focus on bank loans, which have traditionally played a major role especially in continental Europe. However, even if this concern may occasionally prove to be valid, this view is short-sighted against the overarching concept and framework of the current European initiatives. Indeed, at second glance, the issue is less black-and-white than it would first appear.

The goals of the Banking Union and the Capital Markets Union complement one another. The Banking Union, with the Single Supervisory Mechanism, aims to maintain a solid and resilient banking landscape. Resilient credit institutions are in a position to play an active role in the capital markets e.g. as brokers, market makers, structurers and advisors. >>>

>>> Likewise, a well-functioning, more integrated Capital Markets Union will create a broad range of business opportunities for banks as well as other financial institutions.

This is due to the following reasons:

1. Banks will be increasingly in demand for this form of market-based financing. Above all, as mentioned above, for their role as structurers and consultants.
2. From a bank's point of view, an increase in capital market financing could be an incentive to acquire more commission-driven income. In this field, European banks and savings banks are still lagging behind their US competitors. The yields of many European banks are still too interest-bearing, which is a problem especially in view of the very long persistence of low interest rates and flat yield curves. The surplus of interest-bearing business is also one of the reasons for the low capitalisation in some EU countries.
3. The large role played by bank loans in financing companies, especially SMEs, may not continue in the aftermath of the financial crisis since regulation has called for a deleveraging of banks. In order to sustain the required funding level, sources of financing should become more diversified.

### Outlook

European elections are coming up next month. The European Commission's five-year term is about to end. Nonetheless, we may already anticipate that the efforts to foster a truly integrated EU capital market will remain a key focus in the new legislative period. The Commission has accelerated this process and further initiatives are underway to boost the role of both banks and insurance undertakings, taking the Pan-European Pension Product into account. 2019 will thus not only see the conclusion of the "CMU initiative" launched in 2015. We must also use the momentum gained by clarifying the steps to be taken to ensure the smooth functioning of a pan-European capital market, allowing for cross-border economies of scale, enhanced investor protection, a broader range of finance and investment products and, of course, more convergent regulation. ●



## Stéphane Boujnah

Chief Executive Officer and Chairman  
of the Managing Board, Euronext

### Banking Union & CMU - the building blocks to strengthen EU financial integration

Banks and capital markets are fundamentally interconnected as parts of the wider financial system. They complement each other in the financing of the real economy and represent mutually reinforcing initiatives that can strengthen the EU Financial Services Internal Market. I have witnessed and, somehow, contributed to the development of both pillars, in particular from my time at Santander and now at Euronext.

A focus on exploring synergies between Banking Union and CMU is critical in the context of a collective ambition by the EU27 to strengthen the provision of capital markets services within the EU.

Banking Union supports a more resilient banking system which in turn underpins the smooth functioning of capital markets. Secondly, a more

integrated banking system also supports capital markets' integration, particularly via further regulatory and supervisory convergence facilitating the provision of cross-border services by banks. In parallel, a more integrated European capital market will also support cross-border activities and the resilience of banks.

While significantly more integrated capital markets have the potential to reduce the need on banks to develop extensive local expertise for each national capital market, this must be balanced: securing thriving local market ecosystems remains critical, particularly when it comes to the financing of SME and midcap companies.

Euronext, as the operator of Regulated Markets and MTFs across six EU Member States reiterates the need to deliver a strong Single Rulebook with convergent supervisory practices as a means of underpinning the integrated markets we operate.

Delivering on this objective should not, however, undermine core elements of successful local market ecosystems, including the unique competencies of local regulators. As such, the focus should be on strengthening supervisory convergence, based on a recognition of the respective responsibilities of national and European authorities. ●



## Jacques Beyssade

Secretary General,  
Groupe BPCE

### More complementarity thanks to a more ambitious CMU and a more proportionate BU

Europe is heavily reliant on bank loans to finance its economy. This is one of the key reasons why developing additional market-based funding options - which can act as a “spare tyre” when

bank lending is constrained - has rightly become a major objective of the EU and of its CMU project.

Surely reforms that will disproportionately impact how banks operate have the potential to affect capital markets too, but at the same time ensuring financial stability and economic growth share complementary goals; and both can be articulated in a dynamic way. For instance, the concern of the BU to reduce the size of banks’ balance sheets finds an answer in the goal of CMU to increase the size of financing of the EU economy by capital markets.

On paper banking groups, and BPCE in particular, are set to be quality players in both fields (financing through bank intermediation and capital markets) by their very nature as universal banks and in the case of BPCE by its strong balance sheet and diversified business model.

However, the articulation of the CMU and the BU has proven hard to implement and both the CMU and the Banking Union have faced strong headwinds on their own right.

For the BU the latest Risk Reduction Package, still designed on a solo basis, does not consider transnational banking groups at the consolidated level, but as a sum of separate subsidiaries. This, and the fact that it did not respond to the needs of many host Member States to have their concerns addressed, ensured an unsatisfactory outcome. For the CMU the STS securitisation framework,

the Pan-European Personal Pension Product, and encouraging cross-border investment are good intentions but today the consensus is that the CMU needs a new start.

Against this backdrop, should we not be more ambitious with the CMU, especially in times of Brexit uncertainty, while addressing the points that can be taken forward today with regards to the Banking Union?

To serve this ambition let’s be more focused on sustainable finance, probably the flagship in the years to come, and retirement needs which still call for solutions. The Commission could also address the need to involve more retail investors into the CMU, ensure SME research and securitisation and foster global standards for financing EU companies.

On Banking Union, financial regulation needs to be proportionate to the risks involved, well-calibrated and adaptable to evolving circumstances. We should not apply to all banks or to all portfolios the same set of criteria, taking into account the diversity of business models and corresponding risks. Diversity is a strength for any ecosystem; let’s draw the consequences that specific markets (such as real estate or specialised lending) need an appropriate treatment when finalising Basel III. This is how regulation could be tailored to the specificity of the EU and the goals of the Banking Union. ●

## Carmine Di Noia

Commissioner, Commissione Nazionale  
per le Società e la Borsa (CONSOB)

### CMU and Banking Union: it takes two to tango!

It is unquestionable that Capital Markets Union (CMU) and the Banking Union complement each other.

A greater cross-border financial risk sharing supports the functioning of the European Union by smoothing economic cycles and improving the capacity to absorb shocks. With a more integrated Single Market banks could exploit cross-border economies of scale more easily. On the other side a more resilient banking system supports the development of capital

markets, which is one of the objectives of capital markets union, as prospering banks will be able to invest more resources into the development of new capital market products and services. Bank-based and market-based financing systems have a comparative advantage in funding different types of investment project. The end-result is clear: we broaden the set of financing sources the ultimate borrower can choose from.

We should take the chance to move forward merging the two initiatives in a single long-term holistic project: a truly “EU Financial Union”. How? Intervening on the regulatory and supervisory EU architecture.

It is widely acknowledged that the traditional boundaries between banking, insurance, and securities are blurring. In addition, the major European banks and insurances companies are listed on regulated markets and therefore are subject to the



complex bulk of European securities regulation (market abuse, prospectus, transparency, and so on). Financial law however is still organized along sectoral lines. The model is outdated and generates frictions between >>>

>>> regulatory objectives, in particular between micro-stability and transparency goals: information that need to be disclosed according to the securities regulation may be detrimental for the stability of the financial issuer, leading to a very delicate scenario both for market players and supervisory authorities.

While completing the rulebook for Banking Union and CMU, we might consider a consolidated official version of pre-existing rules, adjusted to work smoothly in an “all finance” environment.

Increased harmonization and consistent implementation of EU rules re-open the debate around the European supervisory framework, something that the current ESAs review proposal is trying to address.

The lack of a single securities regulator is a major loophole in the CMU edifice as it is certainly too late for having different supervision for different legal entities performing the same economic activities. A balanced solution might consist in shifting to a federal model based on the size of the capital market supervised entity: SICMIs (i.e. Sistemically Important Capital Markets Institutions) should be authorized and supervised at the central level, while other entities would fall under the umbrella of national authorities.

With stronger legal basis, the Single Supervisory Mechanism could be extended to cover insurance firms and ESMA would be empowered with direct supervisory and enforcement tasks over SICMIs. The endpoint would be a 4-peaks federal model (macro-stability, micro stability, investor protection and competition) irrespective of the nature of intermediaries, with coordination committees at national and central level provided by policy makers and EU Commission. ●

## Tanate Phutrakul

Chief Financial Officer, ING Groep N.V.

### Without Banking Union, no Capital Markets Union

The Capital Markets Union (CMU) is a difficult beast. There is near universal consensus that establishing CMU is a good thing. It will help diversify the EU economy's sources of financing. This should strengthen financial stability. The availability of alternative financing channels should reduce



the amplifying cyclical feedback effects that finance can have on the economy. Moreover, in an increasingly complex and unpredictable world, having deep, liquid financial markets at home adds to the EU's ability to maintain economic stability at home and an open, multilateral, rule-based economic and financial system in the world.

While these goals are broadly subscribed to, there is much less consensus on how to bring about truly integrated financial markets in the EU. What is clear, is that banks play a pivotal role in building Capital Markets Union. Europe's economy is still largely bank-financed. Banks remain the dominant lenders in most countries. By classic means like securitisation, banks can unlock assets to investors for which otherwise no market exists. As finance develops and digitisation progresses, banks will increasingly also be able to serve investors via new channels. Banks are building platforms, intermediating between borrowers and investors. Banks may also specialise in certain functions in the credit supply chain, e.g. client checks, credit risk assessment and loan servicing.

In applying new digital tools, banks like ING are benefiting from economies of scale. The bigger the market, the better and more efficient services can be provided. So yes please, let's implement the CMU today, we all stand to benefit. But let's also not forget that Banking Union is the sine qua non for building Capital Markets Union and for strengthening the role of the euro. A bank like ING services clients throughout Europe. We could strengthen our role as EU-wide suppliers and intermediaries on an integrated EU capital market – provided we are able to manage our liabilities and our assets in a consolidated and seamless way. Only then are we optimally able to channel savings from where they are in excess supply, to where investment is needed the most.

This means that the impediments we know all too well today, including local ringfencing of liquidity, assets and capital, should be removed. That is only feasible if banking risks are managed at the EU level. Which is why when talking about CMU and a strong euro, we are only just a step or two away from stressing the need to manage banking risks at the EU level. The Single Supervisory Mechanism is there, the Single Resolution Mechanism is mostly in place (although a bigger liquidity backstop would be welcome). Yet we still sorely miss a European Deposit Insurance Fund and a way to address skewed sovereign exposures at banks. It is of limited use to discuss how to build CMU, if we not address at the same time these remaining Banking Union issues. ●

## Jean Naslin

Executive Director, Head of Public Affairs, CaixaBank

### Banking sector and capital markets: union creates strength



This debate cannot be reduced to «banks versus capital markets». Both rather complement each other.

Bank lending is associated with an important process of ex ante credit scoring and a deeply rooted relationship between bank and customer. Information regarding debtor is less asymmetric, reducing costs. Monitoring and selecting projects foster stronger corporate governance policies which improves credit capacity >>>

>>> of the private sector. At the same time, reduction of asymmetric information resulting from lending historical data impact positively access to market by banks clients and bank intermediation. Specifically, companies with some association with banks enjoy lower costs for debt and equity issuances compared with those firms with a lesser degree of association. So the effects of traditional bank activities go beyond the sphere of banking per se.

Markets, in turn, fundamentally have two strengths, they help share risks between players according to their preferences and especially their risk tolerance. When markets in which debt securities or equity are traded are sufficiently liquid and the investor base is broad, corporate financing costs tend to fall. A minimal size of firm and issuance is normally required, however. The possibility of trading securities on the secondary market enhances price formation as prices reflect, in the absence of any significant distortions, approximately the aggregate expectations of investors regarding the viability of projects.

So banks and markets are far from being separate, sealed compartments even more so when we add securitisation into the mix, a natural link between banks and markets.

In the absence of a common framework, capital markets are unlikely to replace bank financing. Companies in the euro area still have very limited access to corporate bond and equity markets. This is largely due to the euro area's predominance of small firms where the vast majority of funds obtained by issuing debt are concentrated in just a few very large companies.

In addition, concentration of systemic risks at national level constrain truly EU free flows of capital and liquidity, all of which probably further exacerbated post BREXIT. Supervision and enforcement are still mostly in the hands of NCAs. Far too many national barriers or legal impediments such as insolvency tend to lead to regulatory arbitrage. A single rule book needs to be supplemented by single supervision. Only small market segments are directly supervised by ESMA, calling for enhanced supervisory powers and reinforced governance for ESAs generally. This is particularly relevant in the context of BREXIT where ESMA can play a key role in handling equivalence, a particularly relevant challenge.

Existing fragmentation of financial markets constrain free flows of capital and

liquidity weakening the development of true pan European players. Finally, short of further European integration and a full banking union including Solidarity mechanisms and home host trust, large cross boarder banking, both retail and wholesale, cannot be incentivized. Major integration of the European banking system is key to a successful integration of financial markets. ●



**Michael Percival**

EMEA Head of Regulatory Affairs,  
JPMorgan

## Keeping European financial markets at the deep end of the liquidity pool

Europe's policymakers have recognised the need to develop the region's capital markets. JPMorgan fully subscribes to that objective, in support of greater access to competitive financing and risk management for European firms. Part of the equation, which should not be lost, is the value for the continent of remaining strongly connected to global financial flows.

### Accessing global liquidity

The EU has a good track record of facilitating cross-border financial flows, both within the EU and between the EU and rest of world. JPMorgan's activities in the EU are a testament to that. Brexit has caused us to examine collectively those flows afresh to consider the costs and benefits. We believe that the benefits are significant: cross-border flows allow us to bring global risk management and

financing liquidity to clients in the EU. Conversely, EU investors are able to diversify their holdings and access global investment opportunities. These flows diversify financing globally and bring greater resilience to the system.

As policymakers further the Capital Markets Union and Banking Union we believe they should consider how to reduce frictions affecting cross-border flows, both intra-EU and between the EU and rest of world. These frictions might arise from direct 'barriers to entry', through disproportionate locational requirements, or even from differential application of rules, potentially undermining a 'level playing field'. Sometimes, for example with the Benchmarks Regulation, EU expectations for third countries to have equivalent regimes (which is not always the case) creates a barrier to cross-border flows.

### Strong banks support capital markets

Improving the resilience of the EU banking sector will support capital markets; balance sheet is used for underwriting and making markets in securities, for example. EU policymakers are rightly considering how banks in the EU can achieve more robust balance sheets and stronger earnings, which in turn could drive stronger capital markets activity and growth.

Much work is underway to address NPLs, though stronger profitability for banks in the EU remains elusive. Greater capital markets activity should support bank earnings, through additional fee income and other revenues. Capital markets activity will also diversify bank earnings, while providing a conduit for transfer of risk from balance sheets.

### Where to from here?

Deeper capital markets and a stronger banking sector will help EU growth and resilience. A deeper capital market will also support the Euro's international role – a separate European Commission objective. We have observed in the context of Brexit some commentators suggesting greater 'autonomy' for EU financial markets, with less connection to London. We believe policymakers need to nevertheless ensure continued connectivity between EU and global markets. Fragmented markets tend not to benefit consumers or economies, but rather the vested interests that have enhanced market power within a sub-market. The EU does not need to go down that path. Rather, the EU should have the confidence to maintain its course of facilitating cross-border flows, to stay connected globally and ensure continued access to the deepest liquidity pools. ●

## II. POTENTIAL BREXIT IMPACTS AND PROGRESS MADE WITH G20 FINANCIAL REFORMS

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### Issues at stake

The financial system is global in many areas and global regulatory and supervisory coordination is needed to ensure an appropriate financing of growth, preserve a global level playing field and mitigate the risks associated with highly interconnected players and activities.

However, multilateralism is weakening and increasing fragmentation may be feared in the global financial sector. One challenge is the wish of some jurisdictions to act more independently in order to ensure that regulation takes into account their own specificities and does not affect inappropriately their domestic financing mechanisms.

Brexit is a further concern. At this point in time it is still unclear what the outcome of EU-UK negotiations will be and therefore stakeholders are continuing to prepare for a no-deal Brexit. In this context some stakeholders are calling for an enhancement of existing third-country regimes which are most likely to be the basis of future EU-UK relationships in the financial sector.

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# Brexit preparations and short-term implications



## Bruce Thompson

Vice Chairman, Bank of America

### Preparing for Brexit

Our preparations for Brexit entered their final stages during autumn 2018 and into 2019. With the necessary authorisations in place, on 1 December we completed the cross-border merger of our main UK-based banking entity into our existing Irish entity. This followed many months of detailed engagement with supervisors and means that our primary European banking entity is now based in Dublin, with approximately EUR 50 bn in assets, and branches in Amsterdam, Brussels, London, Frankfurt, Madrid, Milan, Paris, Stockholm and Zurich. A full management team and governance structure is now in place and, where necessary, staff relocations have been completed. After nearly two years of work, our European bank has now moved from 'project' phase to 'business-as-usual'.

Preparations for our EU investment firm, which is based in Paris, are now in the final stages. In Q4 2018 we received the necessary authorisations to commence formal set-up, which allowed us to begin the process of connecting to the relevant market infrastructure. Trading operations have now commenced, management and governance appointments have been made and, where necessary, many staff have relocated into new offices in Paris.

While these processes have involved a significant amount of work for my own colleagues, the same is true for colleagues in the relevant authorities, and we are grateful for the commitment and engagement of staff at the CBI, ECB, ACPR, AMF, PRA, FCA and other National Competent Authorities, that has allowed Bank of America to manage its Brexit preparations so smoothly.

We also welcome the steps taken by regulators and policymakers in the UK and the EU in order to prevent a cliff-edge in the event of a no-deal Brexit, as well as the actions taken by individual Member States and indeed the United States. These are particularly important in the fields of derivatives clearing and contract continuity – so far they have helped the financial services sector prepare for all possible outcomes, and longer term they will play a key role in maintaining financial stability as Brexit continues to develop.

With our Brexit preparations now largely complete, we have also been supporting clients with their own changes in terms of how they engage with us. I am



>>> confident that we will be able to function smoothly and to service our clients seamlessly whatever the final outcome of the Brexit negotiations. Indeed, I believe the sector as a whole is now well-prepared – the longer lead times in finance, driven by the need for authorisations, capitalisation and oversight, are helpful in terms of horizon scanning and outcome modelling. We must not be complacent, however; and we are all aware that some Brexit outcomes may pose difficulties for our clients and the wider economy.

That said, we are embracing our European future and we are excited about the opportunities that our new structure will offer. While centralisation in London brought benefits in terms of cluster effects, so a more diversified European approach is likely to bring benefits in terms of being geographically closer to more European clients. The challenge will be to ensure that the sector maintains a 'virtual cluster' to avoid fragmentation of liquidity and regulation, and to keep costs down for our customers.

To this end, it is important that the UK and the EU continue to work together in support of the financial services sector – and supervisory co-operation, regulatory co-ordination and co-ordination in international bodies will all be important in this respect. Moreover, we would encourage the UK, the EU and the US all to work together to ensure continued high standards of regulation in financial markets – ten years from the financial crisis, the need for international co-operation is more important than ever. ●



## Harald Waiglein

Director General for Economic Policy and Financial Markets,  
Member of the Board of Directors, ESM & EFC,  
Federal Ministry of Finance, Austria

### Brexit – we are prepared

At the time of writing, it is still not clear how Brexit will take place. Currently Member States and EU institutions are preparing for the worst outcome, which is a no deal Brexit.

Preparations need to be made in two different strands. The first one relates to legal and practical arrangements. The EU legal framework, but also the national ones, have to be thoroughly examined in order to identify areas where amendments are necessary and helpful to mitigate any harmful effects. Due to the high number of EU legislative acts in the field of financial services, it was mainly in the hand of the EU-institutions to pave the way for a smooth transition by adopting equivalence decisions and delegated acts. In addition, ESMA and the Bank of England agreed on an MoU for the recognition of CCPs established in the UK but also in Member States in case of a no deal. This agreement covers a crucial area for financial stability by ensuring continuity and legal certainty. At national level, the legal amendments in the field of financial services are of limited size and the EU platform for contingency measures helps to foster exchange of views and best practices by Member States.

The second strand of preparation relates to the need to raise awareness. It is the task of the financial industry to inform customers and clients about the steps they have taken and how they are implementing them. It is in their responsibility to prepare and adjust their business to a new environment. The public sector can contribute to this effort by making publicly available all necessary information and by being in permanent contact with stakeholders to inform them about any new developments and findings. >>>

>>> It is hard to predict whether all these preparations for the no-deal scenario would in fact be sufficient to avoid market disruptions. The contingency planning certainly reflects the best of our knowledge. But you can never exclude irrational behaviour.

Even if market disruptions can be avoided and financial stability is preserved, short-term adverse effects might arise, some of which need to be handled by the competent authorities. Contingency measures are of temporary nature and measures taken at national level might differ. The result would be new fragmentation in the markets. The temporary nature of these measures gives us time to adapt to the new situation and to establish a new relationship with UK in crucial areas which avoids supervisory arbitrage and tries to make the best in economic terms of a difficult new economic and political situation: a situation where market access and obligations need to be addressed in a balanced way to guarantee level playing field and overall stability by ensuring a high level of supervision and credibility. This outcome should be in the interest of all participants, and we are working hard to achieve it. ●



## Mario Nava

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

### Brexit and then what?

The Commission has urged private stakeholders throughout to ensure preparedness for all possible outcomes including a “no-deal” scenario in which the United Kingdom would leave the European Union with no agreement pursuant to Article 50 paragraph 2 of the Treaty on the European Union in place. To support private sector preparedness, the European Commission has published over 70 preparedness stakeholders’ notices, including several notices in financial services alone.

The European Supervisory Authorities, the European Central Bank and the Single Resolution Board also provided guidance to the public on Brexit-related matters in the financial services sector.

In parallel, the European Commission has been assessing possible risks for the financial system related to the UK’s withdrawal without an agreement, building on own analyses and the input from other relevant European institutions like the ECB and the European Supervisory Authorities. The European Central Bank and the Bank of England have analysed risks in a technical group.

On the basis of these assessments, the Commission concluded that in order to safeguard financial stability in the EU27, only a limited number of contingency measures was necessary. These included two time-limited equivalence decisions, which were adopted on 19 December 2018, one allowing EU clients to access UK-based central counterparties, the other relating to central security depositaries services (CSDs) from the UK. The Commission announced its EU level contingency measures in its Communication of 19 December 2018 on “Preparing for the withdrawal of the United Kingdom from the European Union on 30 March 2019: Implementing the Commission’s Contingency Action Plan”.

Following the Commission decisions, ESMA has completed the recognition process of UK CCPs and on UK CSDs. The Commission has also put forward a number of technical provisions targeting central bank (and in some cases also Debt Management Offices’) exemptions in a number of areas.

>>>

>>> Overall, based on a thorough risk analysis, the Commission considers these the only EU measures necessary in financial services. The Commission continues to monitor financial risks that may arise from Brexit, in coordination with the ECB, the European Financial Supervisory Authorities, Member States and stakeholders.

Member States are putting in place measures to address residual risks at national level, thus reducing further the risk that a disruptive Brexit translates into financial instability. The Commission is actively working together with Member States to ensure that measures are targeted to the risks, and that they are limited in scope and duration, on the basis of the principles for national contingency measures mentioned in the Commission Communication of 19 December 2018. ●



## Ian Jameson

Managing Director, General Counsel and Chief Legal Officer,  
EMEA Region, Sumitomo Mitsui Banking Corporation (SMBC)

### Brexit – preparation, challenges and opportunities for SMBC

From the beginning, client service has been at the heart of SMBC's Brexit planning. At the time of writing there is still a real risk of a no deal Brexit on 29 March 2019. The lack of certainty makes business decision-making more difficult, but, having assumed from the start the worst outcome – no deal – we have worked hard to ensure that we can maintain service to our clients without disruption through Brexit and beyond.

Over the last three years SMBC has run a major project to plan and execute our Brexit strategy as regards both our banking and securities businesses. Without an existing EU 27 bank or investment firm in the group, significant time was devoted to deciding where we would set up our new entities. There followed intensive analysis of the regulatory issues and we started the close communication with regulators (in the UK and Japan and in all the EU countries where we have a presence) which continues today. Eventually we opted for Frankfurt and have built a new bank and a new investment firm there. This has entailed major investment in real estate and headcount. We have transferred capital, implemented the necessary systems and joined the relevant market infrastructure. The majority of the branches of our UK bank will be transferred to the new German bank. We are confident we will be ready for business when Brexit occurs.

However, major challenges will remain. Cost, uncertainty and fragmentation are the prime sources of these.

After Brexit, we will initially be providing to our clients the same services as we provide today, but at much greater cost. This is a necessary evil and the inescapable consequence of our Brexit strategy. Tight cost control has been a key factor in our planning, but avoiding inefficiencies in allocation of resources after Brexit will be a major challenge.

Ongoing uncertainty on all levels is a major aspect of Brexit. Much has been written about loss of passports, contract continuity and related issues and, in the absence of an EU-wide regime, different member state regimes are now being put in place. But the patchwork of provisions they create brings its own complexities.

>>>

>>> Generally, financial institutions and major corporate clients are well prepared for Brexit. Some smaller corporates however need a lot of guidance and regulators are understandably focused on this. But in the absence of certainty, there is an element of conduct risk in all customer interactions.

Likewise, there has been talk of a regulatory “glidepath” – a period of adaptation to a new regulatory state that has not yet been defined - but there is currently little clarity as to what the final destination is or when we must land.

Fragmentation is of course the central theme of Brexit. Longer term there is no doubt that there will be regulatory divergence between a post-Brexit UK and the EU. Banks will need to manage the stresses that this may cause for their businesses. We also see fragmentation of governance in the creation of new legal entities with their own management and board structures, and there is fragmentation in the inefficiency of capital and liquidity transferred to these entities.

The above challenges will impact banks' business models, including marketing, risk management and booking. However, the challenges have their benefits too and there will be opportunities for any bank able to exploit these. When planning for Brexit one of our key goals was to put ourselves at the financial heart of Europe. By setting up operations in Frankfurt we will have achieved this and we fully intend to operate as a European bank.

We will find solutions to operational inefficiencies. Potential areas of work include adapting major processes (such as credit, KYC and marketing) to the new realities of Brexit. At a European level we will review our management structure and governance. And longer term we will consider a rationalisation of our legal entity structure. There is room for SMBC to grow in the EU 27. Our Brexit-related investment in Germany and other EU 27 member states will drive further development of our business in those markets.

SMBC will find solutions to the challenges of Brexit and fully intends to benefit from the opportunities it presents. ●

# NEXT EUROFI EVENT

## **The Eurofi Financial Forum 2019**

**11, 12 & 13 September**

Forum organised in association  
with the incoming Finnish EU Council Presidency

**Helsinki - Finland**



# Third-country EU market access post-Brexit



## Katharine Braddick

Director General, HM Treasury

### The benefits of open markets

In the 18th century the Scottish economist Adam Smith said ‘in general, if any branch of trade, or any division of labour, be advantageous to the public, the freer and more general the competition, it will always be the more so’. When we focus on the minutiae of the issues facing the financial services sector, as most of us attending the Eurofi conference will do from time to time by necessity, we can lose sight of the real-world impacts of the decisions and choices that we make. Though now several centuries in vintage, Smith’s words have never been more relevant.

We live in an increasingly globalised world, one in which the trade in financial services and the flow of capital across borders provide tangible benefits to the firms and people of Europe, indeed to the growth of our economy in general. Financial markets provide competitive insurance for our firms and citizens, investment and loans for our industries, and enable people to provide for their and their families’ futures through funds and pensions. Fragmentation of these markets would reduce the flow of investment and increase the costs of finance for firms and citizens.

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*“Trade in financial services and the flow of capital across borders provide tangible benefits.”*

- KATHARINE BRADDICK

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It is clear then that open markets and cross-border trade in financial services benefit individuals, firms large and small, and the health of the economy more widely. It is essential that across the world, including in Europe, that legislators and supervisors keep these facts at the forefront of our thinking as we develop the regulatory regimes of the future. The world around us may be changing rapidly, developments in fintech, cyber and cryptoassets certainly present a challenge for firms and regulators alike, but they also present great opportunities. We must seize these opportunities together, ensuring that we develop consistent regulatory regimes that continue to enable rather than fragment our open markets and provide an increasingly resilient and stable system.

The work of international organisations such as the Financial Stability Board (FSB) is vital in this regard. At the request of the G20 the FSB continues work to



>>> complete the implementation of post-crisis reforms, seeking to build a resilient financial system grounded in agreed international standards that facilitates trade and sustainable economic growth. A key part of this work is evaluation and assessment of the effects of those reforms, examining the effects on the structure and functioning of our global financial system. In this context, the FSB are undertaking specific work on market fragmentation under Japan's G20 Presidency, assessing the cross-border consistency of reforms and exploring issues around market fragmentation, how it can emerge, and its potential impact. The aim is to identify tools that can be used to address the risk of market fragmentation arising.

The UK is host to an open, internationalist, and diverse financial centre, and the resilient and credible regulatory regime in the UK is what underpins this. The UK worked with the rest of Europe on the post-crisis reforms and we will continue to do so in the future, working together to strike the right balance between protecting stability and driving innovation, ensuring that we continue to foster the competitiveness of the European economy. That includes maintaining our commitment to work with our partners through organisations like the FSB, Basel and IOSCO and pursue what the British Chancellor of the Exchequer has called the regulatory "race to the top".

The EU and the UK share a commitment to financial stability and high standards for the financial services sector, and a confidence in the value of open markets. In the future, trade between us in financial services will be managed through equivalence frameworks. It is clear and without question that this change in the regulatory architecture presents challenges.

But it is not an inevitability that we must face damaging levels of fragmentation and friction in our relationship. It is a false choice to say that we must choose between protecting our respective financial stability and maintaining open trade. Are our third country equivalence regimes in need of improvement? Without a shadow of a doubt. Are we capable of getting this right and putting in place co-operative regimes that will enable continuing and vibrant trade in financial services to the benefit of Europe's citizens and firms? Absolutely. ●



## Steven Maijoor

Chair, European Securities  
and Markets Authority (ESMA)

### Evolving EU equivalence regime

In the context of the post-crisis regulatory reform, the EU developed a market access model based on equivalence and recognition. This model, which is available under EU law for a number of areas in financial markets, aims at keeping EU markets open and therefore limiting market fragmentation on the one hand, while preserving financial stability and investor protection on the other.

The most widely known example is the equivalence of Central Counterparties (CCPs) supervision regimes, and subsequent recognition of individual non-EU (Third-Country, TC) CCPs by ESMA. Since the application of EMIR, the European Commission has adopted 16 equivalence decisions and a total of 32 non-EU CCPs from 16 jurisdictions have been recognised by ESMA.

This model, while being quite open for global market participants, however brings certain concerns from the perspective of EU financial stability. These concerns >>>

>>> were already flagged by ESMA in its EMIR review reports in August 2015. In particular, the EU's approach sets out a full reliance on third country rules and supervisory arrangements. The cooperation arrangements that ESMA has concluded, and will continue to conclude, give ESMA very limited powers to intervene should risks arise related to a TC-CCP that are specifically relevant from an EU perspective.

At the same time, the majority of non-EU jurisdictions consider TC-CCPs as systemically relevant infrastructures and apply much closer scrutiny. In general, their processes envisage full registration in the relevant jurisdiction. As part of the authorisation process the third country authority may decide to rely on certain rules of the home jurisdiction of the CCP and certain cooperation arrangements with the home authority of the CCPs, however the CCP would become subject to the rules and the authority of the jurisdiction registering it.

EMIR 2.2 will address some of ESMA's key concerns and therefore introduce a more proportionate approach. In particular, EMIR 2.2 will introduce an enhanced recognition regime for systemically important TC-CCPs (Tier 2 CCPs), whereby such CCPs will have to comply with EMIR requirements and be subject to certain ESMA supervisory powers. Concerning all non-systemic TC-CCPs, the current arrangement with ESMA's full reliance on non-EU supervision will continue to apply.

I believe that this proportionate approach to systemic and non-systemic non-EU market players, assessed from the perspective of EU financial stability and combined with direct supervisory powers at European level, as envisaged by the EMIR 2.2 proposal, should become a guiding principle in an improved equivalence model that will be applied in the future.

This improvement is even more urgent and justified in the context of Brexit, whereby a very large market will move into the third country regime while still being very important for EU capital markets. I therefore also very much welcome the proposal made by the Council regarding non-EU Investment Firms (under the Investment Firms Review (IFR) legislation), which I understand has received support from the other co-legislators.

A more proportionate and balanced approach to the EU equivalence model is required. With a single point of entry for non-EU market providers and certain direct supervisory powers at the European level, the EU is moving one step closer to corresponding approaches of other jurisdictions, while at the same time limiting the risks of fragmentation of global markets. ●



## Felicia Stanescu

Head of Policy Definition and Coordination, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

### Equivalence or how to build bridges over regulatory fault lines

Today several pieces of EU financial regulation stipulate that the Commission may adopt equivalence decisions concerning third country jurisdictions.

Under a typical equivalence decision, the EU recognises that the regulatory or supervisory regime of a

non-EU country is equivalent to the corresponding EU regime. That, in turn, allows authorities in the EU to rely on supervised entities' compliance with equivalent rules in a non-EU country. It means, in practice, that an equivalence decision may reduce or even eliminate overlaps in compliance requirements for both EU and foreign market players. In some areas, like credit rating agencies or audit, it can make the services, products or activities of non-EU companies marketable and acceptable for regulatory purposes in the EU. There are also other, more specific, gains: for example, equivalence under EU capital requirements rules allows a less burdensome prudential regime to apply to EU banks and other financial institutions with exposures in equivalent non-EU countries.

With over 280 equivalence determinations benefitting over 30 >>>

>>> jurisdictions the EU has emerged as the undisputed leader in forging regulatory and supervisory ties with partners across the globe that are like-minded. We operate a system that allows eliminating overlaps in cross-border rules and oversight as long as such outcome preserves financial stability, investor protection and the integrity of the internal market.

We have been among the early adopters of most international regulatory standards and our approach to equivalence closely reflects our strong commitment to multilateralism in regulatory and supervisory relations.

It is not surprising therefore, that the European Parliament, the Member States, third country jurisdictions and financial players with cross-border activities are all very keen participants in the debate on the future of EU equivalence policy.

We all share the ambition to see the EU equivalence consolidate its role as an instrument of choice to deal with cross-border regulation challenges.

***"The EU has emerged as the undisputed leader in forging regulatory and supervisory ties with partners."***

- FELICIA STANESCU

As such, it needs to be even more robust, measured and effective: EU decision makers and supervisors should be able to act with confidence when they accept to expose EU investors and consumers to foreign regulation and supervision. Supervisory and cooperation arrangements with the third

countries must be fit for purpose. There also needs to be a process whereby a granted equivalence may be reviewed over time and the decision may be withdrawn if necessary.

Equivalence empowerments do not confer a right to third countries to be assessed or receive a positive determination. The decision remains a unilateral and discretionary act of the EU, both for its adoption and any possible amendment or repeal. However, it does not mean that the Commission turns a deaf ear to individual requests and submissions made by the interested parties in this context. We are committed to robust dialogue with third countries and the market participants. ●

Contributors: Piotr Plizga and Yann Germaine, International Affairs, DG FISMA, European Commission



## Sylvie Matherat

Chief Regulatory Officer and  
Member of the Management Board,  
Deutsche Bank AG

### EU and UK relationship post Brexit – avoiding fragmentation

International banks drive growth by channeling capital investment to where it can be most effectively deployed and by facilitating distribution of risk to those with the appetite and ability to manage it. To support companies and investors in

a globalised economy, banks need to be able to operate across borders, creating bridges between pools of liquidity and capital. The value of access to deep and liquid capital markets was recognised with the European Commission's Capital Markets Union initiative.

The departure of the UK from the EU risks fragmenting European financial markets, with the activation of new regulatory barriers between financial services firms and their clients in the EU and important pools of liquidity and financial market infrastructure in the UK. Equivalence decisions offer a path through those barriers, providing for continued cross border access in a safe and secure regulatory environment.

Whilst equivalence can help to mitigate the risk and reduce the costs of fragmented markets, it also comes with some drawbacks. The process for granting equivalence can be cumbersome – relying on both political and technical decision makers who are resource constrained and can create bottle necks.

It is also reflected in a patchwork of different provisions with different checks, thresholds and process for assessment. The implications of these weaknesses are much more acute when looked at in the context of cross border access for EU firms and investors to Europe's main international centre in London.

This fact has already triggered discussion amongst EU policy makers and moves towards overhauling the existing equivalence regime. To date the focus of

changes to the framework has been on enhancing protections for EU market participants rather than increasing cross border trade. That is understandable but suboptimal.

***"To avoid market fragmentation there must be an improved and expanded equivalence regime."***

- SYLVIE MATHERAT

To avoid market fragmentation there must be an improved and expanded equivalence regime. To achieve this, three conditions need to be met: first there must be strong cross border regulatory and supervisory cooperation – without that it will be unrealistic to expect any streamlining of equivalence decisions; second there needs to be greater consistency in the approach to equivalence – this will improve the efficiency of the regime and reduce the burden on regulators; and finally, there needs to be greater predictability in the way in which divergence or disputes are addressed – in order to improve confidence of market participants in the durability of equivalence decisions.

Improving the existing EU equivalence regime along these lines would not only help address the fragmentation risk arising from Brexit, but would cement the EU's regime as one of the most advanced in the world. ●



## Simon Miller

Managing Director - Head of Legal and Compliance, Mizuho Bank, Ltd.

### The role of equivalence in business planning for post Brexit EU

The withdrawal of the United Kingdom from the European Union presents financial services groups headquartered in Third Countries with unique, and unwelcome, challenges. Unwelcome as these challenges may be, if we are to serve our customers effectively in future, we must accept the political realities of the situation and adapt our business model accordingly.

Mizuho Financial Group is a diversified international financial services group headquartered in Japan. In common

with many of our global peers, our EMEA operations are centred in London. However, it has never been our approach, to coin a phrase, to put all our eggs in one basket. While London represents a large part of our business resources in EMEA, Mizuho Bank has had significant businesses in several major continental European cities for several decades.

This presence of Mizuho Bank in the EU27 countries includes branches of the Third Country incorporated bank, locally incorporated entities (often referred to as subsidiaries) and branches of such locally incorporated entities. It might therefore be more accurate for us to describe our business in Europe as that of a European Bank. Certainly, EMEA based colleagues and the local supervisory board would see it that way.

For Mizuho Securities, the securities part of the business, for whom the demands of the so-called firewall under Japanese law require a strong degree of separation between their banking and securities business, the challenges posed by Brexit are more substantial. This is because the securities business for Europe and the wider EMEA region has been conducted from London via a UK incorporated entity, which upon Brexit loses its passporting rights into the EU27. Mizuho Securities has therefore established a new European securities business incorporated in Germany and based in Frankfurt.

From this description of Mizuho Financial Group, it will be apparent that we are not relying on equivalence arrangements in the future EU-UK relationships to serve our customers in the EU. Although we are not relying on equivalence, we recognise its importance and value. Brexit will cause our cost

base to increase and our business to fragment, and we look to future progress on equivalence discussions between the UK and the EU to reduce its impact and mitigate its cost.

While we recognise equivalence is of course a political process, and as a result may not always give us the certainty we need, we can see that recent political cooperation involving Japan and the EU is much to the benefit of institutions such as ourselves. The recent EU Japan Economic Partnership Agreement incorporates the requirement for close regulatory dialogue in advance of legislative change in either market. While a little way short of formal binding obligations, this approach will promote orderly change and reduce the risk of regulatory divergence and unwelcome fragmentation.

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*"MHFG's existing business model would benefit from UK-EU equivalence but does not depend on it."*

- SIMON MILLER

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Brexit is a cause for regret for our business, since irrespective of the ultimate outcome any form of Brexit will harm the competitiveness and attractiveness not just of the UK but of the whole EU. When the dust has settled from this rupture in the fabric of Europe, we see that meaningful progress on EU-UK equivalence is an important part in enabling institutions such as ours to recommit to making the most effective contribution to the prosperity, growth and wealth creation of both the EU and the wider European region. ●

## EUROFI MEMBERS



# Taking stock of G20 financial reforms



## Brian Quintenz

Commissioner, U.S. Commodity Futures Trading Commission (U.S. CFTC)

### A holistic review of a global effort

The global financial regulatory system today bears little resemblance to its state ten years ago, in large part due to the commitment of G-20 members to enact meaningful reforms that address the prior crisis and support future financial stability and prosperity. To date, all 27 Basel Committee on Banking Supervision (BCBS) jurisdictions have finalized risk-based capital rules. Similarly, the BCBS jurisdictions with the most active derivatives markets have all implemented margin requirements for uncleared derivatives. This is an impressive accomplishment.

However, now that the post-crisis reforms have largely been adopted, regulators must evaluate the collective impact of these actions to determine if they are achieving their intended outcomes as efficiently and effectively as possible; if not, they should revisit and adjust the reforms to ensure the continued resiliency and efficiency of the financial system.

This past year, the Financial Stability Board (FSB) conducted an evaluation of the holistic impact of post-crisis reforms when it examined “Incentives to Centrally Clear Over-the-Counter Derivatives.” Likewise, the BCBS issued a document proposing options for adjusting, or maintaining, the leverage ratio treatment of client cleared derivatives. I think it is critical that the standard-setting bodies that first developed these global standards continue to evaluate their impacts, seek public input as to their efficacy, and propose solutions to rectify counterproductive results. I want and expect similar reports to be undertaken in the future. But reports are only as meaningful as the efforts taken to address their findings. With respect to the FSB’s conclusions on the leverage ratio’s negative impact on access to clearing, coordinated action needs to be taken to ensure that the leverage ratio is rationalized and not continue disincentivizing the provision of clearing services to clients.

With that example in mind, it is critical to remember that harmonization is only as good as the standard to which we all harmonize. The financial system is not strengthened by unanimous adoption of a rule that misprices risk, inhibits innovation, or inadvertently incentivizes risky activity. I have strong concerns about the current swaps regulatory regime’s reliance upon notional value to establish thresholds designed to achieve large policy goals and impose large regulatory costs. In my view, notional value is an extremely poor measure of activity and a completely meaningless measure of risk. Yet it is pervasive in our rules: swap dealer registration thresholds, leverage ratio estimates of off-balance sheet exposures, and the scope of firms required to post initial margin on uncleared transactions are all based off of notional value.

The Office of the Chief Economist at the CFTC has recently published papers outlining a new approach to measuring derivatives exposure – entity-netted notionals (ENNs) >>>

>>> – that I believe is more representative of the actual size and risk of derivatives transactions. As policy makers continue to improve upon their rules, there is an opportunity to move away from notional amounts to a more rationalized metric, such as ENNs or another construct.

On the topic of market fragmentation, I remain concerned that liquidity pools will be fractured due to regulatory disputes over the extraterritorial application of jurisdictions' rules. The full promise of the G-20 reforms cannot be realized by a single nation acting alone, but it can be actively defeated if each jurisdiction expects all others to adopt the breadth, depth, and detail of their rulebooks. I support CFTC Chairman Giancarlo's embrace of a cross-border regime built on deference to home country regulators, rather than line-by-line comparisons of rules or statutes. In order for a global, vibrant swaps market to exist, each jurisdiction must recognize the sovereignty of other jurisdictions, as well as other regulators' supervisory interests in regulating their own local markets. Where regulatory regimes address G-20 goals and achieve comparable outcomes, I think it is appropriate for the CFTC to issue substituted compliance determinations that facilitate U.S. firms accessing and competing in that foreign market. A global deference approach best prevents the fracturing of a global financial market. ●



## Shunsuke Shirakawa

Vice Commissioner for International Affairs,  
Financial Services Agency, Japan (J-FSA)

### Addressing market fragmentation through regulatory and supervisory cooperation

In 2009, the G20 launched a comprehensive program of reforms, coordinated through the FSB, to enhance the resilience of the global financial system while preserving its open and integrated structure.

With almost 10 years of endeavors by the G20, the FSB and other standard-setting bodies (SSBs), in terms of resilience of the global financial system, we have put a series of regulatory reforms, such as Basel III, OTC derivatives reforms and resolution frameworks, largely in place. On the other hand, in terms of promotion of an open and integrated global financial system, our progress has never been remarkable in spite of the efforts taken by each G20 member authority.

In the course of implementation of the agreed standards in each jurisdiction, inconsistent, overlapping or incompatible regulations or supervisory practices seem to have put unnecessary or excessive burden on cross-border activities of financial institutions in certain instances, potentially leading to global market fragmentation and regulatory arbitrage. These are apparently unintended consequences which could have negative implications not only for the efficiency but also for the stability of the global financial system.

Against this background, in December 2018, G20 Leaders declared in Buenos Aires that they will address fragmentation through regulatory and supervisory cooperation. And addressing market fragmentation is one of the priorities of the Japanese G20 presidency this year. The FSB together with the IOSCO has launched an initiative to explore ways to address the risk of market fragmentation. So, what should we aim for by discussing market fragmentation? In trying to address fragmentation, one tends to focus on convergence in regulations. Amending already promulgated regulations is, however, not the only way to address fragmentation. Sometimes it is easier to make a difference >>>

>>> through discussions earlier in the process by focusing on prevention of future proliferation of inconsistencies.

Then, even when regulatory gaps remain among jurisdictions, we can have a better interface between different regimes by mutual recognition or deference. On top of that, we can avoid unnecessary regulatory/supervisory conflicts by enhancing supervisory cooperation among authorities.

As such, when considering market fragmentation issues, we can look at various phases in regulation: development of international standards, national rule making, recognition of foreign regulatory regimes, and daily supervisory activities. It may be useful to design processes and approaches fitted to each of these phases.

For example, on the phase of development of international standards, the FSB and SSBs should consider implementability or operational challenges more seriously before finalizing them in order to prevent inconsistencies in implementation among jurisdictions. They should also pay more attention to the burden on regulated firms unnecessarily multiplied by similar but different requirements.

We may also be able to prevent unintended regulatory conflicts by meaningful exchange of information on domestic rulemaking processes. Timely input from foreign stakeholders regarding potential impact of draft rules on cross-border activities could help prevent unnecessary regulatory conflicts beforehand.

With regard to recognition or deference, authorities need comparability assessment on foreign regulatory regimes. For such assessment, they tend to conduct line-by-line comparison of domestic rules, though there is a consensus for “outcome based” assessment. Also, the processes for comparability assessment tend to be duplicative and inefficient as they are conducted by each authority on a bilateral basis. Hence, we expect the IOSCO to discuss efficient ways to operationalize “outcome based” comparability assessment.

Sometimes, small and practical steps can make a difference. For instance, consistency in reporting requirements across jurisdictions may be a small step but could significantly reduce compliance costs for international firms. It would also enable relevant supervisors to conduct more comprehensive data analysis on a global basis. Each authority may need to be a bit more flexible and innovative in respective national frameworks. We look forward to discussing possible practical mechanisms for an open and integrated financial market with the colleagues around the globe. ●



## Andrei Magasiner

Treasurer, Bank of America

### Post-crisis reforms: what next?

10 years ago, G20 leaders pledged to repair the financial system and strengthen regulation after the events of 2008. The simple pledge led to extraordinary fiscal and monetary support measures to stabilise banks, and significantly raised the bar for banks' capital, liquidity and governance. And the outcome was successful. Overall, banks are now structurally healthier, less interconnected, and culturally more responsible. This means a higher probability banks get through the next crisis without constraining credit to the real economy and without recourse to the taxpayer.

A necessary consequence of the reforms was adjustment of bank business models to higher prudential requirements. They de-leveraged, de-risked and got smarter >>>

>>> on managing risk. Reducing leverage and risk means lower, but less volatile, earning profiles. So cost reduction became the priority to ensure sustainability of business models through the cycle. In Europe, with larger crisis overhangs, consolidation could play a key role in creating the capacity to reduce costs and clean up NPLs, for which a genuine Banking Union would be an important catalyst.

Now more stable and profitable, the banking sector can support global sustainability and growth. Regulators should reflect on and, if necessary, adjust the post-crisis rulebook to minimise impediments to future growth of socially impactful and economically productive lending (e.g. innovative small businesses, communities or green infrastructure). Policy-makers should encourage growth in areas that have historically been deprived of access to credit. Financial inclusion is a healthy goal for the financial system and for society overall.

It is also important to reassess the global regulatory construct and its impacts on banks' ability to serve their international customers and markets. Cross-border banking has re-trenched since the crisis, which is not good for growth. This is partly a consequence of regulatory fragmentation which increases the cost of sustaining a global footprint, through duplication of processes and trapping of scarce capital and liquidity. To ensure viability of global banking, better international regulatory cooperation and harmonization must be a priority for policy-makers. Increased consistency is required in three key areas:

- Implementation: level-playing-field in implementation of global standards, such as Basel 3 and capital buffers;
- Processes: alignment of processes, such as stress testing and recovery and resolution planning;
- Outcomes: consistency of regulatory outcomes, such as RWA densities and prepositioning of resources.

Separately, while there are new risks emerging from digitalisation in the banking sector (e.g. outsourcing and crypto-assets), the important question is where the risks that were squeezed out of banks have ended up. I think that they were pulled into the wider system in different ways:

- Huge growth in non-bank finance has reshaped the lending landscape. These lenders typically operate with less capital than banks and without central bank liquidity back-stops. This increases risk of funding shocks and reduced credit supply in a crisis;
- Market liquidity has deteriorated as banks play a lesser role as market makers, and may worsen as monetary policy tightens. This makes it harder to effectively monetise assets in a liquidity crunch due to higher volatility;
- Significant build-up of sovereign risk concentration across the financial system owing to liquidity buffer and collateral eligibility rules. This magnifies the "negative feedback loop" risk;
- With the shift to mandatory central clearing, CCPs have become highly concentrated systemic nodes within the financial system, with potential for significant market disruption should a major CCP fail.

In conclusion, policy-makers have been effective in fixing the banking sector, which helped economies recover from the crisis. It is now time to reflect on whether reforms have created any barriers to sustainable growth. In doing so, regulators should curb the current tide of fragmentation so that banks can continue to serve global customers and markets, increasing the overall sum of available credit. And with risks having moved out of banks into less well-lit areas of the financial system, regulators should ensure that their mandates, powers and resources, are still fit-for-purpose. ●

# III. RISK MITIGATION AND FINANCIAL STABILITY CHALLENGES

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## Issues at stake

Much progress has been made in the mitigation of systemic risks in the financial sector. However, some issues remain to be addressed such as the significant development of non-bank financing, the growth of leveraged finance, cyber-risks and other risks associated with technological innovation. The potential impacts of the continuous increase of the global stock of debt, both private and public, and the economic risks linked to rising protectionism also deserve attention. In addition, the global framework needed to mitigate the systemic risks posed by insurance activities still requires significant efforts.

In Europe, the exposure of banks to their sovereigns, which is still significant in certain highly-indebted EU countries, is a matter for concern, as well as the limited scope remaining for the use of monetary and fiscal policies if low growth persists for a protracted period. Improving anti-money laundering (AML) detection and supervision is also becoming urgent.

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# Key macro and micro risks



## Gaston Gelos

Assistant Director & Chief, Monetary and Macroprudential Policies Division, International Monetary Fund (IMF)

### Containing risks in non-bank finance – the role of macroprudential policies

Much progress has been made internationally over the past ten years in improving the systemic risk monitoring of the nonbank financial sector. The types of shadow banking activities that were most closely associated with the buildup of vulnerabilities prior to the Global Financial Crisis have been curtailed. The development of a macroprudential perspective and the creation of macroprudential authorities in many countries has contributed to a more holistic assessment of risks in the financial system, including the nonbank sector. Under the leadership of the FSB, the size and growth of the shadow banking sector worldwide are now regularly measured, and the main risks are being identified. At the IMF, the Global Financial Stability Report (GFSR) now regularly provides a quantitative assessment of the degree to which future GDP growth faces downside risks from financial vulnerabilities, using a Growth-at-Risk framework. Advances have also been made in containing these risks, although much remains to be done.

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*"Although progress has been made in improving the systemic risk monitoring of nonbank finance, much remains to be done to contain risks."*

- GASTON GELOS

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Specific progress has been made on various fronts. In response to the crisis experience, regulations for securitization have been reformed, requiring some risk retention by the originating banks. Regarding insurance companies, solvency and regulatory frameworks have been improved in various jurisdictions (most notably, through implementation of Solvency II in the EU), but a globally consistent approach is still under development. To address concerns about risk management and transparency in OTC derivatives markets, much of OTC derivative trading has been moved to central counterparties (CCPs) and reporting to trade repositories. Since, as a result, many CCPs are now systemic, their financial buffers and liquidity support have been strengthened.

Potential risks associated with the worldwide growth of investment funds are slowly being tackled. The share of so called "other financial intermediaries", in



>>> particular investment funds, has been growing fast (FSB, 2019). IOSCO has developed recommendations to address liquidity mismatches between the investments by mutual funds and their redemption terms. The standard setter has also published recommendations on leverage within investment funds, operational risk, and on securities lending. However, while some countries have adopted measures along these lines, generally regulatory advances remain limited so far. Data gaps continue to pose challenges. For example, available information on leverage among funds is usually limited.

Still, the continued growth of nonbank finance requires further efforts to properly monitor risks and react appropriately through supervision and regulation. Closing data gaps is key in this regard. Entity-based regulation needs to be complemented more systematically with activity-based regulation to avoid the migration of risks across entities.

The macroprudential toolkit will likely need to be expanded to better address risks related to the buildup of corporate debt from nonbank finance. For example, many companies, including in emerging markets, have increased their leverage through bond financing. Nonbanks have in recent years increased their exposure in the leveraged loan market. However, most macroprudential tools that have been adopted so far are aimed at banking activities, but containing risks related to the growth of nonbank debt may require tackling either these nonbank lenders or activities and/or the adoption of borrower-based measures (ESRB 2018). In some jurisdictions, however, this may face legal and institutional obstacles.

Moreover, more thought may need to be given on how to regulate the build-up of leverage in financial markets. The FSB has issued minimum standards for margins and haircuts in securities lending markets (including repos). However, there is ongoing debate on whether it would make sense for macroprudential policymakers to regulate such margins more actively and in an explicitly countercyclical manner (Constancio 2016).

Lastly, international cooperation in these areas is highly desirable, given the potential for (positive or negative) spillovers, leakages, and migration of activities resulting from the adoption of macroprudential policies at the national level. ●

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## Fernando Restoy

Chairman, Financial Stability Institute,  
Bank for International Settlements (BIS)

### Global risks and European vulnerabilities

There is broad consensus across analysts that the major risks affecting the global economy are basically five: (i) geopolitical tensions; (ii) developments in trade policies; (iii) possible disorderly market developments following monetary normalisation; (iv) excessively high indebtedness, growth of leverage finance

and other pockets of vulnerabilities; and (v) cyber- and other risks associated with technological innovation.

The global economy seems to be better prepared than in the past to cope with some of those risks. In particular, the general reduction of current account imbalances, the accumulation of reserves and the adoption of flexible exchange rates have made emerging market economies more resilient to external shocks. Moreover, the significant increase in the quantity and quality of capital in banks' balance sheets, following the international regulatory reform, make financial institutions more able to absorb losses. Yet the large increase of foreign-denominated private sector debt in emerging markets is a major factor of vulnerability.

At the same time, progress at the international level to cope >>>

>>> with new risks emerging from the disruption created by technological development is still modest. So far, it makes sense, in general, to monitor how the emergence of new (fintech/big tech) players and products in the market for financial services are affecting different policy objectives before taking intrusive regulatory action. Yet, in some areas like cyber-security and cryptoassets, where the case for clear policy action is already evident, the development of international guidelines or even standards is becoming increasingly warranted.

In Europe, exposure to different global risks is in some cases moderate. For instance, the degree of indebtedness of the private sector has decreased since the crisis, the relevance of leveraged finance is less than in other advanced economies and the banking union has helped strengthen the resilience of the banking sector. However, given its sizeable openness, the euro zone is heavily exposed to discontinuation of trade agreements and a possible re-emergence of protectionist measures. In addition, depending on the concrete scenario, Brexit may become a highly destabilising geopolitical development.

In addition, the euro zone is exposed to important idiosyncratic risks.

In particular, both monetary and fiscal policies seem to have little room for manoeuvre in case the current signs of deceleration translate into a protracted period of low or negative growth. In that scenario, given also the increase in public debt ratios after the crisis, a re-emergence of tensions in sovereign markets could not be excluded. Low growth could further increase the vulnerability of the banking sector as it would hamper the recovery of sustainable profitability levels and the continuation of the ongoing reduction in non-performing loans.

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*"If risks materialise, the European crisis management framework would face difficult challenges."*

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- FERNANDO RESTOY

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If some of those risks were to materialise, the European crisis management framework would face difficult challenges. While the availability of a public backstop for the ESM will certainly strengthen the resolution framework, the lack of a common

European deposit insurance scheme does not help break the link between sovereign and financial risk. Moreover, as recent crisis episodes have shown, the application of the bail-in tool, a key ingredient of the new resolution rules, seems in practice to be subject to important practical implementation challenges. The need to use public resources in those episodes adds further uncertainty regarding the robustness of the arrangements put in place to deal with the failure of banking institutions.

The combination of both global and idiosyncratic risks and the limitations of the crisis management framework appear especially relevant in a context in which the euro zone has not yet made sufficient progress to develop powerful public and private risk-sharing mechanisms. That implies that country-specific shocks may trigger disproportionate economic and financial instability and generate political tension in affected countries that could exacerbate anti-European political movements. Further progress in the design of mechanisms that could contribute to further economic and financial integration appears to be a priority. ●

## Francesco Mazzaferro

Head of the ESRB Secretariat, European Systemic Risk Board (ESRB)

### Vulnerabilities in the EU and challenges for macroprudential frameworks



Geopolitical factors within Europe and globally as well as the threat of protectionism continue to weigh on medium-term growth expectations. After several years of strong economic performance, the recent outlook has been weaker than expected. This is reflected in downward revisions of GDP projections and a decrease in economic sentiment indicators across most EU countries and sectors, including the financial sector. In light of these developments, the risks to EU financial stability are both structural and cyclical in nature. The non-bank sector is becoming an increasingly important part of the EU financial system, while cyclical risks are rising as reflected by weaknesses in financial institutions' balance sheets as well as debt sustainability challenges in the public and private sectors.

Low funding costs and the search for yield environment can lead to the mispricing of risks and encourage excessive risk taking. Policy uncertainties in some EU countries, the United Kingdom's withdrawal from the European Union, and the possible materialisation of risks in some key emerging market economies contribute to the uncertain

economic outlook. The crystallisation of existing risks could trigger a shift in investor sentiments and induce a rapid repricing in financial markets. This vulnerability is reflected in recent price declines and rising implied volatility across market segments in some advanced and emerging market economies. Some asset classes with compressed risk premia in recent years are particularly at risk of price adjustments. This includes corporate bonds, leveraged loans, real estate markets in some countries and certain stock markets. The commercial real estate sector, for example, has been experiencing an expansionary phase in recent years and the European Systemic Risk Board (ESRB) has previously highlighted the risk from historically high prices.

The non-bank sector has gained importance for the financing of the real economy and assets held in investment funds and other financial institutions increased over the past decade from around EUR 23 trillion in 2007 to just over EUR 43 trillion in 2017. Some of the risks that were previously present in the banking sector have migrated to non-banks, resulting in an increasing >>>

>>> focus on assessing and tackling risks and vulnerabilities in this sector. From a cyclical perspective, a common pattern observed during the past few years in the current low-yield environment is that some EU bond funds have shifted their asset allocation towards lower-rated debt securities. As a result, there are some concerns that if yields in bond markets were to rise suddenly, bond funds could face large falls in value and subsequent outflows.

To help address these risks, macroprudential frameworks have been significantly strengthened across

*"The crystallisation of existing risks could trigger a shift in investor sentiments."*

- FRANCESCO MAZZAFERRO

the EU in recent years. Most EU countries have created macroprudential authorities, macroprudential tools have been developed and frameworks for international cooperation have been strengthened such as the reciprocity

framework within the EU. In recent years, authorities have also made use of macroprudential instruments such as the countercyclical capital buffer. However, the macroprudential framework must continue to evolve to adjust to ongoing structural changes such as the growth of the non-banking sector. Overall, the deepening financial integration relies on cooperation, information sharing and reciprocity, and it is important to ensure that macroprudential frameworks allow for monitoring and addressing the vulnerabilities in the cross-border and cross-sectoral context. ●



## Denis Beau

First Deputy Governor, Banque de France

### There is no room for complacency in a world of increased uncertainties and risks

Since last summer, there has been a series of negative surprises in the global environment: a resurgence of trade tensions between the United States and its partners, notably China; tensions surrounding the Italian budget; the British parliament's rejection of the Brexit deal; and in France the scale and duration of the so called gilets jaunes movement. As a result, the macroeconomic outlook is now less favorable than anticipated a few months ago and exacerbates the risks faced by financial institutions.

First, it raises greater concerns over the sustainability of the high debt levels carried by economic agents, especially in the event of an upward shock to interest rates or a downward shock to activity. The growing uncertainty also feeds the risk of abrupt and marked downward corrections in financial asset prices as they seem elevated from a medium-term perspective. In addition, the low interest rates environment could be prolonged and, despite its overall consistency with the macroeconomic context, have further implications for the economic agents' borrowing behavior and for the profitability of financial intermediaries.

In addition to these cyclical risks, a number of new and structural risks are emerging, including those arising from the digitalisation of the financial industry. Digitalisation requires huge investment, the management of complex projects and greater agility on the part of financial institutions. Therefore, it carries a significant execution risk. Digitalisation is also challenging existing business models and their viability and may have potentially destabilising effects for the banking sector, especially in Europe where there are overcapacity issues and where profitability is rising but remains well below US levels. Finally, digitalization gives operational risk a more systemic footprint.

Yet banks are able to address those risks. They have more and better quality capital as well as larger liquidity buffers than ten years ago, before the Great Financial Crisis. Besides, risk and compliance functions have now become an essential part of their organisations. In Europe in particular, the banking sector has been made more resilient also through major institutional reforms,

including the creation of the Single Supervisory Mechanism under the aegis of the ECB and of the Single Resolution Mechanism. More broadly, the financial system operates in a sounder regulatory framework thanks to the reforms steered by the G20.

However, this outcome should not be a reason for complacency. Supervisors as well as financial intermediaries need to exercise their vigilance in order to understand the risks they face, and take appropriate steps to manage them. This is true for both microprudential and macroprudential supervisors.

Macroprudential policy plays a complementary role alongside microprudential supervision, by following a more preventive approach that addresses the financial system as a whole. In that spirit, the French macroprudential authority, the Haut Conseil de stabilité financière, has taken steps to prevent negative consequences of the growing indebtedness of the private non-financial sector: cap on bank exposures to large and highly indebted corporations at 5% of their capital; banks' countercyclical capital buffer raised to 0.25%.

Macroprudential policy should also be concerned with emerging structural risks, strengthen their analytical capabilities, in order to better understand the consequences of morphing interconnections, eventually conducting stress tests across the entire system rather than just in individual sectors, and adapt their macroprudential policy to the new challenges.

In 2019, more than ever, vigilant microprudential supervision and macroprudential policy should be our compass to advance in a world of uncertainties. ●



## Tomohiro Ishikawa

Head of Global Regulatory Affairs,  
Mitsubishi UFJ Financial Group, Inc.

### Stay focused on building resilience while being mindful of the risks of regulatory fragmentation

The global financial crisis exposed a number of vulnerabilities in the financial system. Many of these were not anticipated due to a lack of cross-border coordination. The necessity for cross border coordination is reflected in the work that has been done over the past ten years by global standard setters, central banks and regulatory agencies, in dialogue with the industry. It has been widely agreed that the vulnerabilities that existed pre-crisis have been addressed; banks have stronger capital and liquidity buffers, the derivatives market is reformed and steps have been taken to address the risks of 'too-big-to-fail' institutions.

As the post-crisis reforms continue to be implemented and reviewed at a national level, it is important to remember the objectives set by the global regulatory community when the rules were designed; making the financial system more resilient while preventing market fragmentation. While the point on resilience has been addressed in many areas, there are signs of regulatory fragmentation due to divergence of implementing standards on key areas of the global reform agenda.

It must be said that implementing international standards requires a certain level of flexibility to reflect specificities

from a risk perspective in a local or regional context. It has, however, become apparent that certain local supervisory measures might become an issue for banking institutions that operate globally. Regulatory fragmentation does not only lead to a reduction of regulatory and supervisory effectiveness but may also negatively impact cross-border investment and economic activity by preventing financial institutions from optimising the allocation of financial flows.

*"It is important to address regulatory fragmentation early on in the implementation process."*

- TOMOHIRO ISHIKAWA

It is important to address regulatory fragmentation in the early stages of the implementation process, as firms have to adapt to a changing regulatory landscape and once the adjustment is done, it is operationally challenging to undo some of the strategic decisions that have been made to comply with the rules. We welcome Japan's leading role in the debate on fragmentation by putting it on this year's G20 agenda. It is also encouraging to see that the FSB has recognised the need to address the risk of regulatory fragmentation and its potential impact. However, further action may be needed to address specific conflicting regulatory and supervisory actions.

The overall aim going forward - which is in the interest of both private and public stakeholders - should be to preserve long-term financial stability, fostering innovation and economic growth and avoid relying on the increasing build-up of leverage. Cross border regulatory coordination and engagement, also about potential conflicts, can help building trust about the fact that financial institutions are indeed resilient. While it is not easy to strike a perfect balance between macro and micro prudential measures, we should not give up on striving for this balance in a globally coherent manner. The regulatory and supervisory approach designed today will be the safeguard of tomorrow's financial system, both in the EU and beyond. Continuing on a path of cooperation and coordination will prepare the financial system in all corners of the world for new risks looming on the horizon, such as cyber risk, climate risk and the ongoing digitalisation of the financial sector. ●

## Sylvain Broyer

Chief Economist EMEA,  
S&P Global Ratings

### Among all risks facing the financial sector, profitability is the most critical



Plenty of risks surround the European financial sector:

- While Europe has largely been spared higher tariffs so far, the U.S. administration's focus on cars imports could mark a turning point;
- Market volatility amid the normalization of monetary policy could turn a mature credit cycle;
- China's attempts to control its own indebtedness have been hurting European exports;
- Lasting political uncertainties are dampening business investment in Europe; and
- Cybersecurity and disruptive technologies are externalities that the financial sector needs to internalize.

While most of these external risks are manageable or can dissipate at some point in time, this is not the case for low interest rates. So, it is certainly no understatement to say that low interest rates remain the key issue for the European financial sector.

Ten years after the Great Recession, one can argue that the European financial sector is more resilient than before, bank's balance sheets are in best shape they've been in decades. Banks have enhanced their capital bases, liquidity buffers have been built, stress tests are run regularly to identify possible pockets of losses in bank portfolios. >>>

>>> Cheap central bank liquidity is plentiful and a palliative to an increase in external funding costs. Nevertheless, the profitability of many European banks is once again at historical lows. While European companies in the Euro Stoxx 50 Index are priced at 1.5x their book value, many European banks are priced at less than 0.6x. Such low valuations correspond to previous episodes of severe economic downturns in 2008, 2012, and 2015.

*"Low interest rates remain the key issue for the European financial sector."*

- SYLVAIN BROYER

Low interest rates and a flat yield curve are among the root causes of this low profitability. They simply make the transformation of short-term savings and deposits into long-term lending less lucrative for banks. The banking sector is not the only victim. Low interest rates in the current regulatory framework compel insurance companies, as well as nonfinancial corporations with pension liabilities, to set aside considerable amounts of funds to secure future payments. The consequences are higher retained earnings and therefore less investment. The situation for banks is particularly worrying because low profitability could overtime undermine bank's lending capacity and reduce loan supply to the economy.

A rapid increase in interest rates is certainly not desirable. But can they gradually return to the levels seen before the Great Recession? There is room for doubt. Low productivity and demographic change are making their singular mark on this economic expansion, both of which point to slow growth and subdued inflation. Central banks will find it difficult to exit their accommodative monetary policies, independently of whether they change their mandate or not. Moreover, the demand for safe assets like U.S. Treasuries or German Bunds seems to exceed supply, despite the widening in the U.S. budget deficit on one side and the shrinkage of the Fed's balance sheet on the other.

Banking will therefore remain a low-margin business for a long time to come, which may bring consolidation and restructuring. As the European economy is still mostly financed by banks, a retrenching banking sector could have implications for employment and prosperity on the Continent. ●

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# Are EU sovereign debts sustainable?



## Collin Ellis

Chief Credit Officer, EMEA  
Moody's Investors Service

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

Public debt ratios rose substantially in the aftermath of the 2008/9 recession, fuelled both by the economic downturn and the direct actions of governments to support banks and other entities. This erosion of sovereign fiscal strength has generally not been reversed, with only three euro area countries – Germany, the Netherlands and Malta – currently having lower public debt-GDP ratios than in 2007. At the same time, we must never forget that we have seen three sovereign defaults in the euro area since 2012; investors are well aware that governments do not always pay their debts in full or on time. This obviously raises questions about the sustainability of sovereign debt in the future.

Debt sustainability generally refers to the borrower's ability to generate resources sufficient to cover operating expenses and interest costs now and in the future, including its ability to roll-over existing debt at affordable rates. There is no single magic number that can define debt sustainability, regardless of whether a borrower is a bank, company, household or a government. In a market context, the sustainability of debt will also depend on other factors including the ability of market participants to assess and price risk, the transparency of market mechanisms and clarity around default scenarios.

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*"Only three euro area countries currently have lower public debt-GDP ratios than in 2007."*

- COLLIN ELLIS

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In the case of sovereign debt, one advantage is that data in Europe are – generally – of a relatively high quality, relative to financial data available in some other parts of the world or for other issues. The role of statistical offices in defining and enforcing statistical standards is critical in this regard. But even armed with good data, assessing the sustainability of sovereign debt is a complex endeavor.

At Moody's, we focus on four key factors: economic strength; institutional strength; fiscal strength; and susceptibility to event risk. We use a range of indicators to inform >>>

>>> our assessment of these factors on a forward looking basis, including the longer-term challenges that many sovereigns face around health spending and other public service provision given their demographic profiles; these challenges, in particular, could lead to debt-GDP ratios rising dramatically over the longer term.

Together, our four key factors give us a sense of how sovereigns compare with each other. But ultimately our sovereign ratings reflect our own opinions, incorporate analytical judgment as well as quantitative analysis.

Excluding Greece and Cyprus, which are both recovering from past defaults and have non-investment grade ratings, our range of sovereign ratings in Europe ranges from Germany and the Netherlands, at Aaa, down to Italy at Baa3. Given that a one-notch downgrade roughly corresponds to a 60% increase in relative credit risk, this illustrates the different credit risks that different euro area sovereigns pose for investors. And while these ratings incorporate our judgments on future event risks, calibrating these is intrinsically difficult hard ex ante. Given the nature of the euro currency union in particular – with individual member states issuing debt in a currency they do not control – greater clarity around potential restructuring mechanisms, even if they are never used, would help investors calibrate associated risks.

For now, European sovereigns generally look well placed to weather the next downturn in credit conditions; most have taken advantage of low yields to extend maturities and reduce financing costs, and new issuance yields remain below maturing yields for many countries. But sooner or later several countries will have to take concerted action to contain explosive debt dynamics; and the financial and political cost of doing so later, when risks are more pressing, is likely to be higher than doing so now while credit conditions remain relatively benign. ●



## Rolf Strauch

Chief Economist, Management Board Member,  
European Stability Mechanism (ESM)

### Europe's debt burden: challenges ahead

Indebtedness improved over the past few years, but public and private debt levels remain high for some euro area economies. During the crisis years, Europe saw its debt levels increase rapidly. Fuelled by the governments' efforts to combat macroeconomic and financial vulnerabilities aggregate debt ratio climbed from 65% of GDP in 2007 at 94% in 2014. Since then, euro area countries started sailing slowly towards calmer waters with favourable economic conditions and overall prudent fiscal policies that brought the aggregate public debt burden gradually down, significantly below debt levels seen, among others, in the US and Japan. However, debt levels remain substantially higher than the pre-crisis levels especially for some large economies. At the same time, private sector deleveraging continued, leading to a lowering of aggregate debt levels, albeit with significantly different pace across countries. In 2017, private sector debt ratios ranged from about 50% of GDP to above 300% of GDP, signalling that in some countries deleveraging needs might still exist.

Sustainability risks remain low in the short term, even if interest rates normalize further, due to favourable debt management and benign market conditions. During the last decade, market conditions allowed countries to issue longer maturities, >>>

>>> locking in favourable rates for long. This has reduced countries' rollover needs and refinancing risks. The average residual maturity increased by 1 year since 2012 and the average interest bill decreased by almost 1% of GDP. The pass through of any gradual interest rate normalization will be slow and with limited effects in the short-run.

Therefore, debt restructuring is, at this stage, not an issue. The favourable debt structure and macroeconomic environment, with low interest rates for the medium-term future, alleviate debt sustainability risks. For individual countries where developments and outlook are less positive, the fiscal space is naturally more limited forward looking. Prudent fiscal policies would strengthen the resilience of these countries before growth softens further as part of the cyclical slowdown. In the longer-run, population ageing will add significant fiscal costs, while the countries' labour force is eroding, weighing on potential growth. Safeguarding long-term debt sustainability requires using the growth enhancing potential of high-quality fiscal policy next to other structural reforms. Experiences show that growth, rather than single-handed fiscal austerity is part of sustained debt reduction.

The decisions of the Euro Summit last December have helped to further strengthen the euro area in facing future crises. The Summit endorsed a stronger role of the ESM as crisis resolution mechanism. It will operate as the common backstop to the European resolution authority, and its financial instruments have been reviewed to be more effective. The approach to assess debt sustainability will be made more transparent and predictable and contractual provisions will be improved to allow for private sector participation, in extreme cases if indispensable, to ensure a country's debt sustainability.

In addition, further work will be done on the completion of Banking Union with the introduction of the third pillar – a common deposit insurance scheme. The task is to outline a roadmap allowing for the introduction of EDIS and creating the conditions of a safe, profitable and integrated banking sector. Moreover, the introduction of a euro area budget is envisaged to support convergence and competitiveness among euro area countries. These initiatives will further strengthen the resilience of the euro area in pushing forward the landmark changes introduced over the past decade. ●



## Stéphanie Pamies

Head of Sector, Sustainability of Public Debt, DG for Economic and Financial Affairs, European Commission

### Fiscal sustainability challenges in the EU: the Commission latest assessment

At an aggregate level, EU public finances compare positively to other advanced economies. The EU government debt ratio has been decreasing since 2014 and should remain on a downward path in the coming years. Some other advanced economies (e.g. United States and Japan) exhibit much higher ratios and less favourable trends. Yet, challenges remain, with fiscal risks concentrated on

a small set of - mainly large - European economies. Some countries – such as Italy, France, Spain and Cyprus – are still faced with increasing or not sufficiently receding government debt ratios. In some of these high-debt countries, most notably Italy, interest rate spreads have increased, and fears of disruptive sovereign-bank loops re-emerged.

*"The Commission Fiscal Sustainability Report points to persisting fiscal sustainability risks."*

- STÉPHANIE PAMIES

The Commission fiscal sustainability analysis critically contributes to the monitoring and coordination of Member States' fiscal policies, as well as of the aggregate fiscal stance for the euro area. As "sound public finances" is one of the guiding principle of the Union's >>>

>>> economic policy, the Commission fiscal sustainability analysis plays a key role notably for the implementation of the Stability and Growth Pact (SGP) and of the European Semester, the EU integrated surveillance framework. Based on a horizontal and transparent framework, the Commission provides, on a regular basis, a comprehensive assessment of debt sustainability and fiscal risks across 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, taking into account in particular the fiscal pressure due to demographic ageing, high risks are identified in Belgium, Spain, Italy, Luxembourg, Hungary and the United-Kingdom.

Against this backdrop, there is a pressing need to make better use of the current economic momentum, including

the low levels of interest rates, to re-build fiscal buffers in those Member States with high government debt. Adhering to European fiscal rules remains essential, along with some fiscal expansion by Member States with fiscal space. Continuing appropriate policy action on all age-related areas (pension, health-care and long-term care) – and not reverting past reforms – is also crucial.

Implementing a combination of policies ensuring macro-financial stability and sound public finances will not be sufficient to address the fiscal sustainability challenge. These policies should be coupled with reforms that increase productivity, growth and employment, as highlighted by the Ecofin Council conclusions supporting the FSR 2018. ●



## Per Callesen

Governor, Denmark's Nationalbank

### The fiscal rules – how to muddle through

Sustainable public finances is about demographics and pension reform, markets and interest rates and not least annual fiscal policy in the context of the EU fiscal framework. Can the latter be improved?

Since the establishment of the EMU and the Stability and Growth Pact (SGP) there have been discussions on – and political controversy over – the EU's fiscal framework, especially when it comes to member states' lack of compliance,

credible enforcement and optimal design of fiscal rules.

Within the EU, national member states maintain the responsibility for fiscal policies. This should always be the starting point for discussing the common fiscal framework.

Sound national fiscal policies are – like other sound economic policies – always in member states' own interest. This may appear more obvious today, also in the short term, because markets are more awake than before 2008. But sound fiscal policy is often politically difficult to manage due to trade-offs between short-term and long-term interests. Fiscal rules can be an important and helpful tool for policymakers to fend off the pressure for short-termism. The EU fiscal framework is at its best when national governments use it as a helping hand, respecting and communicating advice, nudging and pressure from partners as assisting real economic needs, while avoiding using it as a scapegoat.

Can the EU fiscal framework be simpler? This is not very likely. Innovations were made over time because there were strong economic arguments for making the rules more sophisticated, which also made them more complex. The more flexible they are, and the more they work by discretion, the larger the risk of being politicised. The more tuned they are to account for institutional differences and measurement problems in order to be seen as reasonable and fair, the more they have to be detailed and thereby complex.

The fiscal rules were tightened and made more economically refined after

the 2008 crisis. Can they be made still tighter to improve compliance at national level? Perhaps, but this is not obvious. Better enforcement and ownership would help. But, by the end of the day, nationally elected governments may wish to test alternative theories and put short-term popularity over long-term interests, despite peer advice.

*"The EU fiscal framework is at its best when national governments use it as a helping hand."*

- PER CALLESEN

Therefore, complementing remedies could rely on greater transparency of risk analysis and protection against spillovers from adverse consequences in terms of stronger market pressure on the government.

Spillovers to the banking system can be reduced by incentivising stronger diversification of the banks' exposure to sovereign bonds.

Spillovers 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.

And spillovers to other sovereigns can be reduced in the context of a comprehensive framework offering financing support for innocent bystanders. ●

# Sovereign-bank loop in the EU



## Isabelle Vaillant

Director Prudential Regulation and Supervisory Policy,  
European Banking Authority (EBA)

### Bank-sovereign loop: how to tackle the nexus

Perceptions of a persisting nexus between banks and sovereigns has not diminished since the European sovereign debt crisis. Even though trends have been different across EU member states, banks' sovereign exposures are still elevated in many countries. In the same context, sovereigns' debt levels and debt sustainability remain a serious concern in an environment of elevated political risk and the future process of monetary policy normalisation.

The European Banking Authority (EBA) regularly releases information on banks' sovereign holdings as part of its yearly Transparency Exercise, thus, contributing to the public scrutiny of these exposures and fostering market discipline. Supervisory reporting data shows that following an upward trend in the years before 2016, EU banks' sovereign exposures have fallen by 10% to a total amount of EUR 3.0tn as of Q2 2018. This corresponds to a reduction of around EUR 400bn in the last two years, with almost half of the decrease relating to domestic sovereign holdings. Comparing sovereign exposures in relation to capital, supervisory reporting data shows that the median ratio of banks' sovereign exposures to Tier 1 (T1) capital was around 170%, with high dispersion across banks and countries (the interquartile range was around 90% to around 260%).

Nearly 50% of sovereign exposures are towards domestic counterparties and foreign sovereign exposures are mostly concentrated in the European Economic Area (EEA) countries. The proportion of domestic sovereign exposures for the largest EU economies (Germany, France, Italy and Spain) ranges between around 50% and 70%, with the exception of the United Kingdom, which is slightly above 20%. The median ratio of domestic sovereign holdings to T1 capital amounted to about 65% (interquartile range around 25% to around 130%).

Sovereign exposures are not risk-free for banks as, for instance, a sudden spread widening can significantly affect banks' profitability and capital ratios. Material spread widening in certain Member States in recent months has highlighted such effects. Exposures measured at fair value are particularly vulnerable. They also constitute the largest share of banks' respective investment: nearly 60% are measured at fair value. Also, the maturity distribution contributes to elevated risks related to banks' sovereign exposures: more than 40% of their holdings have a maturity above 5 years, as such being increasingly vulnerable to spread movements, whereas less than 30% have a maturity of less than one year.

Finally, it should be noted that the EBA also supports the supervisory scrutiny by conducting its stress test exercise biennially. The risks arising from sovereign



>>> exposures are covered in this exercise depending on their accounting treatment. In particular, the 2018 stress test exercise requested banks to apply the market risk methodology to their sovereign exposures measured at fair value. For sovereign exposures measured at amortised cost, banks had to estimate default and impairment flows applying a set of probabilities of default (PD) and loss given default (LGD) parameters.

As a conclusion, even though with the introduction of the BRRD an important step has been made towards breaking up the bank-sovereign loop, there are still significant risks related to banks' sovereign exposures. Therefore, banks should actively manage related risks and ensure appropriate diversification. From a supervisory perspective, competent authorities need to continuously monitor banks' holdings in sovereign exposures and ensure that respective vulnerabilities are well managed by institutions. Stress testing provides an essential input for supervisory assessments, whereas periodical public disclosures and further transparency enables market scrutiny. This is in particular relevant, given that the prudential framework requires no or limited capital set aside nor sets limits on concentration risk – contrary to other types of exposures held by banks. ●



## David Vegara

Chief Risk Officer, Banco Sabadell

### Completing the European Banking Union

Building a full Banking Union (BU) is a long-term endeavour. Currently, its architecture still remains incomplete and there is an urgent need to move forward as we should not leave the project half-way.

First of all, banks and sovereigns are interconnected by multiple linkages such as direct holdings of government debt on banks' balance sheets, government guarantees of financial products and assets, public ownership of stakes in banks, and the macroeconomic channel. As these links can be interdependent, public policies need to be of a holistic nature. Furthermore, this nexus can be weakened, but probably not completely reversed. Hence, any future regulatory decisions regarding the prudential treatment of these exposures should take into account that domestic sovereign debt serves multiple purposes in banks' balance sheets (aside from being a cornerstone for liquidity regulation compliance). 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. 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.

Secondly, a fully-fledged European Deposit Insurance Scheme (EDIS) in the steady state is essential for the completion of the BU. The third pillar has always been recognised as a fundamental piece since the inception of the BU. The political deadlock on this field should urgently be overcome. The current economic conditions are favourable and the brunt of the risk reduction across the banking sector has already taken place. To name just a few but clear examples: significant improvements in banks' capital positions, higher provisioning, reduction of NPLs and substantial progress in the build up of the Single Resolution Fund (SRF) and the political agreement for its backstop. Consequently, the current window of opportunity can and should be used now.

*"When analysing options to advance in breaking the sovereign-bank loop, policy makers should consider all the different angles and spillovers."*

- DAVID VEGARA

Finally, regulators should also address the barriers that currently prevent a smooth functioning of the different pillars. There is an urgent need to close the loopholes in the Single Rulebook, in supervision and resolution. >>>

>>> In conclusion, when analysing the different options to advance in breaking the sovereign-bank loop, policy makers should consider all the different angles and potential spillovers. More so in a context where several

national disparities that affect the banking system coexist across Europe, ranging from taxation, accounting and auditing, to insolvency laws, pension frameworks and housing finance. Taking a pragmatic and

holistic approach and completing the banking union with a fully-fledged EDIS seems a sensible way forward that should foster cross-border integration in the sector and further reduce risks to financial stability. ●

## Søren Holm

Group Managing Director,  
Chief Risk Officer, Nykredit

### P2G and regulatory leeway is key in breaking the sovereign-bank loop



The European Union has made significant progress towards removing the risk of painful resolutions and bailouts stemming from the sovereign-bank

loop. This includes the creation of the banking union, the CRR/CRD, the recent risk reduction package, and tougher requirements for SIFI's – especially regarding own funds and MREL-requirements. Notably, CRR already treats externally rated banks according to their own rating rather than the sovereign rating when determining risk weights. Further, the finalized Basel III recommendations removes the sovereign rating approach when determining credit risk of exposures to unrated institutions as well. Last and most important, the CRR2/CRD5 Pillar II framework becomes much more transparent when split into the Pillar 2 Requirement (P2R) and Pillar 2 Guidance (P2G).

It is obvious that banks should not be able to drag down states at the tax payers' expense, but the other way around the loop is much more difficult – if not impossible – to break; the resilience of banks will per definition be a mirror of the macroeconomic health of the states that they operate in. Thus, when regulators are seeking to break the sovereign-bank loop, on one hand they should focus on regulatory leeway for banks operating in different macroeconomic scenarios. While, on the other hand, individual capital requirements based on stress testing of the economic cycles of the individual bank's specific exposures – including holdings of liquid assets – is the basic tool for improving the banks' resilience.

Regulatory leeway should be created so banks with a lower credit quality step (notably step 2 and 3) are recognised as valid participants in the real economy, e.g. as deposit takers, and guarantee or derivative counterparties. If regulation is too rigid and only recognises minimum AA-rated banks as eligible counterparties in the financial system, the potential need for sovereign interference even in "normal" economic downturns will be much higher. It also impedes the continued development of cross border European banking and capital markets.

The new Pillar 2 framework is the toolbox for individual capital requirements. However, stress testing should be the main corner stone in the further development of Pillar 2 Guidance, i.e. the specific exposures in states or markets on the top of the economic cycle should be tested towards an economic downturn. Resilient banks always have access to liquidity. Changing liquidity requirements – e.g. further diversification in liquidity holdings – will not itself reduce the total systemic financial risk. On the contrary, it may even be detrimental to the market liquidity of HQLA markets.

Therefore, we should recognize even BBB-rated banks as eligible counterparties in regulation, and strengthen the framework for banks' individual capital requirements. These initiatives would ensure a more robust financial system on its own, thus serving to ease the magnitude of the sovereign-bank loop. ●

## Jesus Saurina

Director General Financial Stability,  
Regulation and Resolution, Banco de España

### About loops, alleged loopholes, and the real missing pillar of the Banking Union

The global financial crisis showed the impact that banks' problems may have on sovereigns. A too low level of capital and too much risk lurking in the balance

sheets of a number of European banks, led to their rescue using taxpayers' money. Bail outs in Europe were necessary to protect bank depositors, avoid contagion and reassure financial stability. But the funds used for those rescues put a significant pressure on some sovereigns, which had to be supported using European programs. This link created between banks and sovereigns should have diminished significantly as regulatory reform and supervisory action increased capital requirements, reduced NPLs and improved governance and risk awareness by banks. Moreover, from now onwards, MREL funds should be used to bail in banks instead of taxpayers' money. >>>



>>> Banks hold a diversified portfolio including loans to households and firms as well as equity and sovereign bonds. The level of risk of banks' assets varies significantly, with sovereign bonds being one with the lowest risk. Defaults of advanced economy sovereigns are extremely rare events since WWII, as empirical evidence shows. Bank holdings of sovereign bonds are countercyclical, that is, increase during recessions when private sector lending is too risky and sovereigns offer a safe harbor. When the economy recovers, banks again focus their lending on the private sector, which delivers a higher expected return. In the last decade, including stress periods, the CDS premia correlation between sovereigns and banks and between sovereigns and non-financial firms, whose balance sheets are free from sovereign exposures, was pretty similar. Therefore, the market perception of banks' risk seems more related to the prospects of the economy than to the

amount of sovereign exposures in their portfolios. The collapse of a sovereign has far more reaching effects than the exposure of banks to it, which underlines the importance of a sound fiscal policy.

*"Regulatory treatment of sovereign exposures...quite less urgent than...a fully-fledged EDIS."*

- JESUS SAURINA

Moreover, sovereign bonds are a key instrument to manage bank liquidity given the depth of their markets. Last but not least, during the sovereign bond stress period undergone by some euro area peripheral countries, banks sovereign holdings played a key stabilization role. All in all, the relationship between sovereigns and banks is much more complex than the

simple amount of exposure held in banks' balance sheet.

Regulatory treatment of sovereign exposures has been discussed in Europe for a long time, as well as at global level. The Basel Committee issued a discussion paper more than a year ago setting out some ideas. There is no consensus on the way forward on this very complex matter among international regulators. A significant number of them are against changing the current treatment of sovereign exposures, in particular those from advanced economies outside continental Europe and from emerging countries worldwide. Certainly, this issue might be more relevant to be discussed among Banking Union countries, in a context of risk reduction and risk diversification. Nevertheless, it seems quite less urgent than finalizing the Banking Union by implementing a fully-fledged EDIS (European Deposit Insurance system). ●



## Benjamin Angel

Director, Economic and Financial Affairs,  
European Commission

### The sovereign-bank nexus: where we are and where we go from here

The euro area debt crisis brought to the spotlight how much banks and their sovereigns are intertwined. Many experts and practitioners knew about

it; however, the extent and implications of this phenomenon, including for the stability of the common currency itself was not fully appreciated until 2012. Since then, loosening the nexus and mitigating its potential to endanger the stability of the common currency have been primary goals of EU policy-makers.

Obviously, crisis prevention on the sovereign side requires prudent economic and budgetary policies. A lot has therefore been invested in strengthening macroeconomic and fiscal surveillance in the EU and the euro area. However, turbulences on sovereign debt markets can still occur. Loosening the nexus between banks and their sovereigns is therefore still of utmost importance.

Of course, this is no easy task. We are talking about reshaping one of the most fundamental and longstanding relationships in our financial system. Hence, we have been developing a comprehensive list of projects that takes into account both the economic necessities and the political realities of today, in order to meet this challenge.

The first measure was to reduce banks' leverage and strengthen capital. This reduced the importance of the sovereign implicit guarantee for the system's liabilities. Then, in 2012, the Single Supervisory Mechanism was created to ensure a consistently prudent approach in supervision across the euro area.

With the Single Resolution Fund (SRF), we have created a European counterparty to banks in the event of a crisis and hence loosened the nexus significantly. The European Deposit Insurance Scheme (EDIS), once agreed, will follow the same logic. Consequently, with the ESM-based backstop to the SRF agreed in December last year, one can say that euro area banks are becoming today European "in death".

However, loosening the nexus also calls for them to be genuinely and persistently European "in life". This requires inter alia tackling the disincentives to cross-border diversification including its costs. This is the prime rationale for the Capital Markets Union initiative, admittedly a rather long-term project.

*"Loosening the nexus and mitigating its potential to endanger the stability of the common currency."*

- BENJAMIN ANGEL

Should we go further and incentivise banks to go cross-border by means of regulation i.e. by reforming to the regulatory treatment of banks' sovereign exposures (RTSE)? This is certainly not an easy question. On the one hand, the liquidity and accessibility to non-resident investors of >>>

>>> sovereign debt markets make them a very efficient vehicle for cross-border asset diversification. On the other hand, those markets are the backbone of our entire financial and monetary system. We need to err on the side of caution especially when some Member States' high debt loads make them vulnerable to possible adverse market reactions.

Many options have been assessed over the years, ranging from no change to introducing a standard approach for risk weights and exposure limits.

Radical changes are unlikely, either because they would be financially very disruptive (e.g. aligning the RTSE on the standard approach) or because there is not yet enough political consensus (e.g. establishing a common European safe asset).

It does not mean, however, that nothing can be done. Taking domestic exposure into account when calculating bank contributions to the EDIS, for instance, would not introduce disruptive practices or mismatches between the European and the international regulatory approach. ●



## Burkhard Balz

Member of the Executive Board,  
Deutsche Bundesbank

### Keeping the Banking Union healthy requires a tackling of sovereign risks

The necessity to break the sovereign-bank loop is the most important lesson learnt of the financial

crisis. The illness named sovereign crisis was identified quickly, but the healing is not yet completed.

The healing is a duty of the Member States to begin with. Since the introduction of the euro 20 years ago the deficit criterion of the stability and growth pact has been missed more than 100 times. As of today, only 7 out of 28 Member States are compliant with the debt criterion of the stability and growth pact. It is obvious that the roots of the sovereign-bank loop go deeper than revising the Banking Union legislation only. The economic governance framework has to be improved so that its transparent and rules-based application is ensured. A politically independent authority could be mandated with the monitoring and enforcement of the framework.

One initial step can be done when revising the ESM. The ESM could act upon its coordination role in the debt restructuring of Member States in order to positively contribute to a stabilisation of the economic and financial system when the refinancing conditions of a Member State are challenged. An automatic prolongation of sovereign bonds holding periods to another three years could be helpful, once the Member State enters an ESM programme. Firstly, such an approach would ensure that the creditors remain responsible for the investment decisions they have taken, secondly, fire sales of sovereign bonds could be prevented, and more time would be granted for setting up a credible economic programme for the Member State in distress.

*"A completion of the Banking Union has to tackle the privileges for sovereign bonds."*

- BURKHARD BALZ

At the same time, while crisis-solving measures such as possible ESM tools are relevant during crisis situations, the prevention of the emergence of a new sovereign crisis is what should concern us the most today. Banks in Europe still have a highly concentrated risk exposure in domestic sovereign bonds. They have no limitation in the amount of bonds they can hold or an explicit capital requirement for their exposure. As long as this is the case, the financial health of banks and sovereigns remains highly intertwined. A sharing of bank risks therefore indirectly implies a sharing of fiscal risks, which

would be in contradiction to the principle of Member States' liability in European economic governance. A completion of the Banking Union which claims to be equally based on risk sharing and risk reduction therefore has to tackle the privileges for sovereign bonds and provide comprehensive solutions for addressing the risks in relation to sovereign exposures. Weakening the sovereign-bank nexus is of course easier said than done. Nonetheless, with the international standard-setting being hesitant on progressing with the treatment of sovereign exposures, it is now on Europe to decide whether it wants to heal. ●

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# Benchmark regulation



## Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

### Questions around the Euro Risk-Free Reference Rates

In order to facilitate the implementation of the EU Benchmark Regulation, the Euro Working Group on Risk-Free Reference Rates (EURO RFR WG) was created in Q1 2018 by ESMA, the European Commission, the ECB and the Belgium FSMA. This industry-led Working Group was established to identify and recommend a risk-free rate that could serve as a basis for an alternative to current benchmarks. The EURO RFR WG achieved its first goal in September 2018, when ESTER was recommended as the alternative risk-free rate for the eurozone. The Working Group is also committed to identifying fall-back rate for Euribor and EONIA based on ESTER.

The main difficulty currently related to ESTER is that it is not yet available, as the ECB plans to start publishing it, at the latest, in October 2019. In the UK and the US, on the other hand, the alternative risk-free rates (SONIA and SOFR, respectively) are already available, and the build-up of derivative market contracts referencing these interest rates is already taking place. The dynamic of the ESTER derivative markets is difficult to anticipate.

On the more particular issue of so-called fall-back provisions, these are required by the Regulation to increase the legal soundness of contracts referencing benchmarks. Thanks to effective fall-back provisions, the litigation risks and the risk of frustration attached to a contract are materially reduced. For these reasons, the Working Group is committed to recommending legal action plans related to both EONIA and EURIBOR. Such plans should provide market participants with practical guidance for the inclusion of fall-back language based on ESTER in new and, possibly, in existing contracts. ESMA is following this development very closely because of the potential impact on consumers across the EU.

Although not yet published, ESTER is already considered by market participants as a very reliable rate because of the authority of its administrator, the ECB. The members of the Working Group will also consider producing a recommendation on the fall-back provisions for contracts referencing ESTER. Looking ahead, it is expected that these fall-back provisions would increase even further the legal soundness of ESTER-based contracts. ●



## Carlos Molinas

Global Head of Business Compliance,  
Crédit Agricole CIB

### A new and progressive approach to benchmark regulation

The LIBOR scandals in 2012 exposed important vulnerabilities in a key element of the economy: benchmarks. These failures have impacted the confidence in our financial industry in a way that may take generations to recover. It is no surprise that international initiatives led by FSB and IOSCO developed recommendations and overarching principles for benchmarks. Additionally, UK and EU legislators adopted hard regulations to bring

into their perimeter the provision, contribution and use of benchmarks.

After many years, it is now time to evaluate the impact of benchmark regulation and to assess whether their original objectives have been met.

We have learnt that the benchmark universe is more dynamic and diverse than we initially thought. Farmers use benchmarks to receive compensation based on a hurricane's diameter and wind speed. Fishermen calculate the exact price of a salmon (gutted and head on) so they can settle future contracts. Indices measure mortality rates or the change of house prices to allow landlords and tenants to enter into rental contracts. We saw a firm sponsoring more than 800,000 benchmarks and an administrator claiming to provide more than 150,000 indices. The variety of benchmarks is such that trying to gather data is as challenging as finding the number of fish in the sea.

We knew that a one-size-fit all approach could not be applied to all benchmarks. The strict requirements for administrators and contributors to critical interest rate benchmarks (IBORs, ONIAs) cannot be applied to other benchmarks. To find a proportionate approach, IOSCO relied on self-assessments but hard regulation such as the EU Benchmark regulation (BMR) requires the use of quantitative criteria. Finding data is vital for the BMR to determine whether a benchmark is "critical", "significant" or "non-significant". Yet, we have found that the granular data needed by the BMR to determine the importance of a benchmark simply cannot be obtained.

Lastly, we have seen that administrators rely on data sources that do not gain much from providing

input data. The BMR requirements have given incentives to data sources to request higher prices or stop providing data. Consequently, some third country administrators face the unpalatable choice of either not complying with the EU BMR or face collapse. Unsurprisingly, the list of benchmark administrators that have taken steps to comply is still very short. The benchmark industry is now polarised between some well-established administrators in EU and a vast number of firms with few incentives to be registered. A prohibition for EU firms to use non-approved benchmarks would impact their capacity to lend, borrow or manage their risks especially in foreign currencies.

*"It is time to evaluate benchmark regulation and to assess whether their objectives have been met."*

- CARLOS MOLINAS

Therefore, a new framework should be considered, based on a step by step approach. The idea is to include all benchmarks under the regulatory perimeter while authorising and supervising only a growing list of "designated" benchmarks. This progressive approach has many benefits e.g. allowing supervisors to apply their resources on a cost effective basis, to learn from the lessons that benchmark diversity can teach us, to keep non-designated administrators on their toes and to mitigate potential dislocations of a quick and too ambitious approach. ●

## Jean-Paul Servais

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

### Benchmark regulation: implementation challenges

Major interest rate benchmarks have been on the global reform agenda since 2013. Great work has been achieved at international level with the endorsement by the G20 of the IOSCO

Principles for Financial Benchmarks. In addition, the FSB Official Sector Steering Group put considerable effort in strengthening IBORS and identifying alternative risk-free rates. Closer to home, global standards have been anchored in European law with the Benchmarks Regulation, fully applicable since January 2018. The two major benchmarks in the euro zone, Euribor and EONIA, both provided by the European Money Markets Institute (EMMI), have been declared critical by the European Commission in August 2016 and June 2017 respectively.

In February 2018, the ECB, together with ESMA, the >>>



>>> European Commission and the FSMA, established a working group on euro risk-free rates ('WG'), tasked, among other things, with identifying and recommending risk-free rates that could serve as an alternative to current benchmarks used in a variety of financial instruments and contracts in the euro area.

In September 2018, the WG recommended ESTER as the new risk-free rate for the euro area. ESTER will reflect the wholesale euro unsecured overnight borrowing costs of euro area banks. The ECB is expected to start calculating and publishing ESTER by October 2019.

Currently, EONIA is the main overnight rate in the Euro area. It is used in many financial contracts, mainly among professional parties. After having chosen ESTER as the new RFR in the euro area,

the WG recommended a transition path from EONIA to ESTER, whereby EONIA would be recalibrated towards ESTER and discontinued by the end of 2021.

*"The transition from EONIA to ESTER is on track and Euribor, under a hybrid methodology, is here to stay."*

- JEAN-PAUL SERVAIS

With regard to Euribor, the story is different. In December 2017, an estimated €9.7 trillion of loans linked to Euribor were outstanding, in March 2018, an estimated €1.68 trillion of debt securities linked to Euribor were outstanding and in October

2017 an estimated €108.7 trillion of interest rate derivatives linked to Euribor were outstanding', including a significant amount of long-term retail transactions. EMMI has developed and consulted on a hybrid methodology anchored to the largest extent possible in transactions. There are good hopes that under its new methodology, Euribor could be compliant with the Benchmarks Regulation. EMMI has confirmed that it will file for authorization as an administrator of Euribor by Q2 2019.

To sum up, the transition from EONIA to ESTER is on track and Euribor, under a hybrid methodology, is here to stay. ●

1. [https://www.ecb.europa.eu/paym/intro/events/shared/pdf/20181109\\_euro\\_risk-free\\_rates/Presentations\\_Discussion\\_on\\_term\\_rates\\_initiatives.pdf](https://www.ecb.europa.eu/paym/intro/events/shared/pdf/20181109_euro_risk-free_rates/Presentations_Discussion_on_term_rates_initiatives.pdf)



## Angus Graham

Global Head of IBOR Transition, UBS

### The transition from EURIBOR poses significant challenges

The Euro Interbank Offered Rate (EURIBOR), which underpins contracts with nominal value of approximately €180 trillion, is ubiquitous to financial markets and is embedded in products, processes and IT globally. EURIBOR has however been deemed non-compliant with the EU Benchmark Regulation (BMR). As such, use of it in its current form will be prohibited in the future. The BMR and international guidelines require that

benchmarks be anchored by arm's length transactions to the extent possible and that the methodology should reflect evolving circumstances in the markets that EURIBOR seeks to measure.

EURIBOR will consequently be extensively reformed by the European Money Markets Institute (EMMI), the EURIBOR administrator, from the current quote-based methodology to a transaction-based hybrid approach. The aim is to provide the market with a more transparent, robust, and representative index.

Orderly and controlled transition is clearly the best case scenario. Anything else could result in market fragmentation and pose a serious threat to financial stability. However, the path to transition and the final outcome of the reform is uncertain.

Given challenging timelines, there is no guarantee that the reforms to EURIBOR will ultimately be successful. The hybrid methodology must first be authorised by Financial Services and Markets Authority (FSMA), the supervisory authority of EMMI. Only then can EMMI start work on transitioning banks to the new methodology.

Ideally, a reformed EURIBOR would be deemed BMR compliant by FSMA and authorised for both new and legacy contracts. Should the new methodology not meet BMR requirements, however, FSMA could still permit the provision and use of EURIBOR for legacy contracts.

EURIBOR reform thus has the potential to be very disorderly and

to cause serious market disruption. Challenges include insufficient liquidity being built up in the transition period to enable positions to be migrated and effectively hedged. Liquidity will be split between instruments using existing and reformed EURIBOR, increasing costs and reducing market efficiency. The reformed EURIBOR may not be economically equivalent to legacy EURIBOR, leading to an inability to meet the commercial needs of market participants and calling into question the accuracy of pricing, valuation and risk management.

*"Orderly and controlled transition is clearly the best case scenario."*

- ANGUS GRAHAM

We welcome the decision taken by EU regulators to extend the transition period for certain benchmarks, to allow more time for the significant operational infrastructure change that lies ahead. We must pay due regard to the interests of our customers and treat them fairly. The speed of transition risks not adequately taking into account the judicial consequences of contract law, conduct and fiduciary obligations.

With effective coordination of benchmark reform at a European and global level, and with the industry working in partnership with regulators, orderly and controlled transition can be achieved. ●



## Chris Allen

General Counsel for Clients and Products, Standard Chartered Bank

### Main challenges posed by the implementation of the EU Benchmarks Regulation and the transition to risk-free rates

Interest rate benchmarks are widely used in the global financial system. The London Interbank Offered Rate ("LIBOR"), for example, is a reference rate for contracts that amount to more than USD 300 trillion, ranging from complex derivatives to residential mortgages. The development of risk-free rates, or RFRs, and the likely discontinuance of LIBOR (and potentially other IBORs), at least in its current form, therefore, represents a huge transition impacting virtually every type of user of financial markets. In addition to featuring in a wide range of financial products used by banks, pension funds, insurance companies, corporates and others, LIBOR is also embedded in regulatory cost of capital, funds transfer pricing, performance modelling, valuations, and accounting (fair value calculations for discounting, impairments and financial leases) frameworks across many institutions.

However, the headwinds to successful transition to RFRs are not limited to the scale and all-encompassing scope of their intended use, significant as those challenges are. Given the potential for transition to RFRs across the next

two to three years, and specifically the signalled intention no longer to encourage panel banks to submit quotes to LIBOR after 2021, most market users are already printing deals across their trading and banking books that will still be live as transition occurs. The market is increasingly developing and adopting fallback or replacement of screen rate language in high yield and syndicated lending deals as well as in derivative documentation to try and cover such transition risk but diverging approaches to the documentation of fallback options across cash and derivative products are already emerging. The resultant basis risk and ambiguity of exposure could have various implications from compromising relief available under hedge accounting to the risk of mis-calculating capital requirements. In addition, while documentary fallback provisions are increasingly being developed and featuring in some deals, the allocation of the costs of transition between buyers and sellers, the management of "value transfer" risk as markets migrate from forward unsecured rates to overnight secured rates, the differing approaches to the voting thresholds required to agree to changes in syndicated deals, and the importance of clear and consistent client communication strategies, all add to the challenge.

*"It is imperative that the EU considers how the application of its rules to non-EU activity may prevent EU firms from conducting economically significant business on the global stage."*

- CHRIS ALLEN

From the point of view of users, there are additional hurdles arising from the implementation of the requirements related to non-European benchmarks. For example, the restrictions on referencing non-EU indices could have a detrimental effect not only for banks, but equally for European corporates and investors engaged in cross-border activities, most notably in the FX markets. The third country benchmark regime is predicated upon third country administrators wanting their benchmarks to be used in the EU. However, there are concerns that the administrators of some benchmarks do not intend to apply for recognition.

The recently announced extension of the transitional arrangements applying to these benchmarks is very much welcome as it will allow EU users to continue using a number of important indices administered outside the EU for an extended period. However, the transitional arrangements do not solve the underlying challenges with the third country framework in the EU Benchmark Regulation. It is vital that EU policy makers continue to focus on practical solutions. Given the effectiveness of the working group set up by the European Commission and the European Central Bank to consider the transition to RFRs in the Euro area, it may be worth considering a similar working group, with participation of non-EU regulators as well as market participants, focused on the issue of third country benchmarks. It is imperative that the EU considers how the application of its rules to non-EU activity may prevent EU firms from conducting economically significant business on the global stage. ●

**Next Eurofi event**  
**Helsinki**  
**11, 12 & 13 September 2019**

# AML-TF supervision and detection



## Adam Farkas

Executive Director, European Banking Authority (EBA)

### AML-TF: improving supervision and detection

Money laundering and terrorist financing (ML/TF) undermine the integrity and stability of the financial system. This is why international standards and European legislation require financial institutions to put in place systems and controls to prevent ML/TF and to report it should it occur.

The European anti-money laundering and countering the financing of terrorism (AML/CFT) framework has evolved considerably over the last five years. The new approach requires financial institutions and supervisors to 'think risk', to take a holistic view of all the factors that, together, determine the overall level of ML/TF risk, and to make the right judgement on the effective and proportionate management of that risk. It also requires supervisors to have a shared understanding of applicable rules, and a similar supervisory response to institutions with similar ML/TF risk exposure and risk profiles to ensure that they are treated consistently wherever they operate in the single market.

A common understanding and approach is important because divergent national practices expose the Union's internal market to significant ML/TF risks. Early analysis of a recent spate of high profile AML/CFT scandals involving European banks in large-scale, cross-border ML/TF operations over a significant period of time suggests that the perceived failure, by some competent authorities, to act decisively and in good time to identify and address shortcomings in banks' AML/CFT systems and controls was at least in part to blame on incompatible views, by national authorities, on the respective responsibilities of home and host supervisors, and prudential and AML/CFT supervisors.

These cases highlighted also that in the absence of a common framework, there was a lack of cooperation and information exchange between prudential and AML/CFT competent authorities. This hampered effective AML/CFT oversight.

The EBA has, since its inception, worked to promote a common supervisory culture and foster the convergence of supervisory practices. On AML/CFT in particular, it is working to create a common understanding of the risk-based approach and how it should be applied by supervisors and institutions. Over the last three years, the EBA, together with ESMA and EIOPA, has issued two draft technical standards, three sets of guidelines and three opinions, facilitated the drafting of an agreement between national AML/CFT authorities and the ECB and consulted on guidelines on supervisory cooperation in AML/CFT matters. >>>

>>> Recent events have highlighted that guidelines and other legal instruments are only part of the solution and they will not, by themselves, be enough to establish an effective European AML/CFT supervisory regime. They need to be implemented consistently and it is here that much of the EBA's focus will be going forward. One example is the EBA's recent launch of a series of staff-led, ex-ante reviews of competent authorities' approaches to the AML/CFT supervision of banks. Over the course of the next three years, these reviews will identify weaknesses and best practices in individual jurisdictions and across the EU, allowing the EBA to give early stage feedback to competent authorities and informing the future development of common policy products and training.

The minimum harmonisation and directive-based approach of relevant EU legislation allows national differences, and therefore limits how much convergence the EBA's work can achieve. To avoid that these differences affect the robustness of the European AML/CFT regime, the consistent and effective application of the EBA's common guidelines and standards becomes even more important. This is why last year's legislative proposals by the Commission and the European Parliament are welcome. If adopted, and supported by sufficient resources, they would allow the EBA to continue its work on strengthening AML/CFT supervision in Europe more effectively, and to improve implementation and coordination through greater legal certainty. And if in time a more harmonised European approach is deemed necessary, whether in legislation or institutionally, the EBA stands ready to support it. ●



## Liviu Voinea

Deputy Governor, National Bank of Romania

### Freedom of capital and shared responsibility: the effective implementation of AML standards

Are information flows among the different authorities involved in the supervision of financial entities adequate? Are existing laundering risk assessment tools and indicators sufficient? In a nutshell, my answer to both questions is no. More needs to be done. I will focus on four key messages that I would like to pass on:

- First and foremost, money laundering erodes the foundation of the Union itself, by hijacking one of the fundamental freedoms: the freedom of capital. This is why priority must be given to the anti-money laundering and counter-financing terrorism (AML/CFT) efforts. AML/CFT is not a side issue, not a by-product of the banking union reform or of the European supervisory authorities (ESAs) regulation; it should be regarded as the very core of the enhanced supervisory rules and procedures. An effective fight against money laundering increases the trust not only in the financial sector, but in the European project itself. Failing to address it, on the other side, is detrimental to public institutions, to private businesses, to society as a whole. Freedom of capital is incomplete without shared responsibility. Not only the regulators and the supervisory bodies are relevant here, but the first line of defence should be the private sector itself. If not for moral reasons, the private sector should understand that short-term high profits will eventually end up in medium and long-term losses, penalties, criminal prosecution and public disgrace. As for the public sector, the EU must find the right balance of fostering innovation, digitalisation, access to finance, capital union, while ensuring adequate and coordinated supervision. Extending regulatory coverage to all financial sectors and activities mitigates migration risk to shadow banking. The era of blind trust in self-regulating markets is gone; the fight against money laundering is in itself a public good.
- Second, rules must be obeyed. Not applying commonly agreed rules weakens the credibility of any regulator or supervisor. The implementation of FATF

>>>

>>> standards is a must. Make sure that the current standards are implemented in a coherent and unitary way at national level, before new ones are set. EU has created in the last decade a series of new laws, new bodies, and new tools. However, some of them are not sufficiently tested and the reform remains incomplete, which creates an uneven playfield and leaves room for discretion. Moreover, discretion, as opposed to rules, is case-by-case deregulation and should be avoided. To address the issue of discretion, more transparency is needed, more public scrutiny and more accountability. To achieve all these, we need more data recording, reporting and assessing.

- Third, Europe is as weak as its weakest link. The recent cases of money laundering in some European banks have raised concerns that gaps remain in the Union's supervisory framework and as such, we need to act. AMLD4 was based on minimum harmonisation at Member State level, setting out general principles and technical standards included in the Guidelines for supervisors, leaving their implementation at the discretion of the Member States that led to different national supervisory practices. While the AMLD5 provides that the ECB should conclude a multilateral MoU with AML supervisors on the practical modalities for exchange of information, as mentioned above, in EU legislation there are no detailed provisions on cooperation obligations between prudential and AML supervisors that would facilitate timely and regular input. The ECB in its supervisory function under the Single Supervisory Mechanism has no competence to assess compliance with AML rules; hence, the ECB remains dependent on national AML supervisors for information relating to potential breaches of AML rules.
- Fourth, enhanced coordination at EU level is needed to address AML/CFT in a coherent, pragmatic and efficient manner. The Romanian Presidency has significantly contributed to the progress of the ESAs with the highly important component that addresses risks posed to the financial sector by the money laundering activities file by reaching an acceptable compromise.

Designing and implementing the highest standards of AML/CFT is a process, not a battle. Yet, Europe cannot afford to lose too many battles – otherwise, public trust in the banking sector and in its regulators will be severely eroded. What we need is understanding of the real significance of the problem, following the rules, setting comprehensive standards and procedure, and ensuring harmonized implementation. ●



## Will Morgan

Financial Crime Policy, Group Public Affairs,  
HSBC Holdings PLC

### Doing more together against criminal abuse of the financial system

The global financial system is changing fast, to the benefit of its legitimate users. But what about those who abuse the system to defraud, to launder money or to finance criminal activity, including terrorism? Is enough being done to ensure they don't benefit, too?

In recent years, most national authorities have enhanced their anti-money-laundering (AML) capabilities. The EU is a good example. It has updated its AML Directive (5AMLD), and has incorporated AML into its review of European Supervisory Authorities in order to strengthen regulatory cooperation.

Meanwhile, financial institutions have made huge investments in human and technological resources to identify and mitigate financial crime risk and to comply with evolving regulation.

So why, despite redoubled effort in the public and private sectors, do large-scale money-laundering networks continue to operate? Why the disappointing impact on criminals (1% of illicit funds seized globally)? It is clear that rapid change in the way financial services are provided and consumed has been greatly enabled by cooperation between public authorities and financial institutions. Perhaps that spirit of collaborative innovation can help keep the financial system safe, too. If so, where should we now channel our collective efforts?

We should start with the information flow from financial institutions to public authorities, which is generally rules-based in response to regulatory requirements rather than risk-based and intelligence-led in response to law enforcement priorities. We can automate routine regulatory reporting and redirect public and private sector >>>

>>> resource against mutually-agreed priority threats. Here we might also apply the lessons from established public-private financial intelligence-sharing partnerships such as those in US, Hong Kong, Canada, Australia, Singapore and the UK. Information flows from other parts of the private sector must be similarly enhanced.

We should also ensure our AML efforts are underpinned with accurate, accessible, verified information on which rapid and well-founded risk decisions can be based. Beneficial ownership registers, digital identities and other government schemes can deliver real-time and reliable information to those that need it for AML purposes. The EU will blaze a trail with successful establishment, under 5AMLD,

of interconnected beneficial ownership registers across its territory.

*“Spirit of collaborative innovation can help keep the financial system safe.”*

- WILL MORGAN

Finally, we should continue to reform information-sharing between and within financial institutions. Barriers here deprive institutions, and the authorities to whom they report, of a shared and comprehensive view of international criminal networks. Policy-makers can

promote the application to AML of transformative technologies such as artificial intelligence, machine learning and cloud computing. Compatibility between data privacy and AML legislation can be enhanced, consistent with the recommendations of global standard-setter, the Financial Action Task Force (FATF). For the EU, this could include realising the intention, expressed in Recital 46 of 5AMLD, to permit proportionate sharing between financial institutions.

We should never stop asking what more our own institutions can do to meet the AML challenge. But the most urgent question is what more we can do together. ●

1. United Nations Office of Drugs and Crime



## Duncan DeVille

Global Head of Financial Crimes Compliance, Western Union

### Making the EU's AML framework appropriate for the 21<sup>st</sup> Century

Western Union is a global leader in the Money Transfer and Remittance business. Supervisors and law enforcement agencies generally consider our industry to be high risk for financial crime as many of our customers do not maintain bank accounts and often still rely on cash. We operate through agents. A particularly large number of transactions is cross-border. This risk profile is importantly mitigated by the level and sophistication of our compliance programmes for anti-money laundering and

counter-financing of terrorism. More than a quarter of our staff worldwide is working in this area alone. Effective risk management is one of our important differentiators in the industry.

I would like to congratulate the EU that AML remains at the top of the policy agenda. We welcome plans to strengthen the coordinating role of the EBA. In fact, we have been advocating for the EU to go even further and consider the introduction of a fully harmonised regulatory and supervisory framework for AML. We would also welcome much better cooperation between the Member States' FIUs. The European Commission announced that it would present a separate legislative proposal on this in early 2020 and we at Western Union can only support them in this. Western Union similarly maintains regular networks with law enforcement agencies. This is another area where the EU could foster cooperation. The better we can understand what information law enforcement agencies require the more we can calibrate our risk-based application of AML solutions.

*“The better we can understand what information law enforcement agencies require the more we can calibrate our risk-based application of AML solutions.”*

- DUNCAN DEVILLE

Effective AML enforcement means that in addition to highly committed colleagues we and the rest of the financial services industry are investing heavily in new

technologies to improve compliance. This extends to a number of areas: transaction monitoring, real time KYC applications, screening against sanctions and other lists, as well as the application of AI to strengthen our analytical capabilities. All of this requires access to the appropriate data, ideally at a global scale.

Eurofi is all about promoting understanding between EU policy makers and the industry. Here are Western Union's recommendations as to how the EU regime could be improved:

- There needs to be real-time public-private exchange of relevant and targeted information on money laundering and terrorism financing. This exchange and cooperation should extend well beyond suspicious transaction reporting.
- EU privacy laws should provide legal certainty on the types of information that can be exchanged across FIUs and the private sector.
- The cooperation between different public authorities (supervisors, FIUs and law enforcement) can be improved.
- There is also still significant room for improved international cooperation between public authorities and with the industry.
- Regulators and supervisors should promote the use of new technologies, such as e-ID, AI and big data analytics.
- At the same time, regulators should maintain a level playing field in terms of requirements and expectations, including from new entrants and FinTech companies.

Western Union looks forward to engaging in a debate with policy makers and the industry on all these options and to ensuring a framework fit for the 21st century. ●



## Līga Kļaviņa

Deputy State Secretary on Financial Policy, Ministry of Finance of Republic of Latvia

### Overcoming challenges of Anti-Money Laundering supervision

Money laundering and terrorist financing through the misuse of the financial system has long been a phenomenon where physical and legal boundaries of the jurisdiction are not an obstacle. Recently some European banks were found in breach of anti-money laundering (AML) provisions questioning the efficiency of existing supervisory mechanisms and reflecting the shortcomings of risk assessment, cooperation and information sharing at the domestic and EU level as well as internationally.

First analysis of European institutions calls for additional resources for the European Banking Authority in order to counter money laundering and suggests for better cooperation and information sharing among AML and prudential supervisors to protect the integrity of the financial system. It also launches a discussion on possible long-term options for reform, including possible centralization of AML supervision and financial intelligence at the EU level.

There are separate national supervisory authorities charged with enforcing AML rules and prudential supervision. In the case of prudential supervision of international banks, both the group's supervisor (home country) and

the subsidiary's supervisor (host country) are responsible, while in the case of AML supervision a territorial approach applies.

Regulatory competition can entail the reluctance of supervisors from different countries to share critical information among each other. Along similar lines, national AML supervisors can face low incentives to report AML breaches by national banks to the supranational supervisor, as it could take more stringent supervisory actions to stop money laundering at the national bank.

As money laundering is primarily connected with criminal proceeds, the process involves financial intelligence units and criminal investigators. This can lead to variance in AML enforcement across the EU due to differences in criminal law and sanction regimes. Financial intelligence information is collected at the national level and exchanged in individual cases without a possibility to gather and analyse cross border flows of suspicious transactions. New and emerging technologies could help find ways to strengthen our capacities and further develop the fight against money laundering.

*"The establishment of an EU body charged with AML supervision would be the best approach."*

- LĪGA KĻAVIŅA

Latvia has recently significantly improved access to the information on ultimate beneficial owners, making it public and improving risk indicators and quality of information at the national company register. This improves transparency of the companies established in our jurisdiction, but the full benefits would become available if company registers within the EU would apply the same standards and go even further with verification of the true identity of the ultimate beneficial owner, thus preventing the use of registered companies in illicit multi layered structures.

The current powers have not prevented money laundering scandals from occurring in the EU in the recent past. In the short-term use of existing structures and institutions is a good start, but to ensure high quality AML supervision and eliminate regulatory competition, the establishment of an EU body charged with AML supervision would be the best approach. To warrant enforcement of the same rules across member states, it would also be useful to turn directives into

regulations. With joint efforts we could bring tangible results to the stability and integrity of the whole financial system and additional value to the fight against financial crime. ●



## Petr Ježek

MEP, Committee on Economic and Monetary Affairs and Chair, Special Committee on Financial Crimes, Tax Evasion and Tax Avoidance, European Parliament

### The EU has realised prudential financial supervision is not the end of the story

One lesson learned from the recent money laundering scandals across Europe is that the EU urgently needs tougher, more coordinated anti-fraud controls including a central body able to enforce laws against money laundering. The focus must be on structurally improving regulation nationally, regionally and on a global scale.

The key takeaway from the numerous hearings we have held in the TAX3 Committee following the various money laundering scandals across Europe, is that there is a worrying lack of coordinated and harmonised measures to ensure that tax crimes are effectively detected and tackled. A clear testimony to this issue is the lack of resources and information exchange among FIUs within most Member States. FIUs usually lack the required >>>

>>> resources and personnel needed to efficiently detect and curb financial crimes, which shows the pressing need for FIUs to be more harmonised and reinforced across Europe, with a focus on more efficient information exchange.

The developments we are witnessing at the Council level to tackle money laundering through the strengthening of the European Supervisory Financial Systems should be welcomed. Nevertheless, many improvements must be made in order to achieve a robust regulatory system that will be able to make our financial system safer when it comes to AML.

The Council's general approach to reform of the European financial supervision architecture will help strengthen the supervisory powers of the European Banking Authority (EBA). I believe this is a good step that will allow the EU to better clamp down on money laundering, notably in the banking sector. This decision will help increase the consistency of rules across EU Member States regarding the carrying out of AML/CFT rules by national tax authorities. Nevertheless, the question remains as to whether the EBA's new powers will be sufficient to ensure effective supervision. Indeed, the EBA already has some jurisdiction over AML but clearly lacks adequate resources and capacity to carry out its functions.

*"The imperative of establishing sound supervisory incentives to fight money laundering demands a stronger EU-level role in AML supervision."*

- PETR JEŽEK

In my view, there should be a single EU authority charged with stronger supervisory powers over banks and institutions including the implementation and enforcement of EU legislation when it comes to money laundering, tax evasion and tax avoidance.

Regardless of the name or nature of the institution that will take on this task, this European AML Authority should work on the basis of deep relationships with national authorities such as financial intelligence units and law enforcement agencies.

While the establishment of such a European AML body should be kept in mind as a long-term solution, other measures can be taken in the short- to medium- term, such as the proper

implementation and enforcement of the provisions of the 5th AMLD by Member States and FIUs. The Council's decision to reinforce EU supervisory arrangements therefore highlights the need to answer the supervisory shortcomings, both of the ECB - which scope is too limited in supervising EU financial institutions as well as the EBA, which should better oversee Member States' AML and prudential supervision of banks.

All in all, the efforts undertaken jointly by the Council and Parliament are going in the right direction to harmonise the implementation of the AMLD legislation into national law and in the way it is applied by national supervisors. ●



## Jesper Berg

Director General, Danish Financial Supervisory Authority (Finanstilsynet)

## Money laundering: three avenues for the future efforts

Modern crime is big business and it is international. Often it is also high tech. This gives us the recipe for the way authorities should work.

We have witnessed, and indeed been heavily engaged with, some very spectacular and worrisome AML cases. They are big and they are international. In Denmark, we are struggling with two cases, Danske Bank and Nordea. If we could, we would have liked the cases to go away. They are damaging to the public's confidence in the financial system and they are damaging to the reputation of the authorities.

We cannot make them go away. But we can learn from them and use the experiences to look forward. Going forward, we should follow at least three avenues.

Firstly, international cooperation is of paramount importance. The authorities shall not only exchange information but cooperate actively in the individual cases, coordinate activities and make sure that cases do not fall in between chairs. In this way, the division of responsibility shall be clear to all parties. The supervisory colleges are already in existence and have been so for many years. AML shall have much more focus in the colleges. In that respect, we have already taken such an initiative in Denmark. But not only shall supervisory authorities cooperate with each other, they shall also cooperate with the FIUs and other authorities. The fora for this cooperation shall be strengthened.

Secondly, new technology shall come into the forefront. High tech shall be used by the obliged entities to have effective and efficient KYC and transaction monitoring and the authorities should push behind this development. High tech shall also be used by the authorities to monitor and analyse the activities of obliged entities as well as the SARs and STRs. Big data is big advantage. It cannot be ruled out that GDPR might raise some issues. If it does, we shall be open to discuss those issues.

Thirdly, authorities shall also have specialised skills. We shall be able to dissect the systems in the obliged entities, we shall be able to see new patterns of money laundering and terrorist financing, and we shall be able to spot the right impact points in a large bank.

The three avenues goes together. We shall set up the right teams composed of people with the right skills, across borders using processed big data.

This is not done overnight but we shall initiate our investments today. We are already lagging behind the big business in crime. ●

# Non-bank finance



## Francesco Mazzaferro

Head of the ESRB Secretariat,  
European Systemic Risk Board (ESRB)

### Developing a macroprudential framework for the non-bank sector

Since the global financial crisis, non-bank finance has become an increasingly important source of funding for the real economy. Total net finance raised by euro area non-financial corporations fell sharply over the past decade due to a reduction in bank lending. The non-bank financial sector has helped to fill this funding gap by providing both debt funding through the issuance of debt securities and equity funding through the issuance of shares. As the Capital Markets Union (CMU) progresses, the role of non-bank finance is expected to increase further.

From a financial stability perspective, this may be seen as a welcome diversification of funding sources as risks are transferred from the banking sector towards a broader set of investors. At the same time – unless the regulatory framework keeps pace with this development – it could lead to excessive credit growth, increasing private sector indebtedness, deterioration in credit quality, as well as risks and vulnerabilities building in the non-bank financial sector.

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*"Tools should deal with liquidity risk and those risks associated with leverage."*

- FRANCESCO MAZZAFERRO

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The asset management industry is an important part of the non-bank financial system. Over the past decade, assets held in EU investment funds increased from around EUR 6 trillion to more than EUR 15 trillion, with growth spread across equity, bond and mixed funds. Vulnerabilities may arise from funds' engagement in risk transformation activities, such as maturity or liquidity transformation, while the use of excessive leverage can also be a source of risk.

Individual fund managers already have tools available that help them to manage some of the vulnerabilities in the asset management sector. For example, liquidity management tools such as swing pricing or fund suspensions can help fund

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>>> managers to deal with the impact of large redemption requests during market stress. The use of such tools can help stabilise markets as first-mover advantages and the risk of fire sales are reduced. As previously noted in the European Systemic Risk Board's (ESRB) Recommendation on liquidity and leverage in investment funds, it is important for fund managers to be given a broad range of tools to better manage such risks.

Policymakers also need a comprehensive macroprudential toolkit to act in case existing risks migrate outside the banking sector or new risks emerge. This means widening the toolkit so that policymakers are able to effectively confront risks emerging beyond the banking sector. Additional tools should deal with liquidity risk and those risks associated with leverage among some types of investment funds.

International coordination is important when trying to address risks in the non-bank financial sector and the consultation on leverage published by the International Organization of Securities Commissions (IOSCO) is an important step. It includes the relevant concepts and building blocks for developing leverage metrics which would need to be applied consistently across jurisdictions. A globally consistent core set of measures would facilitate effective financial stability monitoring and would support supervisors' decision-making.

In order to design effective macroprudential tools, a better understanding of how risks may spread through the financial system is also crucial. Individual fund managers already conduct stress tests to help ensure their portfolios can withstand significant redemption shocks. However, the sophistication of these stress tests can vary and may focus on fund-specific risks rather than systemic risks. Macroprudential authorities therefore continue to work on system wide stress simulations. This is a complex undertaking due to the wide range of entities included in the non-bank sector, the range of market activities they engage in and their linkages to the banking sector and the real economy.

The continued development of such simulations should help to improve regulators' understanding of how shocks are transmitted through the system and inform the design of future macroprudential tools. To contribute to these efforts, regulation introduced since the global financial crisis such as the European Market Infrastructure Regulation (EMIR) and the Alternative Investment Fund Managers Directive (AIFMD) provide new data sources and are already generating new insights. ●



## Natasha Cazenave

Managing Director, Head of Policy and International Affairs, Autorité des Marchés Financiers (AMF)

### Strengthening resilience in asset management: are we there yet?

Considerable effort has been made since the financial crisis to strengthen the financial system, particularly in the non-bank sector and, specifically, in asset management. As we head towards CMU 2.0, a stock-take is warranted. Two points stand out.

Firstly, the holistic monitoring of financial stability risks has improved

significantly. Systemic risk objectives are now full part of market authorities' national (AMF in France), regional (ESMA in Europe) and international (IOSCO) statutory mandates and reach across financial sectors (e.g. at the French High Council for Financial Stability (HCSF), ESRB or FSB). Better understanding is being drawn from the analysis of EU regulatory data collection exercises, e.g. AIFMD and EMIR. Accordingly, risk assessments should not focus on isolated funds only but also on global market activities involving potential liquidity risk or leverage.

Funds may channel such risks but may also re-allocate and mitigate them. Thus, assessing market imbalances requires both granular views of individual exposures and market-wide dynamics. Merit can also be found in mapping interconnections (Benhami et al. (2018)) or stress testing market segments >>>

>>> that could be at risk (HCSF (2018) on commercial real estate). Besides, risk-based policies should avoid unwarranted effects – e.g. impact of pro-cyclicality (say excessive reliance on cash buffers), moral hazard induced by the anticipation of authorities' interventions, or failure to account for stabilizing/contrarian forces correcting market prices.

Secondly, policy reforms to enhance asset management resilience are being completed. As part of post-crisis G20 reforms, new regulations have firstly targeted MMFs and alternative investment funds' (AIFs). The EU framework is prominent in its ability to manage investment fund liquidity and

leverage risks. UCITS' leverage is capped, that of AIFs expressly managed (e.g. by AIFMD article 25).

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*"Recognising the macro-prudential virtues of micro-prudential tools."*

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- NATASHA CAZENAVE

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As for liquidity, in addition to MMF and AIFMD's comprehensive rules, France's open-ended investment fund framework generalizes the availability of liquidity management tools (LMTs) such as managers' powers to suspend

redemptions or implement gates and notice periods. Stress testing requirements are also common on all fund types.

Further guidance is still needed (e.g., IOSCO's recommendation on leverage measures and ESMA's work on UCITS' stress tests) and additional data welcome (e.g. MMFR, SFTR). However, awareness has significantly increased and it is now time to ensure proper implementation and risk assessment. Hence, looking forward, progress in managing financial stability risks in the asset management sector should rest primarily on the recognition of the macro-prudential virtues of micro-prudential tools. ●



## Stéphane Janin

Head of Global Regulatory Development, AXA Investment Managers

### Systemic risks and investment funds: where do we stand today in Europe?

Since the last global financial crisis, regulators have been concerned about the potential systemic risks involved in funds.

In 2009, the G20 decided to enhance the regulation of hedge funds.

Therefore, Commissioner McCreevy launched what was called the Hedge Fund Directive which became the AIFMD.

The AIFMD was explicitly aimed at tackling the potential systemic risks involved in hedge fund management. Such an official objective of AIFMD was finally extended by European institutions to the management of all non-UCITS funds to reduce further systemic risk in the EU. Today, at global level, the EU legislation is the widest and most advanced for systemic risks involved in funds.

Indeed, since the adoption of AIFMD, in spite of many market turmoils – such as the Euro crisis and the Brexit referendum – the various safeties introduced in AIFMD allowed for avoiding any occurrence of systemic failure coming from EU-based funds.

What can be expected from the framework proposed by IOSCO for assessing leverage in investment funds?

IOSCO is currently trying to find the best way to assess at worldwide level the evolution of leverage in funds. IOSCO is aware this is a very challenging task, and wishes to avoid aggregating data which might not be meaningful if they relate to funds having various strategies and profiles.

We are highly concerned by two risks which might come from IOSCO: first, having to add any new leverage calculation method to the various ones we are already complying with through AIFMD and UCITS, which made their proof and which are sufficient to assess systemic risk; second, having to add any new leverage reportings to regulators to the ones we are also already complying with. Alternatively, a solution might be

to communicate directly to supervisors the portfolios of funds themselves – as we already do for France and Luxembourg.

Are there differences or additional elements compared to existing practices in the EU?

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*"The EU legislation is the most advanced for systemic risks involved in funds."*

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- STÉPHANE JANIN

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IOSCO's proposals mention the methods applicable in the EU, among others. Let's see which methods will finally be kept by IOSCO. While the EU is the most advanced region for fund leverage calculation and monitoring, it would be a pity if European securities regulators were not able to make their voice heard.

Is leverage a major issue for EU-domiciled funds?

ESMA is monitoring the evolution of leverage in EU-domiciled funds, and publicly reports on it in its Quarterly Risk Dashboard.

Furthermore, national regulators receive from fund managers comprehensive reports required by AIFMD, and in addition some supervisors ask for receiving the fund portfolios themselves to make their own calculations.

Based on such information, facts did not show that currently leverage is a major issue for EU-domiciled funds – while of course it must be kept monitored. ●



## Alexandra Richers

Managing Director,  
DekaBank Deutsche Girozentrale

### Asset managers play an active role and take responsibility

The further growing significance of the asset management sector leads also to a higher responsibility for asset managers. Their active role within the economy as well as in society for retail and institutional investors becomes evident.

Being aware of this enormous responsibility, asset managers are keen on identifying and limiting risks. Their reputation - their most important asset - is at stake.

Thus, asset managers support early identification of potential risks and structural risk vulnerabilities. The implementation of sound investment processes is key.

The most discussed potential risks are leverage, liquidity risk and herding.

However, it is essential to highlight that the European legislator has already adopted very strict legal requirements in the asset management sector, in particular the UCITS Directive and the AIFMD, where strong legal requirements apply for asset managers with a focus on protection of the interests of investors in Europe. Strict standards are also set in the field of

liquidity management and leverage limits as potential structural vulnerabilities of investment funds.

Additionally, many macro-prudential instruments that take into account the investor's profile and behaviour, explicitly considering prospective redemption rates as well as the liquidity profile of fund assets, are in place.

The existing EU fund framework is appropriate to ensure the continued success in the asset management sector and is supported by significant supervisory experience and expertise that fosters certainty for both asset managers and investors.

In terms of current efforts of supervisors to better assess the impact of leverage measures in funds on financial market stability at the macro level, we support the two-stage approach proposed by IOSCO, whereby only those funds which may pose risks to financial stability at the first stage due to their leverage use are subject to more detailed risk-based assessments.

This approach should build upon the comprehensive and advanced EU regulatory framework AIFMD and UCITS Directives. The main leverage metrics (the gross and commitment methods) should serve as a point of reference for developing a matrix of consistent measures at international level.

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*"The principles of proportionality and subsidiarity need to be maintained."*

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- ALEXANDRA RICHERS

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It should also be examined to what extent smaller funds or funds with low leverage can be exempted from extensive reporting requirements. In general, we call for uniform reporting based on existing reports from the AIFM Directive, without adding overlapping reporting layers. A threatening jungle of different data standards and formats presents a huge burden for asset managers. The principles of proportionality and subsidiarity need to be maintained.

Asset managers are aware of their huge responsibility for institutional and retail investors. Also, the supervisor should hold the administrative burden, that leads automatically to increasing costs, at an adequate level. ●

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# Insurance comprehensive risk framework



## Jonathan Dixon

Secretary General, International Association of Insurance Supervisors (IAIS)

### Towards a holistic framework for systemic risk in the insurance sector

#### Introduction

The International Association of Insurance Supervisors (IAIS) has consulted on a proposed holistic framework for the assessment and mitigation of systemic risk in the insurance sector.

The proposed framework is holistic in the sense of:

- Recognising that systemic risk may arise from both the collective activities and exposures of insurers at a sector-wide level, as well as from the distress or disorderly failure of individual insurers;
- Addressing cross-sectoral aspects of systemic risk, by comparing the potential systemic risk stemming from the insurance sector with other parts of the financial system; and
- Moving away from a binary approach in which certain additional policy measures are only applied to a relatively small group of insurers (based on a list of identified global systemically-important insurers (G-SIIs)), to an approach with a proportionate application of an enhanced set of policy measures targeted at the exposures and activities that can lead to systemic risks from the insurance sector as a whole.

#### Finalising the holistic framework

Over the course of 2019 the IAIS will finalise the details of the holistic framework. This includes:

Supervisory policy measures and powers of intervention: The proposed set of enhanced supervisory policy measures (which provide the pre-emptive part of the framework, designed to help prevent insurance sector vulnerabilities and exposures from developing into systemic risk) and supervisory powers of intervention (which enable a prompt and appropriate supervisory response where a potential systemic risk is detected) will be translated into IAIS supervisory material (revised Insurance Core Principles (ICPs) and the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame)). The ICPs establish the minimum requirements for effective insurance supervision and apply to all insurers on a proportionate basis, whereas ComFrame sets additional standards focusing on effective group-wide supervision of large,

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>>> internationally active insurance groups. The draft revised supervisory material will be published for public consultation in June 2019. This will include guidance for supervisors on application of the proportionality principle. It will also demonstrate the link between macroprudential surveillance, the supervisory framework and powers of intervention.

Global monitoring framework: The IAIS will further develop the details of its global monitoring framework, designed to detect the possible build-up of systemic risk in the global insurance sector, including an individual insurer systemic risk assessment methodology and a sector-wide monitoring approach. The IAIS monitoring will complement the macroprudential surveillance by national supervisors. Collectively, this analysis is aimed at supporting a forward-looking conversation within the IAIS on trends and developments, and a coordinated supervisory response to any identified build-up of global systemic risk.

Once the IAIS has finalised the holistic framework in November 2019, the Financial Stability Board (FSB) will assess the IAIS' recommendation to suspend G-SII identification from 2020.

*"In November 2019, the Financial Stability Board will assess the IAIS' recommendation to suspend G-SII identification."*

- JONATHAN DIXON

### Implementing the holistic framework

Implementation of the holistic framework will begin in 2020. Supervisors will be expected to implement the enhanced set of policy measures and supervisory powers of intervention contained in the ICPs and ComFrame. To ensure a globally consistent application of these policy measures, the IAIS will undertake a robust and transparent assessment of implementation. The details of the IAIS' assessment approach will be finalised during the course of 2019.

In November 2022, the FSB will, based on the initial years of implementation of the holistic framework, review the need to either discontinue or re-establish an annual identification of G-SIIs by the FSB in consultation with the IAIS and national authorities. ●



## Dimitris Zafeiris

Head of Risks and Financial Stability  
Department, European Insurance and  
Occupational Pensions Authority (EIOPA)

### Micro- and macro-prudential supervision – going beyond blurry lines

The need to supplement the micro-prudential approach with the macro-prudential approach is one of the main lessons learned from the financial crisis. While the potential systemic risk originating from the insurance sector is less prominent than in the banking sector, the recent work of the European

Insurance and Occupational Pensions Authority (EIOPA) suggests that there are indeed instances in which systemic risk can be originated in or amplified by the insurance sector. This poses relevant policy challenges in terms of the interaction between the micro- and the macro-spheres, potential feedback loops and potential tensions that supervisors and other authorities should duly consider.

For example, a certain triggering event may initially impact one or several undertakings. This would require a micro-prudential policy response to ensure that these companies recover or can be resolved in an orderly manner. Under certain circumstances, however, the institution(s)' specific distress may end up creating systemic risk in a negative feedback loops if, for example:

- The number of institutions affected reaches a critical share of the >>>

>>> market, or if the institutions affected are considered systemically relevant - entity-based sources of systemic risk.

- As a reaction to the shock, undertakings engage in certain activities or products that are more prone to create systemic risk - activity-based sources of systemic risk.
- Undertakings start behaving collectively in a way that exacerbates market price movements, such as fire sales - behaviour-based sources of systemic risk.

The potential feedback loops are not one sided. They can go in a bottom-up or outward direction, i.e. from institutions, to the market as a whole but could also have a top-down, or inward direction, where the materialization of systemic risk for example coming from the banking sector will directly or indirectly affect insurance undertakings operating in a relevant market.

In such a context, the distinction between micro- and macro-prudential supervision becomes blurry and tensions between the two approaches may potentially arise. Coordination and cooperation between the micro- and macro-authorities is necessary to avoid potential conflicts.

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*"Consistency and coherence of micro- and macro-prudential policies is essential to ensure the stability of the financial system."*

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- DIMITRIS ZAFEIRIS

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This cooperation - not always sufficient - must therefore go beyond the national level. And here EIOPA has a

crucial role to play, particularly through its interaction with the European Systemic Risk Board (ESRB) but also with other international organisations such as the International Association of Insurance Supervisors (IAIS) and Financial Stability Board (FSB).

The policy response should avoid focussing on defining strict border lines between the micro- and macro-approach and whether a crisis affects one or more individual institutions, or the market as a whole. Considering the complexity of risks, feedback loops and the potential tensions, consistency and coherence of micro- and macro-prudential policies is essential to ensure the stability of the financial system. The 2020 review of the Solvency II Directive and the potential inclusion of macro-prudential tools and measures is an opportunity not to be missed. ●



## Joseph L. Engelhard

Senior Vice President, Head Regulatory Policy Group, MetLife, Inc.

### Global monitoring: a forward-looking perspective

MetLife welcomes the significant policy shifts in the November 2018 IAIS Holistic Framework consultation document that will help better identify, analyse, and mitigate potential systemic risk in the insurance sector. The new IAIS approach focuses on what activities could generate asset liquidation risk or

counterparty exposure, which is more consistent with how insurers manage risk. We support the IAIS intention to update ComFrame and the ICPs to incorporate best practices in risk management related to the transmission channels of asset liquidation and counterparty exposure. We do have a few remaining concerns, however, such as the lack of clarity about what intervention powers are appropriate and the continuing assumption that an activities-based approach fails to address a domino-type propagation of risk.

In our view, even with the appropriate policy measures in place, the main challenge for the Holistic Framework going forward is whether it can fulfil an essential function: the early identification of potential build-up of systemic risk on a cross-sectoral basis. Even if supervisors have the right policy tools to manage systemic risk, it is essential that the IAIS as a global standard setter obtain the "complete picture of the development of risks and trends in the insurance sector," which is referenced in the consultation document.

There is no better way to prevent or mitigate the impact of a financial crisis than by having an effective surveillance mechanism in place that acts as an early warning system. For this reason, we suggest that the global monitoring exercise described in the consultation document rely less on the analysis of annual quantitative data and more on the creation of a first line of defence against a next crisis. We were very encouraged by FSB Chair Randall Quarles'

inaugural speech, which lays out a vision for an FSB focus on identifying new vulnerabilities through a framework that benefits from insights from private and public stakeholders across the financial sector, including industry, regulators, and relevant official bodies. In addition to the IAIS building out their own macroprudential surveillance capabilities, we support and recommend the IAIS to take a proactive role in the FSB's cross sectoral surveillance activities. This would require the IAIS to not solely rely on annual data. Instead, they could use their analysis of quantitative data as a starting point for a much more thorough, qualitative inquiry that includes a fulsome dialogue with the private sector to help detect market trends that create new risks or add to current risks in a cross-sectoral context.

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*"There is no better way to prevent a financial crisis than surveillance that acts as a warning system."*

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- JOSEPH L. ENGELHARD

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The most effective systemic risk policy tool for the IAIS would be a macroprudential surveillance capacity that can identify the build-up of liquidity or counterparty risk and proactively contribute to a cross-sectoral global monitoring exercise to prevent or mitigate the next financial crisis. ●



## Alberto Corinti

Member of the Board of Directors, Italian Insurance Supervisory Authority (IVASS)

### Systemic risk holistic framework: key factors for success

In November 2018, the International Association of Insurance Supervisors (IAIS) published for consultation a holistic framework for the mitigation of systemic risk in the insurance sector. With this framework the IAIS proposes to evolve the approach to mitigating systemic risk, which is currently based on the application of a predefined set of policy measures to a cohort of insurers (G-SII) that are identified based on their systemic footprint. The new

framework considers both individual and collective sources of systemic threats and applies mitigating measures to a wider range of insurers, proportionate to the systemic relevance of those sources.

In summary the key elements of the framework are:

- a set of policy measures for macro-prudential purposes to help prevent risk exposures from developing into systemic threats;
- a monitoring exercise by the IAIS to detect the possible build-up of systemic risk in the insurance sector at a global level, capturing, as far as possible, cross-sectoral aspects;
- a set of supervisory powers of interventions that should enable a prompt response by national supervisors to possible systemic threats;
- a mechanism, based on a collective assessment of global systemic risk at the IAIS level, to help ensure a consistent application of the policy measures and any intervention at jurisdictional level;
- an assessment by the IAIS of the consistent implementation of the entire framework across jurisdictions.

The above elements also identify the main challenges for the proposed framework. Its success will depend on the following factors:

- how national supervisors will apply the measures to mitigate the sources of systemic risk and, in particular, how they will use the discretion left by the framework to identify the scope of application of these measures and to calibrate the intensity of their application, proportionate to the risk exposure;
- how capable the global monitoring exercise by the IAIS will be to promptly detect potential systemic threats, both at

individual-insurer and sector-wide level. This means, in particular, how effective and proportionate the data collection and analysis will be and how prompt, clear and coordinated the identification of supervisory responses will be;

- how national supervisors will make use of their own macro-prudential monitoring and the collective assessment at the IAIS when applying the policy measures and deciding if and which supervisory intervention should be taken;
- how effective and transparent the collective assessment at the IAIS will be in identifying global systemic threats and supporting appropriate and consistent responses by national supervisors.

*"Its success depends on how supervisors will apply it and their ability to work together."*

- ALBERTO CORINTI

Finally, with regard to all the above factors, it is paramount that the implementation assessment process of the IAIS will be effective in supporting an appropriate and consistent implementation of the holistic framework.

The finalization of the framework is a unique occasion to endow the insurance sector with a systemic risk mitigation regime that is consistent with the financial sector supervisory approach, but also tailored to the specificities of insurance. Its success, however, does not depend so much on the design of the regime, but, more importantly, on how supervisors will apply it and their ability to work together. ●

## Dr. Frank Grund

Chief Executive Director of Insurance and Pension Funds Supervision, Federal Financial Supervisory Authority, Germany (BaFin)

### A common understanding of systemic risks in the insurance sector is a key priority

Subsequent to the financial crisis of 2007/08, the topic of systemic risk in the insurance sector has been discussed

extensively over the last ten years. In 2018, the International Association of Insurance Supervisors (IAIS) sought feedback on its latest development in this area, the "holistic framework", as part of a public consultation. One component of this framework, which I very much welcome, is an activities-based approach to systemic risk in the insurance sector. In addition to this, the framework includes an entity-based assessment of individual insurers. Alongside the potential threat to global financial stability posed by individual insurers the activities-based assessment seeks to identify those activities that insurers engage in that could potentially threaten global financial stability under specific circumstances. Overall, >>>



>>> I support the IAIS's approach of looking at systemic risk through a combined lens that is able to zoom in on the activities of individual firms but also zoom out to keep track of developments in the sector as a whole.

One lens is to identify five exposures that might lead to a potential systemic impact via three defined transmissions channels. The exposure measures - fully supported by BaFin - are: liquidity risk, macroeconomic exposure, counterparty exposure, substitutability and other such as operational risk or wide-spread under-reserving. Another lens is the systemic impact that might be then possible through the transmission's channels of asset liquidation, exposure channels or either the fact that one deals with a critical function.

One final important element for me is the ongoing work of the IAIS on the concrete implications for policy measures of dealing with potential systemic risk arising from several insurers at the same time. Policy measures should be divided into preventive and corrective measures. In the first category, BaFin includes, amongst others, liquidity management plans, recovery plans and stress testing. Corrective policy measures, in contrast, include limits or regulatory stays.

A global monitoring framework should assess potential trends in the insurance sector as well as the potential risk arising from individual companies for the sector as a whole. In my view, it is therefore crucial that we construct a solid framework that monitors sector-wide developments so that, as supervisors, we are in a position to react to emerging risks before they reach a level that threatens financial stability. The same is true for individual firms: we as supervisors should be in a position to identify the next AIG before it reaches a critical stage and causes a meltdown in the financial markets.

I firmly believe that all of these developments will help the global supervisory community to create a toolkit specific to the insurance sector with which we can assess, identify and monitor potential systemic risks in an efficient and effective manner.

Arriving at a common understanding of systemic risks in the insurance sector that takes into account the fact that these risks are different to those of the banking sector is a key priority. It remains to be seen whether we will achieve this goal - which is why the IAIS is rightly planning an implementation assessment for 2022. ●



## Eugenie Molyneux

Chief Risk Officer of Commercial Insurance, Zurich Insurance Group

### Assessing challenges of a holistic framework for systemic risk in the insurance sector

In the past, macroprudential rules were intensively debated and primarily focused on the banking sector. Considering the insurance sector, they currently figure prominently on the agenda, both at global (IAIS) and EU-level (EIOPA).

The main goal being to mitigate potential systemic risk in the financial system, considerations must focus on identifying risks and vulnerabilities across all sectors.

*"Insurers do not consider essential the development of additional macroprudential tools."*

- EUGENIE MOLYNEUX

For the insurance sector, a holistic approach to systemic risk should comprehend the complex web of dependencies and interactions between different actors, take into account international regulatory developments and determine the appropriate level of legislation.

We are pleased that EIOPA considers that EU-level work on systemic risk must be consistent with international developments and not pre-empt

them. Indeed, while the International Association of Insurance Supervisors (IAIS) is currently developing a holistic approach to systemic risk in insurance, in parallel, EIOPA is committed to develop its own European framework.

Regulatory developments addressing systemic risks should appropriately consider the differences between the business models of banks, insurers and other financial institutions.

The core business of an insurance company, such as Zurich Insurance, is of long-term nature and its investment strategy is very risk averse. Given the limited level of systemic risk originating from the insurance industry, additional macroprudential measures are not necessary.

Before discussing additional measures, supervisors and regulators must focus on the implementation of the regulation currently in force, assess to which extent microprudential measures may already address macroprudential challenges.

In fact, at the EU-level, the insurance supervisory system already includes a fully functioning monitoring framework (i.e., specific reporting requirements for financial stability, EIOPA's biannual financial stability reports and stress tests) and many instruments with a macroprudential impact. For instance, Solvency II, currently under review, includes many macroprudential elements, the impact of which will only become apparent over time (long term guarantee measures - volatility adjustment, matching adjustment, the symmetric adjustment for equities; the ORSA mid-term view and scenario analysis).

The negative impact of over-regulation is clear, particularly on insurers' socially-essential roles of risk carriers and as long-term-oriented investors. New measures would be costly, not only for insurers but also for the society in general. Further, it would come on top of the very costly implementation of Solvency II.

An in-depth cost-benefit analysis is required before a macroprudential framework can be fully implemented. Those tools should be applied at group level, given the intention is to address risks to the entire financial system.

Macroprudential supervision for insurance, if at all needed, should be specific to insurance, and, those secondary risk drivers that could be channelled by insurance. If there are aspects of financial stability that go beyond the current regulation, these should be discussed in the context of the 2020 review of Solvency II. ●

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# Implementation of EMIR 2.2



## Nathalie Aufauvre

Director General Financial Stability and Operations,  
Banque de France

**The preparation of EMIR 2.2. is well advanced and must be completed as soon as possible**

The discussions relating to the EMIR 2.2. proposals (relating to CCP supervision) have been ongoing for the last twenty months. The goal of the European regulators is now to have EMIR 2.2 adopted by the next European elections in May 2019. A number of aspects have already been settled but the allocation of responsibilities among supervisors and the related decision-making processes between is still pending. The key question underlying this allocation is to which degree ESMA should intervene in the decision-making process.

For EU CCPs, there is a consensus that their supervision should be centralized to some extent. First, preventing any form of regulatory arbitrage is a prerequisite for the building a genuine Capital Markets Union in the EU, or at least enhancing further the integration of European financial markets. In this perspective, the centralization of the supervision of EU CCPs is viewed as an essential step, because on-going differences between national supervisory practices are compromising the level playing field among EU CCPs. In addition, further harmonization of supervision rules seems all the more warranted as a failure of a given EU CCP may have large spill over effects across markets and jurisdictions. Following the subsidiarity principle, any issue that concerns the EU as a whole should be treated at the European level. Against this background, a key pending question is to which extent the supervision of EU CCPs should be centralized. ESMA should be granted indeed with more powers in the related supervisory process. The establishment of a dedicated Supervisory Committee for EU CCPs is a welcome step in this regard but the devil is in the details.

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*"A key pending question is to which extent the supervision of EU CCPs should be centralized."*

- NATHALIE AUFAUVRE

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Such a Supervisory Committee will be useful only if ESMA is given a lead role in fostering the convergence of supervisory practices. In addition, concerned central banks should remain involved in the supervision process to ensure that all relevant standpoints are taken into account for a proper assessment, in accordance with the spirit of the

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>>> EMIR college setup which has proved effective in this regard. In practice, we may expect ESMA to pay special attention to the protection of the EU financial system as a whole from excessive exposures of clearing members to third-country CCPs. With respect to European currencies-denominated transactions, central banks of issue would look more specifically into issues relating to liquidity, collateral management and settlement issues relating to their currency.

Regarding the operation of third country CCPs, near term measures have been enforced with the aim to avoid potential cliff-edge effects relating to a no-deal Brexit. The European Commission has indeed adopted a delegated act determining for one year after the Brexit that the regulatory framework applicable to UK CCPs is equivalent to the EU's one in case of the absence of a deal. ESMA and the Bank of England have agreed Memoranda of Understanding (MoUs) regarding cooperation and information-sharing arrangements with respect to CCPs. During this phase of intense preparation, the European authorities have demonstrated their ability to adapt swiftly and cooperate effectively in order to avoid the disruption of financial processes and maintain business continuity and financial stability on both sides of the Channel after the Brexit.

From a longer-term perspective, the proposal under discussion is to follow a three-tiered approach for the supervision of third-country CCPs, which in particular provides an enhanced supervision for the systemically important CCPs and even a location requirement for the most important one. While the operational features of such a framework require close attention and have to be worked out further, the good news is that a consensus has already been reached on the principle of this risk-based approach, which depends on the CCPs' systemic importance to the EU financial system. This is in my view a major step forward deserving a strong and clear support from all stakeholders insofar as it will help avoid the mismanagement or facilitate the mitigation, if not prevent the occurrence, of crisis situations in the EU stemming from the demise of third country CCPs. ●



## Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

### EMIR 2.2: it is time for implementation

The EMIR 2.2 legislative proposal was adopted and published by the European Commission in June 2017. Since then the EU Institutions, notably the European Parliament and the Council, have made significant efforts to analyse and negotiate this very important piece of financial market legislation. It is expected that the political agreement on the final text will be struck by the end of March 2019.

ESMA welcomes this progress, especially in light of the main objectives of this legislative proposal - ensuring financial stability through EU-level oversight over critical international financial infrastructures.

Under the new legislation, ESMA would have an enhanced role in monitoring recognised Third Country

Central Counterparties (TC-CCPs). In particular for those that are determined to be systemically important TC CCPs (Tier 2 CCPs) ESMA would be assigned some direct supervisory tasks. The new legislation also recognises the important involvement of relevant Central Banks of Issue (CBI) in important decisions on Tier 2 CCPs.

*"ESMA's priority is to ensure its operational supervisory capacity once EMIR 2.2 becomes applicable."*

- VERENA ROSS

Regarding EU CCPs oversight, the role of ESMA has been enhanced with the inclusion of a consultation process, under which ESMA has to provide its opinion on decisions to be taken by a national competent authorities (NCAs) in a number of areas. While the number of areas where ESMA consent is needed has been reduced, compared to the original Commission proposal, the involvement of ESMA has been overall broadened compared to today, which should >>>

>>> enhance supervisory convergence in the future.

Once the legislative process is completed, and the final legislative text published, ESMA will proceed with contributing to the relevant Level 2 measures under EMIR 2.2. In particular, its technical advice to the Commission for the delegated acts specifying the TC CCPs tiering criteria and how to conduct the assessment for “comparable compliance”. Both areas have been identified as of significant importance already at earlier stages of the legislative process, therefore ESMA will pay particular attention to the

right calibration and carry out extensive public consultations.

The other important priority for ESMA is to ensure its operational supervisory capacity at the time EMIR 2.2 becomes fully applicable. While ESMA is progressing with its internal preparations and planning, a crucial aspect to be ensured is the timeliness of additional resources to be granted to ESMA for the new tasks foreseen under the EMIR 2.2. In this respect, funding by industry fees is key in order to fulfil the legislative requirements.

ESMA will continue its close cooperation with the regulators and

supervisors involved with CCPs around the globe. We are committed to build further on the existing cooperation arrangements and MoUs, taking into account ESMA's additional tasks and competences under EMIR 2.2.

Finally, regarding the relevant governance arrangements, the Parliament and the Council have decided to maintain the Board of Supervisors as the ultimate decision-making body of ESMA, and to create a more specialised new Supervisory Committee. ESMA will need to be operationalise the establishment of this new committee over the next months. ●



**Daniel Maguire**

Chief Executive Officer,  
LCH Group

## Regulatory supervision and cooperation across jurisdictions – The way forward

The temporary recognition of UK CCPs by ESMA and non-UK CCPs by the Bank of England in case of a “no-deal” Brexit was well received by market participants and authorities across the globe. The decisions are in line with calls from the G20, the IMF and the FSB to address liquidity fragmentation and associated risks and vulnerabilities. They provide financial markets and their participants with important legal certainty to continue accessing effective

risk management practices and preserve financial stability.

Regulators across the globe must now shift the discussion to ensure that, on a longer-term basis, open, globally interconnected and unfragmented markets are preserved. Only then can participants, and ultimately national economies, benefit from global and resilient markets post-Brexit. In the UK, the BoE intends to recognise non-UK CCPs within the three years temporary recognition period. In the EU, the full implementation of EMIR 2.2 should introduce an enhanced third-country regime that will enable a discussion around the recognition of third-country CCPs on a permanent basis.

End-users in the real economy need access to global pools of liquidity in both their local and foreign currencies, whether they are established in the UK, EU, the US or elsewhere, to hedge their risks and benefit from extensive clearing and risk management efficiencies. They should not be facing liquidity fragmentation, which is associated with increased risk and decreased market efficiencies and inevitably result in higher costs borne by the end-users whose money is invested in the hedging tools that are critical to the smooth operation of the real economy. It is of paramount importance that cross-border regulatory architecture preserves efficient access to all real economy hedging markets tools and liquidity.

In line with the IMF recent reports, G20 Declarations and FSB recent statements, the market should avoid regulatory driven liquidity fragmentation and build on regulatory cooperation to ensure a coordinated supervision of global operators. Safe and resilient markets need a diversified membership

with global pools of liquidity and the corresponding regulatory input. Going forward, regulatory initiatives should build on existing global cooperation and supervision enabling market participants to operate without limitations in a safe and robust environment.

Today, our CCPs on both sides of the Channel are subject to extensive supervisory input as they are directly regulated by several authorities across the globe, in addition to their home supervisors. In the EU, EMIR 2.2 should provide EU authorities and central banks of issue with the appropriate level of assurances to monitor international pools of liquidity. It should also introduce a workable equilibrium between a proportionate EU supervision and home and other regulators' supervision. This supervisory model has worked effectively in the past and allowed the construction of a comprehensive and well-functioning supervisory framework for CCPs.

*“Supervisory solutions  
should maintain financial  
stability, regardless  
of borders.”*

- DANIEL MAGUIRE

The future landscape should be shaped by market choice, healthy competition and avoid creating unnecessary financial stability risks that could destabilise global markets. The short-term issues have been addressed. It is now time to implement a longer-term solution for the supervision of global pools of liquidity that will maintain financial stability, regardless of borders. ●



## Eric J. Pan

Director, Office of  
International Affairs,  
U.S. Commodity Futures Trading  
Commission (U.S. CFTC)

### Building bridges and not barriers

The views expressed in this article are the personal views of the author and do not necessarily reflect the views of the CFTC staff, the CFTC Commissioners, or the US government.

A year ago, I had the privilege of addressing Eurofi on the topic of central clearinghouse (CCP) supervision. At the time, I noted that efficient and vibrant

cross-border financial markets are critical to long-term economic growth and the CFTC and EU share a mutual interest in applying our regulatory and supervisory programs in such a manner as to avoid overlaps, gaps and conflicts.

With the pending passage of new amendments to the European Market Infrastructure Regulation (EMIR 2.2), the sentiments I expressed before are even more relevant today. EMIR 2.2 gives the European Securities Market Authority (ESMA) and European Central Bank (ECB) powerful new tools to regulate and supervise third-country CCPs. But with such new powers, also comes a responsibility to use those powers carefully and wisely.

*"EMIR 2.2 now looks to  
revisit [2016 CFTC-EU Agreement]  
– hopefully to build upon the  
agreement in a positive way  
and not to tear it down."*

- ERIC J. PAN

As noted by the G20 Leaders in 2009, central clearing is a critical measure to mitigate systemic risk in the global financial system. CCPs must be able to conduct their services across borders, allowing market participants around the world to manage their risk. A lack of coordination on supervision of CCPs will undermine this objective, increasing risk to the global financial system.

In 2016, the European Commission and CFTC concluded three years of

negotiations to reach an agreement on the terms and conditions of (i) what EMIR requirements US CCPs would have to follow in order to provide clearing services to European market participants and (ii) what EMIR requirements would be included in the CFTC's substituted compliance regime for EU CCPs. Those terms and conditions set forth a deference-based regulatory and supervisory framework that governs how we regulate and oversee each other's CCPs. Moreover, this framework has helped our trans-Atlantic market operate smoothly by providing regulatory certainty to market participants. EMIR 2.2 now looks to revisit this agreement – hopefully to build upon the agreement in a positive way and not to tear it down.

The CFTC is fully supportive of the EU's efforts to strengthen its institutions and its financial markets. CFTC Chairman J. Christopher Giancarlo has expressed his great respect for, and desire to work constructively with, all EU authorities, especially ESMA. Chairman Giancarlo has spoken at Eurofi about the importance of regulatory and supervisory deference where we can rely on each other because we have strong regulators on both side of the Atlantic Ocean who are dedicated to cooperation and comity.

The CFTC has a long track record of working well with non-US regulators with respect to the supervision of cross-border CCPs. The fact that CCPs in the United States, Europe and other jurisdictions have thrived in serving U.S., European and other international market participants is evidence of this success. The CFTC hopes that we can continue to work with EU authorities to make sure this history of success continues well into the future. ●

## Claudio Impenna

Deputy Head of Markets and Payments  
System Oversight Directorate, Banca d'Italia

### The new EU regulation on CCPs: the costs and benefits of a complex route

After a difficult negotiation on the role and powers of different authorities, the supervisory framework of European CCPs ('EMIR 2.2') is being finalized. The first review exercise ('EMIR Refit') was merely for fine-tuning, aiming (primarily) to increase the

efficiency of the OTC derivatives market reform; the UK referendum outcome then made the need to tighten supervision on third country (TC) CCPs an urgent issue.

The new framework has two basic features: i) to enhance the coordination and consistency of supervision over CCPs in Europe, strengthening the role played by ESMA and central banks of issue (CBI), and ii) to acknowledge national fiscal responsibilities.

ESMA's supervision of TC CCPs is greatly reinforced, following a proportional approach: a lighter supervision applies to CCPs that are not systemically relevant for the EU, whereas EMIR 2.2 applies to CCPs playing such role. Finally, a relocation requirement in the EU is imposed on 'super-systemic' CCPs, whose clearing activity may >>>



>>> significantly impact financial stability in the EU. Supervision will be exercised by ESMA's Supervisory Committee, mainly composed of national authorities. CBLs will play an important role for TC CCPs: they will be consulted by ESMA as regards clearing activities deemed relevant for the conduct of monetary policy, and will also be able to set additional requirements for them.

A 'more Europe' stance is being pursued in the supervision of EU CCPs as well. A clear allocation of responsibilities among national competent authorities (NCAs), colleges, ESMA and CBLs and a satisfactory balancing of their needs are under way. NCAs hold a primary role in the supervision of EU CCPs, for which Member States retain fiscal responsibility, and chair the colleges whose competences increase; ESMA fosters supervisory convergence in the EU through its Supervisory Committee, while CBLs bring their expertise both to the colleges and to the Committee.

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*"Overall, the new framework seems to add complexity to CCP supervision."*

- CLAUDIO IMPENNA

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Overall, the new framework seems to add complexity to CCP supervision: decision-making will likely become more costly and time-consuming, since coordination is needed among multiple authorities; compliance burdens for CCPs will increase as well. It could be asked to what extent the old architecture needed changing, which after all had proved to be effective. Structurally adjusting the supervisory framework on TC CCPs after the UK referendum was certainly a requirement, as well as taking account of the increasing interconnectedness and integration in the European clearing market. Having said that, the objectives of consistency in supervisory practices and outcomes and of a correct allocation of responsibilities among authorities could likely have been pursued also through a more proportional approach to the treatment of EU CCPs. The highest prudential requirements (e.g. cover 2 for both credit and liquidity risks) are applied to all CCPs, irrespective of their size, business model, and assets cleared; more proportionality would likely be beneficial for the competitiveness of EU CCPs in the global financial system; after all, it is the model adopted for TC CCPs. Nevertheless, this is now a challenge ahead of us, pointing perhaps to a future 'EMIR 3'. ●



## Laurence Caron-Habib

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

### Supervision of non-European CCPs – will EMIR 2.2 bring answers on all aspects?

The European Commission's decision in December 2018 to adopt temporary equivalence for UK CCPs in case of a no-deal scenario was definitely a strong positive development for all market participants. Indeed this big move by European authorities was inescapable in view of the potential systemic risk dimension of a statu quo approach. Otherwise the markets would have been confronted with a magnitude of systemic risk at least equal to the one experienced with the Lehman Brothers failure. First due to the time required to move such an amount of contracts from a UK CCP to a Continental European (in any case much longer than the remaining timeframe until end of March 2019). Secondly, as a result of most likely contagion effects on all financial participants, including those that would not been forced to migrate their contracts. The combination of these elements could have certainly resulted in a general crisis situation.

The question now is how long it will take to make the EMIR 2.2 text fully effective as the temporary equivalence granted by the European Commission is

for one year only. The trilogue discussions between the European Commission, the European Parliament and the Council are on track and will probably end in a consensus before the European elections in May this year. However implementing measures will still have to be adopted before the new text can enter into force for true. That will probably take several months due to the associated consultation process and the topics to be addressed. A key area for review will be the criteria to be applied for the identification of the highly systemic non-European CCPs, i.e. those who represent a high systemic risk for the stability of the Euro in case of crisis situation. They will be used to identify the situations where relocation of €-denominated clearing would be imposed.

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*"Question is how long it will take to make EMIR 2.2 effective as temporary equivalence is for 1 year?"*

- LAURENCE CARON-HABIB

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Beyond the legislative framework, there is still a question mark on what will be the available offering in Continental Europe post-Brexit for segments which have to be relocated. There are some contracts for which the alternatives are quite limited. If a new CCP is to be built in a quite short timeframe, it is not to be excluded that such a challenge is not feasible and may require much more time to achieve a satisfactory end solution which meets at the same time the expectations of the industry and those of the public authorities.

In that context the possibility to extend the temporary equivalence of UK CCPs is to be considered and may prove to be the most appropriate solution, as long as final measures are adopted and financial players can adapt to the new landscape. In addition, whatever the final outcome, it is essential to ensure that potential resulting fragmentation of the liquidity would not cause unlevel playing field for European market participants. Otherwise it could result in their exit from this business where effective competition is probably one the most efficient safeguard for financial stability. Such developments could also have indirect negative impact on the financing of the economy in Europe, which is in total contradiction with the purpose of the Capital Market Union project. ●

# NEXT EUROFI EVENTS

11, 12 & 13 September 2019  
Helsinki - Finland

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22, 23 & 24 April 2020  
Zagreb - Croatia

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September 2020  
Berlin - Germany

# IV. ENHANCING SUSTAINABILITY AND LONG-TERM INVESTMENT

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## Issues at stake

The EU investment gap is due to widen as a result of developments such as ageing populations, climate-change and digitalization, in a context where relaunching growth remains challenging.

Many innovative public sector initiatives have already been launched to support investment in the EU. Additionally, encouraging the allocation of an appropriate share of the large savings surpluses generated in Europe towards suitable long-term investments will remain a priority in the coming years.

The EU long-term sustainability strategy supported by the on-going sustainable finance legislative proposals, which aim to raise the interest of EU and international investors for sustainable investments, should also contribute to achieving EU investment objectives. A further challenge is the revision of the Solvency II framework in order to enhance the contribution of the insurance sector to EU investment needs.

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# The EU long-term sustainability strategy



## Daniel Calleja Crespo

Director-General, DG Environment,  
European Commission

### From well-defined investment needs to bankable projects

The EU has set clear and ambitious environmental sustainability policy objectives and targets in line with the UN Sustainable Development Goals ('SDGs'), the 2015 Paris Agreement, and its own environmental priority needs. This includes targets for waste reduction and recycling, for energy efficiency improvements, for renewable energy generation, for water quality protection and improvement, for air quality improvement, etc. These are further supported by programmes and objectives that approach the sustainability challenge from a more systemic viewpoint such as the shift towards a circular economy, sustainable consumption and production, etc.

Achieving our climate and environmental policy objectives is going to require substantial financial investment – both public and private. Recent estimates<sup>1</sup> suggest an additional 180 billion euros per year will be needed between now and 2030 in the EU to meet our climate mitigation and adaption objectives. For achieving the EU's other environmental objectives, the estimates<sup>2</sup> include, for example, an additional 54 billion euros per year until 2030 to meet our air pollution objectives and an additional 60 billion euros a year to meet our water quality objectives.

So, for many of our environmental sustainability objectives the priority investment needs are relatively clear and well defined. With the launch in May 2018 of its proposal for a Regulation on the establishment of a framework to facilitate sustainable investment<sup>3</sup>, the EU Commission aims to develop a comprehensive taxonomy of 'real economy' activities that substantially contribute to the achievement of the EU's environmental and climate change objectives. This will greatly help delineate and improve the identification of sustainability investment needs.

The EU Commission has also suggested, as part of its next Multi-annual Financial Framework (2021-2027) proposal, to substantially increase both the absolute levels, as well as the proportion, of funding that is orientated towards needed climate and environmental infrastructure investments.

But it will require much more than what is available from EU and Member State public purses to close the investment gaps. Private sector finance has a huge role to play. By all accounts, however, the challenge is not private sector funding availability but the pipeline of bankable projects.



>>> So, the investment funds are there, and the investment needs are fairly clear. However, one further important piece of the investment puzzle needs to be addressed; creating the market and structural conditions that make the project investments bankable. Consider the need by a local region or commune to build and operate a sewage treatment plant. If the local authorities are able to set up a framework whereby the local citizens pay an annual service fee, this generates an identifiable, predictable revenue stream thus creating an attractive investment opportunity. Or, it may be about finding ways to group a series of smaller investments needs (e.g. energy efficiency improvements in a series of apartment buildings) to create an attractive, bankable project proposition.

In short, addressing the 'missing pipeline' issue is going to require some creative, innovative, and joined up thinking between the different actors involved. We need to get much smarter and much better coordinated in how we internalise the environmental externalities, so they are not simply a cost to be borne from the central pot of taxpayers' money or by businesses, but are set up as 'services' which create identifiable markets and revenue streams.

Finally, it is not only about investment projects and fixed income instruments. It is also about directing investment towards companies and activities that are substantially contributing to achieving our environmental and climate mitigation objectives. This requires greater attention and transparency by the financial sector on how it integrates longer-term sustainability/ESG considerations into the set up and marketing of its exchange-traded funds (ETFs), pension funds, and other equity-based financial instruments.

I am confident that it is possible to move in the right direction if we are able to link sustainable finance to the real economy, to deliver bankable projects. ●

1. Restoring EU competitiveness, EIB, 2016.
2. Restoring EU competitiveness, EIB, 2016. Impact assessment for Regulation establishing the Invest EU Programme. SWD(2018) 314.
3. COM (2018) 353 final.



## Andrew McDowell

Vice President, European Investment Bank (EIB)

### Big ambitions and investments for net-zero emissions

The European Commission's new long-term strategy on greenhouse gas reduction aims for an ambitious net-zero emissions target by 2050. For those of us who work at the confluence of policy and finance, the question now is: How do we get there from here?

The net-zero target requires an economic transformation. The energy sector's role is central, because it's responsible for over 75% of EU emissions. Multilateral investors like the European Investment Bank have a big contribution to make, which is why we're currently reviewing our energy lending policy. Our financing and advice must be directed at investments that cut emissions and combat climate change. We must create the jobs and growth in the renewable energy and energy efficiency sectors that will ensure the transition leaves behind no part of our societies and no region of the world.

Our impact is already significant. In 2013-17, the energy projects we signed resulted in avoided emissions of about 8 million tonnes of CO<sub>2</sub> annually, equivalent to >>>

>>> emissions from 1.7 million cars driven for one year. In the last five years, the EIB provided over € 50 billion in energy investment to renewable energy, energy efficiency and grid projects. This lending helped make solar and wind power much cheaper. The global impact of EIB renewable energy projects since 2013 will ultimately be 38,000 MW of generation capacity, producing enough clean energy to supply 45 million households.

But it's not enough. The Commission's strategy estimates that, to achieve a carbon neutral economy by 2050, investment in energy systems would have to increase to 2.8% of GDP, from 2% today. This means additional investment of €175 billion to €290 billion a year (excluding transport) from 2030 onwards. That's not the kind of money any one EU member state can find all by itself. Multilateralism will be crucial to delivering on this strategic goal, and the EIB will be a keystone investor in this great challenge.

It isn't only the sheer size of the investment that's a factor here. The long-term nature of these commitments requires a steady hand like the EIB to back them. For grids, annual investment needs are expected to rise by nearly 70% in the post-2030 period. Similarly, power generation is likely to double.

Let's not forget that all policy must take into account the needs of the citizens we serve. That's why the concept of a "just transition" was so much discussed at COP24. The economic and social impacts of the energy transition on regions with high employment in fossil fuel extraction, energy intensive industries and conventional automotive manufacturing are included in the Commission's long-term strategy. Planning for the social implications will be vital for successful decarbonisation in Europe and elsewhere.

In all this, the EIB can be a central catalyst. The bank can address market failures and support other financial entities to identify sustainable activities. We are already working with commercial banks to help them identify climate action windows in our lines of credit. This can be extended to other intermediaries and to other sustainable activities beyond climate action. Another possible avenue should be increased cooperation with national promotional banks in identifying green investment and the assessment and management of negative impacts and risks. Here our extensive advisory and technical assistance can be vital.

There are many pieces to the puzzle, as we develop the plan for financing the path toward net-zero emissions. The EIB's role is to show that decarbonisation is a viable business model. We aim to do exactly that. ●



## Artur Runge-Metzger

Director, Climate strategy, Governance and Emissions  
from Non-trading Sectors, DG Climate Action, European Commission

### Legal, loud and long - Is the EU's climate policy bankable?

The European Union has just agreed the full legislative framework in order to fulfil its obligations under the Paris agreement. Ahead of the Paris COP, the EU pledged to reduce its domestic greenhouse gas emissions by at least 40 % in 2030 compared to 1990. At the beginning of the Juncker Commission, a whole set of legislative proposals was tabled comprising the revision of the EU ETS, new targets for Member States outside the emission trading sectors, new targets for renewable energy and energy efficiency, new standards for emissions from cars, vans and for the first time heavy trucks. In addition, improvements to the enabling framework were

>>>

>>> proposed like for instance the electricity market, the clean vehicle directive, eurovignette. All of these pieces of legislation have been adopted, and in the case of renewables, energy efficiency, standards for cars and vans, the European Parliament and the Council have agreed on even more ambitious targets than those proposed by the Commission. If agreed policies are fully implemented, greenhouse gas emissions could be reduced by around 45% in 2030.

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*"2030 signals to investors are legal, loud and long,  
more necessary for a climate-neutral EU by 2050."*

- ARTUR RUNGE-METZGER

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Moreover, the Commission has tabled the new multiannual financial framework that proposes to significantly ramp up innovation and technology development. In addition, the new Innovation Fund with revenue from the EU ETS will cater for risky "first of a kind projects" in the energy and industrial sectors in Europe as of next year.

This new comprehensive legal framework provides certainty and predictability for investors until 2030 – as often demanded by the private sector, and this will happen almost instantly. For instance:

- i. In the aftermath of the adopted revision of the ETS Directive, carbon prices have risen from € 5 per ton CO<sub>2</sub> to around € 20 per ton CO<sub>2</sub>. This will make many investments indeed bankable, and provide an additional market pull for renewable energy technologies.
- ii. Improving the efficiency of cars by 37.5% between 2021 and 2030 will require a significant roll-out of new zero and low emission vehicles and establishing the necessary infrastructure. It is estimated that around 25% of newly sold cars in 2030, either battery electric or hybrid car, will have an electric engine. These represent 5 million new clean cars in 2030 or in total 35 million clean cars on the road by 2030. Clearly, this creates opportunities for investments into new factories and new technologies.
- iii. Improving energy efficiency by 32.5% by 2030 will require a staggering increase in investments into renovation of buildings until then, the majority of it to be mobilised from the private sector. Member States have just delivered their national energy and climate plans until 2030 that provide further detail how this ambitious target can be achieved.

Often one hears that for long-term investors 2030 is already around the corner and predictability until then might be insufficient. Many investments, in particular, in infrastructure are long-lasting with long pay back periods. Therefore, the Commission has looked at the long-term until 2050 proposing that by then Europe should become climate neutral. No doubt, this will be a Herculean task. Not only will it require a significant additional investment over the coming decades in the order of € 170 - 260 billion per year, but also a restructuring of investment from business as usual to "clean" investments. For instance, will we see a penetration of around 80% renewables in Europe's electricity production in parallel with a significant increase in the use of electricity. In addition, hydrogen, biofuels and e-fuels will be new players in the energy system which can also be used for energy storage. In the coming months, the European Parliament, EU Heads of States and Government and national fora in Member States will discuss this long-term strategy.

In parallel, a serious discussion on sustainable finance has emerged in the EU over the past years. The Commission together with Member States and stakeholders is trying to chart a way forward to ensure that investors direct finance to the benefit only sustainable investments. Transparency in the green bond market is one aspect here which can support investors in their choice. Anticipating potential stranded assets, like long-term investment in fossil fuels, can equally help investors to reduce risks of their investment portfolio. ●



# Gerassimos Thomas

Deputy Director General, DG Energy, European Commission

## A predictable investment environment for energy transition

The recently agreed legislative package, “Clean Energy for All Europeans” completes the EU’s 2030 energy and climate framework and opens up enormous opportunities for investors in the clean energy transition. From 2020, each Member State will produce detailed National Energy and Climate Plans that will engage them on concrete commitments on energy transition and greenhouse gas emission reduction. Drafts are now being assessed by the Commission who will issue recommendations next June. Plans will be fundamental points of reference to increase predictability for 10 years to business and investment in particular sectors and technologies.

The direction of travel is decarbonisation of Europe by 2050. With the 2030 package and without any further policy change we will only reach 60% reduction in GHG emissions by 2050. So in reality more action will be needed in all fields post 2030. The EU’s legislative framework provides the predictability necessary to mobilise private investments at the necessary scale.

The new Renewables Directive strengthens investment certainty by preventing retroactive changes in support schemes. The new Electricity Market Design Directive strengthens market access for renewables and introduces effective demand response enabling renewables (RES) to become the backbone of our electricity system. It phases in a balancing responsibility and phases out priority dispatch eliminating market distortions. It obliges Member States to de facto increase cross border electricity trade by imposing among others a new min threshold of 70% in capacity allocation. The electricity market rules will also provide the first EU framework for capacity mechanisms taking into account the regional dimension. This ensures they are a last resort measure minimally distortive to regular market functioning, while phasing out carbon intensive generation capacities. Gas generation, including low carbon gas, will also be used as a means to accompany the transition out of coal power generation. This will require investments as outlined in the EU’s gas infrastructure strategy.

As regards the demand-side huge changes will take place on energy efficiency for buildings and on mobility. Buildings account for 40% of total energy consumption and around 75% of the EU buildings are energy inefficient. The Energy Efficiency Directive and the Energy Performance in Buildings Directive require higher renovation rates. Long-term renovation strategies of Member States will provide clarity on the decarbonisation of the building stock through: (a) provisions on “nearly zero-energy buildings”, (b) strengthened energy performance certificates, (c) provisions on the low-emission mobility strategy (e.g. adequate charging infrastructure for electric vehicles), and (d) the smartening of buildings through automation and controls. Finally, ecodesign and energy labelling regimes continue to stimulate consumption of more energy-efficient products. All these measures provide investment opportunities in developing and deploying new technologies and services. Moreover the clarity these measures provide will materially diminish regulatory risk and have a direct, positive impact on project risk assessment and the consequent cost of capital.

The transformation of mobility will be another area where ground breaking developments will take place in the next decade. Electrification of private cars, development of a European battery capacity and hydrogen solutions for cars and other heavier vehicles are only examples of areas where dramatic investment opportunities take place. In an >>>

>>> example of increasing “sector-coupling”, greater (low carbon) gas use, including from electricity, will also enter maritime fuel consumption, together with increases in biofuel in maritime and aviation in the long-term.

Although private investment is expected to finance most of these needs, public finance will continue to play an important leverage role. The Commission has proposed that 25% or EUR 320 billion of the EU budget should contribute to climate action in 2021-2027. Indicatively this will break down to approx. €85bn through structural and cohesion funds, €34 bn of the Horizon Europe budget and 30% or approx. €195 bn of the investment generated under the Invest EU budget will be dedicated to climate change and energy transition.

With detailed plans and strengthened measures, investment in clean energy becomes clearer, safer, and thus cheaper. It is now time to bank on the opportunities provided and so steer the financial system towards becoming integral part of the energy transition. ●



## Natalie Westerbarkey

Head of EU Public Policy,  
Fidelity International

### Pace over perfection - accelerating EU long-term sustainable investments

Progress has been made on the EU sustainable finance agenda and most importantly: the collective awareness of all players - the financial services industry, investee companies and investors - is shifting, as they all increasingly focus on sustainability.

Despite this improved awareness, the absence of universal agreement on taxonomy remains a major impediment to achieve greater levels of sustainable investment in the EU. Major efforts have been made, with close collaboration between regulators, governments and the financial services sector, however more progress is essential.

At present, there is no commonly agreed definition as to when an investment can be considered sustainable. The European Commission's taxonomy proposal aims to overcome the uncertainty by establishing an EU-wide classification system to identify which conditions need to be fulfilled for an activity to classify as sustainable. The creation of a system that is fit for purpose, is therefore the most critical piece of the puzzle we need to get right.

The secret to success will be striking the right balance between a nuanced, yet not prescriptive system. It should allow for flexibility to accommodate innovations in technology, science, product development and investment strategies. The greater the flexibility, the greater the diversification potential and hence, choice for the end investor.

As we navigate the challenges to creating such a taxonomy, it is important to take the following principles into consideration:

First: timing - pace over perfection. It may take some time to complete the taxonomy, especially to achieve coherence at the international level. Nevertheless, it is important that industry and policy makers progress with implementing the system to the extent that they can, instead of waiting for an optimal global framework to be completed. This >>>

>>> will bring about change quicker. The development of a taxonomy is a reiterative process that will need to be perfected over time.

Second: non-binary classification - engagement over exclusion. The taxonomy aims to identify what sustainable economic activities are. In reality, the lines are not always clear-cut. Hence the taxonomy needs to capture activities that may not yet be considered fully sustainable but could become sustainable in the near future through a clear roadmap. Asset managers have a key role to play in the process through active engagement. If the aim is to make EU long-term sustainable investment strategies more “bankable”, the taxonomy needs to be as wide as possible to catch a genuine breadth of economic sectors and activities. Asset managers - through their investment process and engagement skills - can then incentivise companies towards a more sustainable behaviour. If definitions are designed too narrowly, they may limit the ability of having a thematic or positive impact.

Third: ratings and research - taking a differentiated view. As investee companies are embracing non-financial disclosure practices, a more transparent, detailed and comparable data set is becoming available. This will allow asset managers to translate the data into financial investment metrics. To accelerate the EU’s long-term sustainable strategy, developing appropriate sector and asset class specific rating systems and benchmarks is key to help move each asset class and sector forward at its own pace. For example, classifications may be easier to establish for sovereign green bonds and infrastructure investments. For corporate green bonds or equities, it is more challenging: specific instruments issued could be considered sustainable, however, the overall issuing or parent company may not fulfil the same level of green criteria. In combination with active company engagement by asset managers, corporates can become more sustainable, having overall positive impact.

Lastly, and very importantly, asset owners - both retail and institutional - will be critical for the success of the EU’s long-term sustainability strategy: their preferences ultimately decide how capital is channelled into the economy. With a robust and workable taxonomy, public and private stakeholders will be better able to deliver on identifying their preferences, improving suitability related client communication, investor education and overall enhancing awareness of sustainable finance among asset owners. ●

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# Sustainable finance legislative proposals



## Sylvie Goulard

Second Deputy Governor, Banque de France

### Improving climate-related risk disclosures is a necessary step towards a green economy

The Network of central banks and supervisors for Greening the Financial System (NGFS), launched one year ago during the One Planet Summit, is a coalition of the willing, which aims to share experiences and best practices on a voluntary basis. It also aims to promote recommendations in order to contribute to the development of environment and climate risk management in the financial sector and to mobilize mainstream finance to support the transition toward a sustainable economy. The network grew from 8 to over 30 members and observers (as of end-February 2019) and is today present on the five continents.

In its first progress report, released in October 2018, the NGFS unanimously concluded that “climate-related risks are a source of financial risks. It is therefore within the mandates of Central Banks and Supervisors to ensure the financial system is resilient to these risks.” To operationalize this breakthrough statement, the NGFS will publish its first comprehensive report on April, 17th 2019 during an international conference in Paris, including recommendations towards all stakeholders of the financial system.

One key topic that must be addressed is clearly the improvement of climate-related risks disclosures. Indeed, this is a necessary step to properly shape investors’ expectations and facilitate accurate pricing and assessment of climate-related risks embedded in the assets held by financial institutions. Climate-related risks disclosures would facilitate the transition of financial markets, thanks to market discipline in the spirit of the Basel Committee and its Pillar 3 framework.

France has been at the forefront of this issue. Since 2015, asset managers, banks and insurance companies in France are required by law to publish information about how they take climate change into account. This approach, that follows a “comply or explain” principle, has the advantage of making disclosure compulsory for financial institutions while allowing for sufficient flexibility in the way they report information. Equally importantly, it has helped set up a new financial ecosystem dedicated to sustainable investment, underscoring that ambitious climate policies could benefit to the global economy.

At the international level, a substantial amount of work has already been completed. The recommendations of the FSB’s Task Force on Climate-related Financial Disclosures (TCFD) provide a worldwide benchmark for the voluntary disclosure of information about climate-related risks on a comprehensive and consistent basis. At the European level, the ongoing action plan on sustainable finance of the European Commission is also very ambitious and will notably provide increased guidance on non-financial disclosures. Usefully leveraging on the TCFD recommendations, the update of the non-binding guidelines related to

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>>> the Non-Financial Reporting Directive will help companies disclose climate-related information in a more comprehensive and comparable manner.

As to the Banque de France itself, it will disclose this year the climate-related risk exposures and impacts of its own funds and pension funds' portfolios in accordance with the French legislation by using a TCFD-like approach. This upcoming publication is consistent with the Responsible Investment Charter that we published a year ago.

However, to be efficient, disclosure frameworks must go hand in hand with taxonomies which are: i) robust and detailed enough to prevent green washing; ii) dynamic and reviewed regularly to account for technological changes and international developments; iii) publicly available and easily comparable.

This is why the work on taxonomy made of the Technical Expert Group set up by the European Commission is likely to be a decisive step forward, as it will provide one of the most ambitious policy blueprints ever published on sustainable finance. ●



## Lauri Rosendahl

President, Nasdaq Nordics

### Supporting sustainable economic growth across the economy

The world is currently at a tipping point, where we need solutions to climate change, inequalities and a number of other global challenges. Exchanges, issuers, investors and other financial market participants can play a critical role in the transition towards more sustainable capital markets, and Nasdaq Nordic's ambition is to take a leading position in this shift.

Exchanges play a key role in creating jobs and growth across our economies. Given our central role in the financial ecosystem, we have the ability to support the flow of capital in a more sustainable direction, by fostering a dialogue between issuers and investors and ensuring that sustainability is considered across our product and service offerings.

At Nasdaq, we are encouraging sustainable markets in a number of ways. In March 2017, we issued a voluntary support program on environmental, social and governance (ESG) data disclosure to support our listed companies across the Nordic and Baltic markets. Based on positive feedback from this program, we were excited to expand this initiative by launching an updated version of this guide in March 2019 – aiming to serve all Nasdaq listed companies globally.

Apart from our work with issuers, we have a number of other initiatives and products in place, from an ESG Data Portal connecting issuers and investors, ESG screened indexes

and index futures to one of the world's most successful sustainable debt markets; a market that more than doubled in size last year.

While I sincerely believe that these examples confirm that the financial market is moving in the right direction, it is evident that a lot of work remains to be done.

Our experience is that true development on sustainability is driven by demand, rather than by regulatory intervention. More and more businesses do see benefits in adapting to more sustainable business models, and more are also communicating their efforts in ESG reports, responding to an investor base which is becoming increasingly ESG oriented. While all ESG and sustainability related discussions are welcomed, Nasdaq generally favors self-regulation.

However, I do believe our industry needs a more clear definition of what is sustainable and what is not sustainable. Nasdaq therefore supports the idea of having a common taxonomy which can help us define what can be considered an environmentally sustainable economic activity. There are several useful guidelines and frameworks in place, and the challenge is to not destroy what already works.

Policy measures which can support and further bolster development, without interfering with innovation and companies' ability to raise growth capital, are welcome. As an example, Nasdaq is looking forward to further developing our index portfolio based on the incoming rules on low-carbon benchmarks.

I am convinced that we all will benefit from more sustainable markets, not least from a commercial point of view. Nasdaq is fully committed to continuing to explore opportunities in the ESG space and look forward to work together with all our stakeholders to achieve better, more transparent and sustainable markets. ●



## Rhian-Mari Thomas

Global Head of Green Banking, Barclays Bank

### Barclays supports the EU sustainable finance taxonomy to provide clarity and inspire ambition

Barclays supports the EU's proposed Sustainable Finance Taxonomy and with it the notion of providing greater clarity for the financial marketplace on the scope, scale and ambition of Green financial products and services.

#### Is the envisaged taxonomy effectively providing greater clarity to the markets?

The envisaged taxonomy will provide greater clarity to the markets, if, as expected, it provides clear definitions for the markets to adopt, which cover a broad range of economic activities and investments, across the global marketplace. A range of definitions, rather than a binary set of definitions, will more accurately reflect the investment marketplace, and most help both Corporates to identify financing opportunities associated with sustainable activities, and Investors to better judge the risks and opportunities associated with their investments.

Current proposals focus primarily on what is 'Sustainable', whereas Barclays also encourages exploration of the broader ecosystem, including, for example, the role for oil, gas and nuclear power within the transition toward a lower-carbon economy.

Utilisation of existing frameworks is also key. Different financial markets already work to a number of frameworks which have guided the development of new, 'Green' products and services. These include ICMA's Green Bond principles, the Energy Efficient Mortgages Initiative, and the Principles for Sustainable Insurance Initiative. The Climate Bond Initiative and the European Investment Bank have also committed extensive work in this area. Barclays recommends utilisation of the most popular and widely embedded frameworks in a 'bottom-up' approach, rather than 'top-down' approach which threatens

the validity of many existing 'Green' products and services.

#### Is it flexible enough to take into account the evolution of technology and to avoid possible bureaucratic burden?

Barclays believes the taxonomy should be sufficiently flexible to take into account the evolution of technology (and broader marketplace adjustments), through regular reviews and maintenance. This may be best achieved via the proposed 'Platform on Sustainable Finance' set out in Article 15 of the taxonomy regulation, or a similar body. A review every two months should be sufficient to ensure the taxonomy continues to reflect market developments.

#### Is the taxonomy providing sufficient incentives to head toward sustainability adaptation?

We believe the primary incentive for market participants to engage with the taxonomy is the clarity it will provide around the sustainability implications of economic activities. However, the broader question around legislative or regulatory levers to support take-up of sustainability activities is pertinent. For example, Barclays supports the exploration of what preferential, prudential treatment may be given to Green Assets. Such interventions would enable us to engage more fully in the Green marketplace, while also passing on the economic benefits to our clients for further Green purposes. ●

## Dr. Manuel Rybach

Global Head of Public Affairs and Policy, Credit Suisse

### Mitigating greenwashing risk by introducing defined carbon benchmarks

The European Commission's Action Plan on Financing Sustainable Growth is a welcome initiative showing the EU's strong commitment to implement the Paris agreement. The financial sector can play a role in contributing to sustainable growth by allocating capital towards sustainable investments and by helping to promote the transition of the global economy towards low carbon activities. However, to deliver on the EU's ambition and commitment to transition to a low-carbon, more resource-efficient and



sustainable economy, it is important that the EU does not adopt an overly-prescriptive and static regulatory approach in financial services, but rather ensures sufficient flexibility to support innovation in a field where the market needs to develop further. Finally, it is key that the EU framework is designed in a way that can be "exported" at international level to encourage other jurisdictions to follow suit.

The low carbon benchmark (or "climate transition benchmark", as called by the European Parliament) is based on the decarbonisation of a standard benchmark. The underlying stocks would qualify for selection on account of their reduced carbon emissions when compared with stocks constituting a standard benchmark. As such, the low carbon benchmark allows for relative differentiation of stocks and assets, which can incentivize companies to move the needle towards environmentally-friendly technologies, and process improvements leading to lower carbon emissions.

The positive-carbon impact benchmark (or the "Paris-aligned benchmark", in the proposed terminology of the European Parliament), would select stocks which save more carbon than they produce, and which contribute to attaining the 2-degree objective of the Paris Agreement. As such, the positive-carbon impact benchmark sets a higher ambition and allows for an absolute measurement of the climate performance of the underlying stocks against a defined objective. To qualify >>>

>>> for selection, companies will need to be on the emissions reductions trajectory that has been defined for its sector based on widely accepted scenario models.

A variety of benchmarks claim to pursue environmental, social and governance (“ESG”) objectives or low carbon investment strategies. In the absence of clear definitions or minimum standards for such strategies, there is a risk of marketing speech and misrepresentation. The required disclosure of the methodologies applied by the two benchmarks for selecting and weighting underlying assets, of the types and sources of data used for calculating carbon footprints and carbon savings, as well as how the benchmark differs from its underlying parent index, will serve to reduce the risk of such greenwashing. Among the two, the low carbon benchmark, based on relative differentiation, is more prone to greenwashing compared with the positive-carbon impact benchmark, which relies on absolute differentiation. However, the methodologies for measuring a company’s contribution to the 2 degrees objective are still work in progress (like other banks, Credit Suisse is working on methods to measure the alignment of its credit portfolio with the Paris Agreement). Moreover, a risk of unintended greenwashing remains, since both approaches by necessity are dependent on the availability and reliability of corporate disclosures of carbon emissions.

The two benchmarks can meet their intended objective to “reorient capital flows towards sustainable investment” if they are designed as minimum standards beyond which market participants are free to innovate, if they are not too narrow and prescriptive, and if they allow for a sufficiently long period of transition. The benchmarks should be reflective of the real economy and cover all industry sectors without exclusions; especially the most carbon-intensive sectors have the biggest potential to decarbonize – and they need investment capital to transform their production methods and business models. ●

## Mario Nava

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

### Sustainable finance in the EU: achievements, challenges and outlook

The EU is committed to the Paris Agreement on climate change and the UN



2030 Agenda for Sustainable Development. It has been estimated that the EU needs to annually invest around €180 billion just to achieve the 2030 EU climate and energy targets. The scale of this investment challenge is well beyond the capacity of the public sector alone.

The financial sector has a key role to play in transforming our economy into a more sustainable one. That is why in March 2018, the Commission adopted an Action Plan on Financing Sustainable Growth consisting of ten ambitious legislative and non-legislative measures to help mobilise the private sector to finance sustainable investments and sustainable growth.

Just one year later, and at the end of this legislative term, we have made major progress in the implementation of the Action Plan. In May 2018, the Commission tabled three legislative proposals.

The first legislative proposal concerns the establishment of a unified classification system (taxonomy) that will define what is ‘green’ in order to identify activities and projects where investment can make the biggest impact. This EU taxonomy focuses on environmentally sustainable activities starting in the area of climate change mitigation, followed by climate change adaptation and other environmental fields. The taxonomy will help us develop standards and labels for green financial products. It will also underpin disclosure and reporting of financial institutions and companies on climate and environmental impacts.

The second legislative proposal concerns the disclosure requirements related to sustainability risks and opportunities by asset managers, institutional investors, and financial advisors. Our proposal will require them to disclose how they integrate sustainability considerations into their processes. To better inform retail investors, we will also require investment and

insurance advisors to ask clients about their sustainability preferences, and offer suitable investment products.

The third legislative proposal on low-carbon benchmarks will create a new generation of benchmarks. The two new categories are voluntary labels designed to orient the choice of investors who wish to adopt a climate-conscious investment strategy.

Thanks to the quick work by the European Parliament and the Council, a political agreement has been reached on the legislative proposals on sustainability disclosures and low-carbon benchmarks, while we continue to work full speed on the taxonomy proposal.

A key to success of revising the financial system depends on companies being more transparent about their impact on the climate and on the business risks and opportunities that climate change creates. The Action Plan announced that the Commission will amend its non-binding guidelines as regards climate reporting to take into account the results of the FSB industry-led Task Force on climate-related disclosures. Following a consultation in March 2019, the Commission is scheduled to adopt its amended non-binding guidelines by this summer.

In parallel, the Commission established a Technical Expert Group (TEG) to assist it with the technical work underpinning some of these legislative proposals. The TEG has prepared reports and asked for feedback from external stakeholders on taxonomy, an EU green bond standard, low-carbon benchmarks and climate-related disclosures, that will feed into EU policy.

Regardless of these achievements, challenges remain ahead. To put the taxonomy in place we need an agreement by the co-legislators. At the same time, constructing the technical aspects of the taxonomy is complex, and needs to proceed step-by-step. For the short-term the TEG is doing an outstanding job. However, for the long-term a more robust governance structure is needed, bringing together all relevant stakeholders. Therefore, the Commission has proposed to establish a platform to further develop and adjust the taxonomy. But once this taxonomy is established, we should be able to make green finance the new normal.

Moving to a greener and sustainable economy is a long journey. I believe that our concrete actions are an important step to achieving our mid-term goals of the 2030 agenda, and long-term vision of a fully climate-neutral economy by 2050. We hope that the EU can lead by example, and inspire others to modernise and decarbonize their economies. ●

# Addressing sustainability risks



## Gabriel Bernardino

Chairman, European Insurance  
and Occupational Pensions Authority (EIOPA)

### 2020 Solvency II Review – Macro meets Micro

The review of a regulatory framework constitutes a window of opportunity to further enhance the existing frameworks as regards efficiency and effectiveness and by that to ensure better consumer protection and better contribution to the stability of the financial system.

A clear example is the 2020 Review of the Solvency II Directive which the European Insurance and Occupational Pensions Authority (EIOPA) is currently working on. It is clear that Solvency II has proven to be a significant step forward in the regulatory landscape. However, EIOPA supports the view that the framework can be further strengthened both from a micro- and from a macro-prudential point of view.

On the macro-prudential front, EIOPA's latest publications shed some light on what changes are needed. The first publication entitled "Systemic risk and macro-prudential policy in insurance" sought to better understand if and how insurance can create or amplify systemic risk considering three different sources of systemic risk, i.e. entity-, activity- and behaviour-based sources. The second publication on "Solvency II tools with macro-prudential impact" identifies, classifies and provides a preliminary assessment of the tools or measures already existing within Solvency II. The main conclusion is that, although Solvency II contributes to mitigate some of the sources of identified systemic risk, there is still room for improvement. This is further explored in the third paper presenting "Other potential macro-prudential tools and measures to enhance the current framework" including an initial assessment of possible tools and measures.

We welcome that the European Commission has included a specific item on macro-prudential policy in its recent Call for Advice to EIOPA on the review of the Solvency II Directive. And similarly, adding two additional items on recovery and resolution and Insurance Guarantee Schemes (IGS) is a logical step to enhance Solvency II also from a micro-prudential point of view.

Indeed, in its 2017 Opinion to the European Union institutions, EIOPA stressed that there is a need to move towards more harmonisation in the field of recovery and resolution. Furthermore, EIOPA always considered that a harmonised



>>> framework should be aligned with Solvency II. Therefore, EIOPA has put forward several proposals for each of the building blocks identified in the Opinion, namely, preparation and planning including the request of pre-emptive recovery and resolution plans, early intervention, resolution covering relevant aspects such as objectives, conditions and powers of supervisors as well as cooperation and coordination.

EIOPA's ongoing work on IGS is closely linked with the work towards a minimum harmonised recovery and resolution framework. In fact, an IGS can be seen as an important tool for the effective resolution of insurers and can play a relevant role in the resolution process. And – as it is the case with the currently existing national recovery and resolution frameworks – the current fragmentation is definitely not optimal, particularly when it comes to failures involving cross-border business. And this is not simply a theoretical situation. On the contrary, we are already observing exactly this type of issues in the European Union. The absence of a consistent framework for IGS in the European Union led to a situation where policyholders across Europe are not protected to the same extent in case of liquidation of an insurer. Furthermore, this creates an un-level playing field in the single market. As a result of this ongoing work, in July 2017 EIOPA published a “Discussion Paper on resolution funding and national insurance guarantee schemes” to gather stakeholders' views. The feedback received is currently thoroughly analysed and will be considered in the development of the Advice to the European Commission.

Now is the time that the relevant micro- and macro-prudential proposals find their way into the legislative process. EIOPA will follow a thorough, evidence based and transparent approach in its process of consultation with all interested stakeholders, effectively using this window of opportunity to make Solvency II a more complete and sound prudential framework. ●



## Sarah Breeden

Executive Director, International Banks Supervision,  
Bank of England

### Financial risks from climate change: far-reaching, foreseeable, for action today

Climate change brings financial as well as environmental risks. These financial risks arise in two ways.

Physical risks arise from damage to property, land and infrastructure from weather-related events such as heatwaves, droughts, floods and rises in sea level. Inflation-adjusted insurance losses from such events have increased by a factor of five in recent decades.

Transition risks result from changes in climate policy, technology and market sentiment as we adjust to a lower carbon economy. While the timing and the form of transition is inherently uncertain, risks are already materialising now – for example, through tightening energy efficiency standards impacting on the UK property market or credit risks associated with the low-carbon transition emerging in the automotive and energy sectors.

>>>

>>> The Bank of England has therefore been working to deepen our understanding of the risks that climate change poses to the financial system, whilst remaining firmly grounded in our financial stability and safety and soundness mandates.

Our view is not only that these risks are financial, but that they are far-reaching, foreseeable and for action today.

The risks are far-reaching in breadth and in magnitude. They affect all customers, all sectors and all geographies. Their impact will likely be correlated and non-linear.

While uncertain, the risks are eminently foreseeable. Even if we do not know now exactly what will happen and when, we do know now with a high degree of certainty that some combination of physical and transition risk will materialise at some point in the future.

Finally, and most importantly, the size of future risks will be determined by actions taken now. The carbon we release today is creating the physical and transition risks of tomorrow. Climate change therefore represents the tragedy of the horizon: by the time it is clear that changes to the climate are creating risks that we want to reduce, it may well be too late to act.

So the question is not if these risks exist, when they will crystallise, or why central banks, supervisors and the financial sector should care. The question is how we can best manage them, especially in an uncertain world, where data may not be readily available, and where our technical capabilities are still developing.

In support of this aim, we have published reports on the impact of climate change on the UK insurance and banking sectors. We have issued proposals on how firms should enhance their approach to managing these risks – in particular to:

- embed consideration of the financial risks from climate change in their governance arrangements;
- incorporate the financial risks from climate change into existing risk management practices;
- use scenario analysis to inform strategy setting and risk assessment and identification; and
- develop an approach to disclosure on the financial risks from climate change.

The desired outcome is that firms take a strategic approach to managing the financial risks from climate change, taking into account current risks, those that can plausibly arise in the future, and identifying the actions required today to mitigate current and future financial risks.

Recognising that approaches to managing these risks are understandably immature, and that best practice will take time to develop, the Bank has established with industry participants a Climate Financial Risk Forum to help build intellectual capacity in this emerging field.

And importantly, while the Bank of England is playing a lead role, we are not alone. Internationally we have supported the work of the FSB Task Force on Climate-related Financial Disclosures. And we have been a founder member and work closely with what are now 28 partners in the central bank and supervisors Network for Greening the Financial System.

It is not for the Bank of England, as a financial policymaker, to drive the transition to a low-carbon economy. But we expect financial firms to manage these far-reaching, foreseeable, future financial risks today. The window for minimising these risks and ensuring an orderly transition to a low-carbon economy is finite and closing. And while the challenges are significant, it is better to be roughly right now, not exactly right later. This work could not be more important. ●



## Michael West

Managing Director, Global Ratings & Research, Moody's Investors Service

### Assessing ESG risks in credit analysis continues to evolve

The drive to reshape the financial ecosystem to appropriately reflect Environmental, Social and Governance (ESG) considerations and their long-term effects is not limited to redirecting capital flows and increased corporate disclosure. Assessing the credit effects of ESG is complex and multifaceted but is an important sub-element of the ESG initiative.

Take the credit exposure of environmental risks, for example. Moody's analysts have undertaken a comprehensive study to assess the exposure of 84 sectors globally - representing around EUR 65 trillion in rated debt - to environmental risks. From this universe, 11 sectors with EUR 1.9tn in rated debt have elevated credit exposure from environmental risks. These sectors have clear exposure to environmental risks that are either already material to credit quality or could be within the next three to five years. The most impacted sectors today include, e.g., unregulated utilities and power companies and the coal mining industry.

Other sectors show greater susceptibility to more direct environmental risks, such as natural and man-made hazards and water shortages. This includes, among others, central and local governments in developing economies, which will have to deal with the aftermath of extreme weather events and natural disasters or seek to prevent them by investing in climate adaptation and resilience measures.

That said, not all debt issuers will have the same degree of exposure. In general, companies that have the capacity to diversify product portfolios or assets away from exposed operations will be better positioned to mitigate environmental risks. For others, the transition to a low-carbon and climate-resilient global economy may present opportunities by offering consumers cleaner, more sustainable products and services.

Going forward, the broad adoption of the Task Force on Climate-related Financial

Disclosures recommendations would allow for a more discernible and comparable assessment of the relative credit exposure of rated entities to carbon transition risk. For instance, additional visibility into the potential financial effects of different warming and emissions scenarios would provide credit analysts with a toolkit to evaluate the potential impact on creditworthiness. Furthermore, broad access to harmonised metrics and targets, such as greenhouse gas emissions by scope or water use per unit of revenue generated, would facilitate a better understanding of an issuer's progress in managing and adapting to climate issues. It would also allow for cross-comparisons of the relative impact and performance of organisations in a given sector.

*"11 sectors with EUR 1.9tn in rated debt have elevated credit exposure from environmental risks."*

- MICHAEL WEST

The ability to effect change is not something the private sector can do alone. The significant policy intervention introduced through the Commission's action plan on financing sustainable growth is an important step in the evolution to better incorporate ESG factors into the workings of the financial sector. Moody's will continue to review its rating methodologies to incorporate new information and analysis that flows from the ESG disclosure and policy initiatives. ●

## Carlos Montalvo Rebuelta

Partner, EMEA Insurance Risk and Regulatory Leader, PwC

### The challenges around sustainability: turning need into a virtue

There is consensus that long term strategies of financial institutions must encompass value creation for all their stakeholders, rather than focusing only on shareholders. Indeed, customers and employees, but also Society, shall be part

of this win-win model, the only sustainable one. This is already the right starting point, isn't it?

Yet, the list of challenges remains high; let me focus on two I am concerned about: firstly, regardless of the long term focus that Sustainability embeds, progress has to be made already in the short term, with the risk of shifting means, such as incentives, into ends. Let me elaborate: Reorienting capital flows towards more sustainable investments, one of the objectives of the Commission Action Plan on sustainable finance, entails a risk: Whilst investing in "green" makes full sense, as it does an underlying taxonomy to help us all speak the same language, not all "Green" investments will make similar sense from a risk return view point, and regulatory incentives should not hide that fact if they want to be efficient. Beware this is an area where not only we



need incentives, including regulatory, but we cannot afford not bringing the right ones. Furthermore, focusing only >>>

>>> on regulatory incentives may be tempting, yet it will not give us a long term solution. Financial sector players must play a role beyond investing in green assets, by accelerating change in those entities they invest in. Yes, it can be done!

Secondly, the traditional approach to risk management has been over-reliant on past experience (rear mirror approach), and this will not work when it comes to Climate change, where once in a century is becoming the new normal. Here, the role of the regulator, "enhancing awareness" of risks stemming from climate change (e.g. via stress tests), must be combined with a holistic approach by the regulated entities, in terms of risk taking and managing, assets

holding and risk appetite, both for direct as well as transition risks.

*"Regardless of the long-term focus progress has to be made in the short-term."*

- CARLOS MONTALVO REBUELTA

There is another issue worth raising, due to its impact on people: the Protection Gap, and the fact that (counterintuitively) it has increased in the last 20 years, both in developing countries and in developed ones. This is an area of great opportunity

particularly for Insurers, let's not make it a lost one. An opportunity to put into value the delivery of the promise made, and one of enhancing resilience to Climate risk via management of claims, underwriting and pricing processes, making steps to reduce the probability and impact of the next catastrophe, thus better protecting people.

Let me conclude not with a message of optimism, but with a new idea to debate: Shouldn't we also focus, under an ESG agenda that is also Social, on Sustainability (and adequacy) of the Pensions model and the role of all stakeholders in order to ensure that people will live in dignity? Between you and I, this is a much bigger challenge! ●



## Eugenie Molyneux

Chief Risk Officer of Commercial Insurance, Zurich Insurance Group

### Integrating sustainability risks

At Zurich, to ensure our businesses are applying our purpose and values, we have a systematic and fully integrated approach to potential ESG risk and opportunity areas from a sustainability perspective. Particularly for Investment Management and Underwriting.

The Group Chief Risk Officer (CRO) acts as executive level sponsor for the Zurich's sustainable business framework with responsibility for overseeing its implementation and integrating sustainability risk into the overall risk management framework. Climate change

is a central pillar of the Group's sustainable business framework.

The Group Chief Investment Officer is responsible for execution of Zurich's responsible investment approach and climate change investment strategy.

Zurich assesses risks, including climate risk, systematically and from a strategic perspective through its proprietary Total Risk Profiling™ (TRP) process, which allows Zurich to identify and evaluate the frequency and severity of a risk scenario. The Group then develops, implements and monitors improvements. The TRP process is integral to how Zurich deals with change.

ESG positions relating to underwriting are generally reflected in risk appetite, product development, or updates to pricing for sustainability risks, which reflect trends in weather, and climate related risk, for example, assessment of natural catastrophe risks. Where appropriate these updates are reflected in our capital models and pricing models as a natural catastrophe load.

Overall, the Group considers its near-term (3 - 5 years) climate change-related risks to be manageable and foreseeable. The longer-term view (5 - 10 years) is deemed more relevant when considering the long-term sustainability of the organisation, and here risks are highly uncertain.

Today, any evaluation in relation to 'longer term' future physical climate impacts, is made with a significant uncertainty. Adding to that uncertainty is the relatively unknown climate risk adaptation actions of customers, governments or other bodies. To the extent those actions are effective at reducing the impacts from climate risks, then any expected future 'longer term' physical climate impacts may be mitigated.

The current Solvency II risk framework allows sustainability risks to be captured without needing to add their explicit specification.

*"Climate change impact valuations mean it would be premature to require any reporting in that regard."*

- EUGENIE MOLYNEUX

Further, we consider it unnecessary to make climate change related disclosures mandatory. The industry is in the process of adopting disclosures voluntarily. Disclosures can develop along with the further development of risk assessments.

Last but not least, the significant uncertainty surrounding climate change impact valuations mean it would be premature to require any reporting in that regard. ●

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# Review of the Solvency II long-term package



## Fausto Parente

Executive Director, European Insurance and Occupational Pensions Authority (EIOPA)

### Solvency II: a modern risk-based supervisory framework

The implementation of Solvency II, in January 2016, marked a shift in the way that solvency is assessed, moving beyond a purely capital-based perspective. Solvency II introduced new capital management and disclosure requirements. It also introduced governance and risk management as a central pillar of the framework. These requirements were designed to make sure that insurers are ready to meet their customers' obligations, under any circumstances, including extraordinary events such as a global financial crisis or a natural catastrophe.

Together, these new requirements have resulted in a more preventive and risk-based approach to solvency, which have increased the overall soundness of the insurance sector.

Insurers now have to consider and be prepared for all types of risk that they might face. Through tools such as the Own Risk and Solvency Assessment, the ORSA, insurers have significantly strengthened their governance models and risk management capacity. Boards now consider risk and capital factors in their strategic decision-making.

Enhanced reporting requirements have resulted in improved legibility, transparency, reliability and comparability of insurance companies' risk profile. The use of harmonised templates for supervisory reporting and the public disclosure of more information means greater transparency for the industry and is the basis for better market discipline.

More broadly, the Solvency II framework has modernised the supervision of the insurance industry, driving towards a consistent approach to supervision across Europe. Supervision is evolving towards a stronger and stronger evaluation of risk and risk management. Supervision is also evolving to take into account the increase in cross-border business.

Solvency II is not, however, 'one size fits all.' To reduce the burden on smaller insurers, the notion of proportionality runs through the regulation. This helps to ensure fair competition between insurance companies across Europe whatever their size.

All this means that consumers are better protected. Across Europe, consumers enjoy similar levels of protection, no matter where they are based or from where they buy insurance. Consumers can also have greater confidence in their insurance products, the insurers and the financial system as a whole.



>>> In the three years since the implementation of Solvency II, the insurance industry has better aligned capital to the risks it runs using a risk based-approach to identifying and managing risk.

For the legislation to remain effective, it must remain relevant and therefore the subject of regular review. From the outset, two reviews have been built into the Directive. The first review has already started. Last year, EIOPA delivered technical advice to the European Commission on the review of the Solvency Capital Requirement. The advice was based on an in-depth analysis of 29 different elements and focused on increasing proportionality, removing unjustified constraints to financing the economy and removing technical inconsistencies.

The second review, which will conclude by the end of 2020, will look at more broader issues so that the framework can be adapted to new market conditions, while maintaining the principles underpinning the risk-based regime and consumer protection. EIOPA will review issues related to long-term guarantee measures, illiquid liabilities, reporting and public disclosure requirements, supervisory tools and measures needed to reinforce the macro-prudential nature of Solvency II and sustainability considerations. Insurance plays an important role in Europe's economy. Assets represent a significant amount of the European Union gross domestic product; insurance companies employ large numbers of staff; and most citizens rely on some form of insurance as protection against unwanted or unforeseen events. The failure of any insurer brings with it the possibility of disruption to the provision of financial services, the economy and, of course, people's lives.

In its capacity as a European Supervisory Authority, EIOPA will continue to supervise the implementation of Solvency II and present recommendations for its improvement, so that consumers and businesses can continue to benefit from a well-functioning and stable financial system. ●



## Clément Michaud

Chief Financial Officer, Crédit Agricole Assurances

### Solvency II, facing the long-term investment challenge

2019 is a turning point for the future of European integration. Going forward, the responsibility of political and economic leaders is immense as we must collectively bring solutions to European citizens. Work on the delegated act of Solvency 2 was an opportunity for all stakeholders to carry out an initial assessment of the implementation of this Directive and to think about potential evolutions. The review of the Directive provides us with an opportunity to complete this process so that insurers can provide concrete solutions to address today's economic, financial and societal challenges.

The insurance sector has indeed a leading role to play in building a Europe that protects its citizens, and, at the same time, invests in the productive economy. The prudential framework must be adapted by credible proposals so that insurers can fully endorse this dual role.

The first challenge is to incentivize insurers (whose role is to assume risks) to invest more in diversified assets in order to provide savers with more yields. To achieve this, the risk framework should take into account the real horizon of their investments instead of systematically setting a penalizing cost of capital. The European Commission's >>>

>>> recent proposal on the long-term equity class goes in the right direction, but is not enough to fill the investment gap in companies' capital. The euro fund responds to citizens' need of having a guaranteed investment product and allows insurers to pursue a long-term investment strategy in the economy (equities, infrastructure, etc.). It is crucial in this regard to strengthen this financing tool, in particular within the framework of the Capital Markets Union project.

The second challenge is to ensure that the calibration of SCR calculation parameters is a process based on relevant impact studies, to anticipate their consequences for the financing of the economy. The case of the interest rate risk sub-module is very telling because it can easily disrupt the balance sheets of insurers, which are mainly composed of interest rate financial products. As a result, any change in the interest rate risk sub-module modeling would have significant consequences that could affect insurers' investment capabilities.

Another important challenge remains the fight against climate change, a key topic on which citizens expect political and economic leaders to assume their responsibilities. The insurance risk framework should indeed reflect the integration of climate risk into investment decisions. Building on discussions around a risk based Green supporting factor in the banking regulation, the pillar 1 of Solvency 2 could be amended to further encourage insurers to hold green assets and better take into account the risk associated with climate change. Green assets could be defined on the basis of a harmonized taxonomy that must be simple in order to allow efficiency and transparency in its application.

If we want to gain a comprehensive view of the factors for long-term investment improvement and volatility correction, accounting regulations should not be set aside. IFRS 9 is an international reporting standard which introduces a Fair Value classification and measurement of finance assets – the unrealized gains and losses of equity products are recognized either (1) in the P&L, which gives it a very high volatility, or (2) in non-recyclable OCI (no volatility but no performances). CAA has been applying IFRS 9 since early January 2018 and has been witnessing a very high volatility of its P&L – that we were able to correct with the “Overlay”. Without this transitional measure, we would have been forced to “de-risk” our portfolio. Thus, we think that the recycling of realized gains or losses should be reintroduced and required upon sale of the equity instrument as accumulated gains and losses in OCI are part of the performance of LT investments.

Finally, preparing the entry into application of IFRS 17, we realized in our simulations that our P&L is subject to a much higher volatility than under IFRS 4.

At Crédit Agricole Assurances, we believe that European insurers can play a leading role in meeting the challenges of a European Union that defends a model of sustainable, long-term and less volatile growth at the service of its citizens. Prudential and accounting regulations must, more than ever, strive towards these objectives. ●



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## Dr. Frank Grund

Chief Executive Director of Insurance and Pension Funds Supervision, Federal Financial Supervisory Authority, Germany (BaFin)

### Solvency II – our goals for the upcoming revision

You might ask: “Why is Solvency II already being reviewed just three years after it came into force?” The answer is quite simple: because this is what the Directive

states, requiring the Commission to review certain elements of Solvency II in 2020. This affects long-term guarantees and measures to counter equity risk, the calculation of the solvency capital requirement (SCR) using the standard formula and the advantages of enhanced group supervision, but also the appropriateness of reporting and the issue of “proportionality”. The Commission is now asking EIOPA for technical advice about these and other issues.

BaFin will play an active role and put forward its proposals in the working groups that EIOPA has established for this purpose. There are several issues that are of particular concern to me: for BaFin, it is imperative for insurers to continue to be able to offer >>>

>>> contracts with long-term guarantees. This requires that the necessary capital be calculated such that it is commensurate with the risk. Procyclical effects should therefore be avoided and appropriate account must be taken of the insurers' investments with a long-term horizon. I also think there is a considerable need for improvement with regard to the issue of "proportionality". We already use the scope available to us to the best of our ability. However, it is evident that the framework within which supervisors and undertakings are allowed to move here also has to keep pace with growing experience. Further opportunities for flexibility should be created. Supervisors must always be able to order a particular undertaking to comply with all the requirements on the basis of its risk profile. But I also see a need to simplify some of the reporting requirements and to reduce their scope. BaFin is advocating a tougher prudential reporting regime. We want to scrutinise all of the templates and ask

whether they are suitable for achieving the relevant supervisory objectives. If the answer is "No", they either have to be modified accordingly or removed. BaFin believes that reporting should be expanded in some areas.

*"It is imperative for insurers to continue to be able to offer contracts with long-term guarantees."*

- DR. FRANK GRUND

Once the work is completed, reporting should overall be leaner and more focused. I hope that we will win support for this work and that our idea of what the outcome should look like will be shared in the European context.

"Better is the enemy of good" also applies to the SCR. The standard formula

must be simpler without this negatively impacting risk sensitivity. This sounds rather like squaring the circle, but I also see some leeway here, for example in the simplification of the requirements for calculation modules that are not regarded as material. I also expressly support the recommendation by EIOPA to the European Commission to reassess interest rate risk. The current standard formula does not acknowledge negative interest rates and has thus become decoupled from both reality and the internal models. This imbalance must be removed. But I would also like to observe that the calculation of the solvency capital requirement may not be allowed to become the plaything of political interests.

To sum up, there are many issues that we will address actively with the aim of making the Solvency II rulebook more commensurate to the risk and giving it a more practical design. ●



## Tobias Bücheler

Head of Regulatory Strategy, Allianz SE

### An evolution of Solvency II to promote growth, effective old-age provision products and financial stability

With the recent call for advice on the 2020 review by the EU Commission, the further development of Solvency II has entered its decisive phase. The call includes amongst other key issues also an assessment of the volatility adjustment

as well as an analysis regarding the extension of macroprudential measures in Solvency II.

The review is performed against a background of large-scale discontinuation of traditional guarantee products and the rise of new products that push investment risk back to policyholders. The reassessment of bond spreads of some European countries during 2018 illustrated on the other hand strikingly the relevance of the supervisory framework from a macroprudential perspective.

While we believe that the upcoming regulatory reform should avoid to unravel Solvency II fundamentals, it should on the other hand consider the real risks and opportunities of long-term stable investing, remove unwarranted conservatism and carefully finetune Solvency II to address relevant risks.

More specifically, the role of the insurance sector as a stable long-term investor should be better recognized. The (life) insurance business model is by nature long-term and related long-term insurance liabilities can ideally be covered by long-term assets. As such, the most prominent risk is a potential asset default. In contrast, short-term market price fluctuations are largely irrelevant. Unfortunately, insurers are treated under the current Solvency II framework more like traders whose assets may have to be sold quickly to settle short-term liabilities. In contrast, insurers typically don't need to sell assets quickly as they receive liquidity from regular

premium inflows, yield and dividend income as well as maturing assets.

Solvency II acknowledged the issues above in principle with the introduction of the so-called Volatility Adjustment aiming to mitigate the impact of asset spread movements on the solvency situation of insurers thereby improving financial stability. Unfortunately, after more than 2 years of experience with the Volatility Adjustment one can only describe its impact as „too little, too unspecific“. It even introduces additional basis risk into the system if an insurer's portfolio does not fully match the reference portfolio set by EIOPA. In contrast, an enhanced Volatility Adjustment that acknowledges the insurer's actual investment portfolio (which is insulated from short-term liquidity needs) would much better reflect the underlying risk assuming that related default risk is recognized in capital requirements and relevant prudential limits are observed.

We believe that economy and society would benefit from an improved Volatility Adjustment twofold: Firstly, it would enable the sector to invest more into long-term assets matching its liabilities. This would support growth of the real economy while at the same time allowing the provision of more effective old-age provisioning products. Secondly, it would reduce pro-cyclicality thereby enhancing financial stability and possibly even reduce the need for any further macroprudential measures for Solvency II. ●



## Lionel Corre

Deputy Director Insurance  
Division, Ministry of Economy  
and Finance, France

### It is time to take stock of our regulations to foster long-term investment

After years of negotiations, Solvency II came into effect on January 1st 2016. Stakeholders generally agree that this new and sophisticated prudential framework significantly improved the soundness of the insurance sector.

Solvency 2 is based on the assumption that insurers should, on a fair-value basis, resist, in the year to come, to shocks that statistically happen every two hundred years. This very well depicts the situation of an insurer that would actually have to deal with those shocks on a short-term horizon, selling assets in stressed situation in order to be able to cope with its liabilities.

However, this approach has drawbacks. The main one is that it does not reflect the specificity of long-term investments detained by insurers, which are not expected to be sold, even in stressed situations.

Due to their business model, insurers are very well adapted to such long-term investments, and the prudential framework should not discourage the financing of our economy as long as those insurers are able to prove that they are not exposed to realize the losses

calculated in the one-year shock. This is a question of paramount importance for the European economy, which we tried to address this year in the level 2 review, by creating a new asset class for long-term equity investments. This new approach of equity investments is a step in the right direction. Beyond, there is still room for improvement and we will have to go further on this issue with the other co-legislators, notably within the level 1 review.

Such a reform of the prudential framework would need to be accompanied by a broader review of the regulations applying to insurers in order to be effective. For instance, the accounting treatment of equities can create various disincentives to hold this type of assets and can even discourage to have them at all. The current impact studies on IFRS 9 are important in that regard.

We will need to draw conclusions from the results from a public policy perspective, as we do not want the accounting rules to hinder the impact of what we improved on the prudential framework.

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*"Due to their business  
model, insurers are very  
well adapted to such  
long-term investments."*

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- LIONEL CORRE

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As a national regulator, and European co-legislator, our mandate is also to protect our consumers and policyholders. This is why we have to take action after what we experienced in 2018 with a multiplication of collapses of cross-border businesses.

Freedom of provision of services is a pillar of the single market and a chance for Europe. But if we want to preserve it, we need to make sure that the supervision of cross-border businesses is efficient.

The policy holders should benefit from the same level of protection regardless of the origin of their insurers, which can be achieved only with a fair and equivalent supervision across Europe. This is why we issued proposals in the ESAs review package, together with other member states and with the support of the European parliament.

This topic should be a matter of priority for the coming years. ●

## Jean-Jacques Bonnaud

EUROFI

### Enlarging the capabilities of the insurance sector to invest in equity



The insurance sector is by far the main long-term institutional investor in the EEA. However, paradoxically its contribution in this area has been reduced by nearly 50% since the beginning of the financial crisis in 2007, although the EU economy shows under investment in long-term projects, including notably infrastructure ones and SMEs, contrary to what has happened in the other countries of the O.E.C.D.

The consequences of this trend on the financing of the EU economy are aggravated by the fact that banks in the EU - which provide 80% of the financing of these investments - are constrained by stricter capital requirements to better optimize their risks.

This is the general rationale of the CMU Project of the Commission, which seeks to enlarge the relative contribution of financial markets to the financing of the EU economy. However the last round tables organized by Eurofi - and notably the one in Vienna (September 2018) - have shown that the evolutions of prudential rules for the insurance sector, as featured in Solvency II, though they have improved its risk management and governance, >>>

>>> did not allow the insurance sector to increase its contribution and even according to surveys conducted by the industry showing that it is the opinion of roughly 50% of Eu insurance undertakings, had negative effects.

In particular equity financing seems penalised by the pressures of the capital charge of the standard formula, despite the context of a long-lasting period of low interest rates, deepening investment needs resulting from raising climate-related risks in the economy.

Some of the recommendations of the panellists have since been adopted in the new proposals of the Commission regarding the 2018 review of L.T.G. measures of the Solvency II, open to consultation until 7 December.

In particular the capital charge regarding certain equity investments for specific ring-fenced portfolios encompassing certain unlisted equities, are reduced from 39% and 49% to 22%. This specific treatment is subject to the criterion of an adequate diversification and thorough credit risk assessment of the investment portfolio. The proposal also includes regulatory reliefs for exposures to regional governments and local authorities. These would be concrete and effective measures.

A new review of Solvency II is programmed by the commission for 2020, and a request for advice has been recently submitted to EIOPA for the end of 2019. In this respect according to Insurance-Europe the review should in particular address the fact that currently the regulatory framework treats the insurers as if they were short term traders, although their specificity is precisely that their underwrite long term liabilities matched with long term assets consistent with their Asset And Liabilities Management (ALM) policies.

Another important point to address in parallel, is the undue pressure on the insurers coming from the accounting standards and the mark to market obligations for the evaluation of their assets, be they long-term nature resulting from the fact that they will be sold according to the long-term maturity of their liabilities. In this respect the industry has insisted on the validity of the comments made by the European Financial Reporting Advisory Group (EFRAG) to the International Accounting Standards Board regarding the evolution of the IFRS 17 accounting standard.

There is thus a crucial opportunity to simplify and adjust the rules without losing of sight the need to protect appropriately policyholders. ●

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# V. DEVELOPING EU CAPITAL MARKETS

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## Issues at stake

Developing capital markets in the EU is essential for providing businesses with additional sources of financing and better connecting savings with increasing investment needs. Financing needs are also changing, notably in the CESEE region, with more emphasis on innovation and intangible assets that are difficult to finance via traditional bank credit.

The Capital Markets Union action plan comprises a wide range of measures aiming to further develop EU capital markets. These are however still in the process of being implemented. A review of the progress made is needed in order to identify whether additional actions or a different approach are necessary in certain areas. One of the main challenges is making sure that all the vital components of an efficient EU capital market are in place and that an appropriate balance can be found between EU-level integration and the development of local ecosystems.

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# Future of securitization in the EU



## Edouard Fernandez-Bollo

Secretary General, Autorité de Contrôle Prudentiel et de Résolution (ACPR)

### A robust EU securitisation framework that remains to be fully finalized

The new EU simple, transparent and standardised (STS) framework paves the way for a strengthening of investors' confidence in the securitisation market and in turn for a relaunch of the latter. Indeed, it is designed to fix the main deficiencies identified in the prior framework.

The Securitisation Regulation (Regulation EU 2017/2402) establishes a set of criteria which must be met by all securitisations and also defines what are 'STS' securitisations, while the targeted amendments to CRR (Regulation EU 2017/2401) set out a framework for a more risk-sensitive regulatory treatment of exposures to securitisations and a preferential treatment for those complying with the STS criteria. By providing clarity, enhanced regulatory requirements and the right incentives, this regulation will improve efficiencies in the financial system and offer additional investment opportunities. Safe securitisation is useful for financial actors but also for the financing of the economy.

Indeed, the crisis highlighted several weaknesses within the previous framework. They were, among others, related to the calibration of risk weights and a lack of incentives for good risk management. These flaws have been translated into specific objectives that the revised framework has sought to achieve, therefore creating a simpler, more transparent and more standardised approach for securitisations. Among the most significant revisions are the reduction of the automatic reliance on external ratings and the enhancement of the risk sensitivity of the securitisation framework.

Yet, in order to be fully implemented within the Union, the revised framework must be completed by technical instruments, some of which are still to be published.

The revised framework is applicable since 1st January 2019. For the securitisation framework to be fully finalised, the Commission and the ESAs must still provide the market with a series of technical texts including several necessary guidelines and technical standards, relating for instance to risk retention, homogeneity, disclosure or interpretation of the STS criteria.

Despite the dedication of the teams of the ESAs involved in the process, complying with the deadlines set out by the legislator has proved to be challenging. The uncertainty about the content of the standards may limit the relaunch of the EU securitisation >>>

>>> market on the short term but one can be confident that in the medium term (hopefully before end 2019) these issues will be solved.

Work is still in progress regarding the harmonisation of the concept of significant risk transfer (SRT) and the potential development of a framework for STS synthetic securitisations.

Synthetic securitisations have been mostly excluded from the STS scope (apart from certain senior positions in SME securitisations under specific circumstances). Yet synthetic securitisations can be executed promptly and, through an improvement of the credit risk position of the originators, help their ability to support the financing of the real economy. The EBA shall publish a report on the feasibility of a specific framework for STS synthetic securitisation, limited to balance-sheet synthetic securitisation: the analytical work to come will be most interesting.

Above all, the EBA has been mandated to treat the overall subject of SRT. If SRT has been put on the back burner following the implementation of the revised framework, the subject needs to be further scrutinised, in light of the responses to the Discussion paper that was published in September 2017 by the EBA on this theme. Further analysis at Basel level would also be desirable to achieve a harmonised global framework on SRT, considering the importance of this concept on the overall economics of the transactions.

The completion of a global and comprehensive approach to securitisation still remains challenging but nevertheless the Europe has made good progress. The entry into force of the STS framework is already an important step towards both a safer and well-functioning (therefore actively funding) securitisation market. ●



## Philippe Bordenave

Chief Operating Officer, BNP Paribas

### Relaunching securitisation in Europe: where do we stand?

For some years after the financial crisis, European policy makers have considered securitisation as one of the main source of the crisis, not differentiating between the US and Europe, although default rates in European securitised assets resisted much better than US ones. Securitisation is only as good as the underlying asset pool... "Garbage in, garbage out!"

ECB, Bank of England<sup>1</sup> and Banque de France<sup>2</sup> were the first in 2014 to call for a revival of securitisation, to rebalance the financing of the European economy which may be dried up by the progressive roll-out of restrictive bank regulations. Securitization hence became an essential building block of the Capital Market Union.

The concept of "Simple, Transparent and Standard" securitisation was coined by EBA in 2014, and was welcomed by the industry, as there were few, if any, criteria which would not make sense from a risk management standpoint. However, the EBA proposal paved the way for slippage in the regulatory design, as (a) many criteria were expressed in a subjective manner, which led to further conservatism throughout the process, (b) the criteria did not differentiate between types of securitisations (cash, synthetic, ABCPs, public vs private,...) leading to some impracticable requirements, and (c) capital charges for originators and investors remained punitive, with an intended "non-neutrality" between capital required before and after securitisation. Actually though, apart from the legitimate layer of

>>> operational or counterparty risks that are created by securitisation, the credit risk of the underlying pool is the same, whether securitised or not, and such “capital neutrality” would be necessary for a sound market to develop, where offer and demand can match.

Not only those comments were not heard, but the political debate added even more conservatism. As the STS legislation enters into application in 2019, we are now facing, in the real life, the issues raised 5 years ago! There should be no surprise that the market is not taking off...

For originators and for investors, the STS framework introduces so many regulatory and operational constraints that, instead of reviving the market, it may rather further disincentivize securitization issuance. Indeed, issuing a STS securitisation is extremely demanding, with limited benefits in cost and capital, and major liabilities if some of the 100+ criteria may prove to be unmet. And issuing non-STS securitisation has become more costly.

Contrary to the growing US market, the European securitization market never recovered from the crisis, and issuance remains at half of the already low pre-crisis level. It has even continued to decrease in 2018 and since the beginning of 2019. If Europe wants to constrain the size of banks, like in the US, and substitute it by the development of a securitisation market, like in the US, it should go without saying that we should be inspired by the way the US market works: investor confidence relies on scoring rules defined by the GSEs, which allows to issue low rate securities and organize the transfer of conforming mortgages to investors via securitisation.

In Europe, long term savings are abundant, housing loans are high quality, and we have supranational institutions active in the debt market, and competent to buy/enhance credit portfolios. What we miss is a true willingness to develop capital markets, which continue to inspire mistrust to regulators and supervisors as in 2009.

But then, we must make a choice: constraining both the size of banks and the functioning of markets is highly detrimental to the capacity to finance European growth recovery. ●

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1. «The impaired securitisation market: Causes, roadblocks and how to deal with them», March 2014.
  2. See for instance the French ESNi initiative, April 2014.
- 



## Alexander Batchvarov

Head of International Structured Finance Research,  
Bank of America Merrill Lynch

### EU securitisation market still awaits regulatory clarity and level playing field

EU securitisation market is in a wait-and-see mode. The delays in the finalisation of the EU securitisation regulations, the remaining grey areas in their scope and implementation, and the regulatory complexity have significantly delayed the re-launch of the European securitisation – a key EU CMU initiative. They, in conjunction with the loose harmonisation of covered bond regulations, have further tilted the playing field against traditional cash securitisation market recovery in the EU, in sharp contrast to the post-financial crisis market developments in the US, China, Australia and Japan.

To illustrate: in the first six weeks of 2019, EU RMBS issuance was a mere €0.7bn, only one deal from the UK and mostly placed in the US, while EU benchmark covered bond supply reached €45bn, a 30% growth over the same period of last year. Even the

>>>

>>> total (including CLOs and corporate sectors) securitisation supply ytd of €5.5bn pales in comparison with the covered bond market new issuance. On the positive side, the placement of the small EU securitisation issuance is mainly with non-bank investors, thus dispatching credit risk away from the banking system and improving market transparency. Disconcertingly, half or more of the covered bond placement is exchanged between bank issuers, raising questions about interdependence and systemic risks in the EU banking system. Covered bonds are the funding instrument choice for banks, while bilateral synthetic risk transfers are their choice for risk capital management. This is at the expense of the transparency and liquidity of the broader fixed income markets in the EU.

Many challenges still cause consternation on the EU securitisation market. Among them is the question of the extra-territorial application of the EU securitisation regulations to non-EU investors managing money for EU based investors in non-EU securitisation markets and to non-EU based issuers marketing non-EU securitisation deals to EU-based investors. Another question is whether there is a differentiation in the scope of disclosure for public, private and bilateral securitisations. Yet another challenge is the application of SRT requirements which are goldplating the current SRT regulations. A further and lasting problem is the disparate treatment of securitisation exposures between banks and insurance companies for regulatory capital purposes and the large regulatory capital differential between STS and non-STS securitisations under Solvency II. Yet another one is the large discrepancy in liquidity treatment of residential mortgage covered bonds (Level 1B) and prime residential mortgage securitisations, qualifying for STS, (Level 2B). All these issues underlie the systemic and liquidity risks that we highlighted above, and distort markets' level playing field.

These challenges need to be addressed sooner rather than later. One necessary step is the coordinated guidance by ESAs on securitisation matters; the set-up of a joint securitisation subcommittee will not be a sufficient step if such committee cannot clarify and resolve conflicts in regulatory texts. Another step can be a clear differentiation among markets and regimes for deal execution on the example of the US: a (SEC-) registered deal, a deal for qualified institutional investors (144A) and a private placement deal. Another useful reference to the US securitisation regime is the reduced regulatory overreach especially as it concerns qualified institutional investors and private placements. Building a framework for STS synthetic securitisations is important, but their execution will be dependent on resolving some broader issues such as SRT and disclosure regime. Clarity is also needed on SRT for NPL disposals and securitisations in order for securitisation markets to help address the backlog of non-performing loans in Europe. A useful tool to borrow from Australia, Canada and the UK regulations to level the playing field between covered bonds and RMBS, and reduce the system risk and interdependence among banks is the introduction of asset encumbrance limit for covered bonds at low single digit levels. ●



## Felicia Stanescu

Head of Policy Definition and Coordination, DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

### A more secure path ahead for EU securitisation

Reviving the securitisation market on a sound basis with a view to strengthen banks' ability to finance the economy, provide additional funding sources for companies, and enhance private risk sharing is among the key building blocks of the Capital Markets Union.

To this end, following negotiations with the European Parliament and the Council, the new securitisation framework was published at the end of 2017 and entered into application on 1 January 2019.

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>>> This initiative aims to revive the market in several ways. Firstly, it establishes a clear and consistent legal framework, thus ensuring clarity for all parties involved. The harmonised regime includes common rules for due diligence on investors, risk retention, transparency, credit standards as well as a ban on re-securitisation.

Secondly, the Securitisation Regulation creates a new asset class of high-quality structures – Simple, Transparent and Standardised (STS) securitisation. The STS product has high standards for the manufacturing process, legal certainty and comparability across securitisation instruments. This aims to facilitate the issuance of securitisations by originators and sponsors as well as the due diligence process by investors.

A set of regulatory and implementing technical standards are being developed in order to specify the details of the revamped securitisation framework and ensure its clarity and consistent application in order to achieve the policy goals.

Finally, the prudential treatment for the major investors, banks and insurance companies, has been amended in order to establish a closer relationship between the riskiness of a securitisation and the prudential capital required. This aims to further incentivise the development of the STS market.

Securitisation issuance in the EU has not bounced back after the financial crisis in the same way that it did in other developed markets across the globe. The new EU securitisation framework addresses the key deficiencies of the past – regulatory inconsistencies across the EU and the flawed pre-crisis “originate-to-distribute” business model that also led to a significant investor stigma towards securitised products thereafter.

The regulatory efforts are geared towards creating a solid and sustainable footing, on the basis of which a safer securitisation industry can grow. The European Commission and the European Supervisory Agencies will closely monitor market developments and take action, as appropriate, in order to facilitate the transition to the new regime. ●

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Contributor: Presiyan Petkov, DG FISMA, European Commission

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# Investment firm prudential regime



## Adam Farkas

Executive Director,  
European Banking Authority (EBA)

### The investment firm prudential regime: proportionality, risks and competition

The set of regulatory reforms related to the Basel 3 accord were tailored to credit institutions and driven by micro-financial considerations as well as financial stability concerns. However, the European Union's transposition of the Basel accord applies to all the institutions subject to the CRR and CRD, which includes credit institutions and investment firms authorised under MiFID.

Since these investment firms are not part of that international agreement, it is fair to recognise that their services, activities and business models were not the main drivers of those reforms. This raised the question on whether the prudential requirements of the CRD/CRR would have been still suitable for investment firms in the medium and long-term.

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*"Prudential regulation for investment firms will be simpler, tailored, easier to implement and maintain."*

- ADAM FARKAS

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In order to explore that question further, the European Commission asked the EBA to consider whether the current prudential regime would be disproportionate for investment firms and, if necessary, to propose alternative approaches. The EBA, in close collaboration with central banks, prudential supervisors of investment firms and ESMA, carried out a sequence of detailed analyses in order to identify those areas.

Surprisingly for some stakeholders, the EBA identified only a handful of investment firms for which the CRR would have been appropriate in the future; these investment firms are usually very large subsidiaries of non-EU banking groups that are usually GSIs. Since they do not hold deposits for their clients or provide lending, these investment firms may operate in the EU under a MiFID license. However, the size and complexity of these investment firms makes them more similar to investment banks, and therefore the banking prudential framework remains well suited. Furthermore, as these large and highly interconnected investment firms are in direct competition with credit institutions, that would ensure a level playing field.

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>>> For the large part of other investment firms, however, systemic risk considerations are less predominant and deposit-holders' protection is not at all applicable. Therefore, the EBA recognised the need to completely separate the prudential regime of investment firms from the one for credit institutions. The proposed regime uses key metrics, such as total assets under management or daily trading flows, to identify the risks posed by these firms, which are not well captured in the existing banking framework.

Among the benefits that such separation would have, one is that a dedicated regulation for the prudential requirements of investment firms would be simpler, tailored to that type of business and, overall, easier for the investment firms to implement and maintain over time without, for example, having to monitor technical standards or guidelines not applicable to them.

Nonetheless, a failing investment firms poses risk to customers and to the markets where they operate. Therefore, the EBA recommended that all the investment firms should be subject to going-concern and gone-concern capital requirements, but under a simpler regime.

Similarly, because of the risks to customers and markets, other aspects such as liquidity requirements, concentration limits, risks arising from trading activities, reporting and disclosure requirements were deemed essential for ensuring a healthy environment for investors when relying on these services.

At this juncture, the development of the finalisation of the Level I regulation and directive seems to be at its final stage and it is likely that the ball will go back to the EBA who will have to develop technical standards, guidelines or reports in a broad range of areas.

Since this phase will require a few years to be completed, with a staggered publication of the various documents, the EBA commits to ensuring quality, full transparency and timely information to stakeholders. To this end, the EBA plans to disclose its envisaged workplan before the end of the year and accompanying any publication with public consultations. ●



## Mario Nava

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

### Review of prudential rules for investment firms

Investment firms are important market intermediaries. They give investors access to capital markets by providing investment services, ranging from investment advice to underwriting and dealing on own account.

There are over 6,000 investment firms in the EU. The sector is diverse, both in terms of the scale and scope of services they provide. The large majority of firms are very small and concentrate on a limited range of services. However, there is also a small number of big firms that provide a broad range of services, resulting in them being systemically important. These make up around 80% of total assets.

Investment firms are subject to EU rules governing their conduct on the markets in which they operate set out in the regulation and directive on markets in

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>>> financial instruments (MiFIR, MiFID II). They are also subject to prudential requirements, set out in the regulation and directive on capital requirements (CRR/CRD IV).

The decision to subject investment firms to prudential requirements stems from the early 1990s, when legislators considered that if these firms were to operate on the internal market, then they needed to be prudentially sound. Legislators also wanted to ensure a level playing field in prudential terms with banks, who may provide the same services. They therefore incorporated investment firms into the banking prudential regime.

While this regime was sufficiently general to incorporate these different business models at the time, it has become more problematic since. In particular, in the wake of the financial crisis, the prudential supervision of banks have rightly become significantly strengthened both in terms of “scale” (quantity and quality of capital) and “scope” (also addressing risks in terms of insufficient liquidity buffers and excessive leverage). While appropriate for banks, this would result in a disproportionately strict prudential treatment of investment firms. Unlike credit institutions, investment firms do not accept deposits, nor do they provide loans on a significant scale.

This means that they are less exposed to the risk of depositors withdrawing their money at short notice and of borrowers failing to pay them back. To address this, legislators have over time put in place a number of dedicated regimes within the banking prudential framework. However, this has resulted in a complex framework that is unevenly applied across the internal market. It has therefore become more costly for investment firms to comply with these rules.

The Commission proposals adopted in December 2017 acknowledge that the broad diversity of investment firms in terms of scale and scope of services provided merit a differentiated prudential regime. Building on EBA advice, the Commission therefore proposed to divide the investment firm population into three different classes and to tailor the prudential regime applying to each.

The largest firms with assets above EUR30bn (class 1) have business models and risk profiles that are similar to those of significant banks. Given their size and systemic importance, they present a risk to financial stability. The regulatory framework for banks is the best equipped to deal with these risks. These firms should hence be regulated and supervised as large banks.

The remaining investment firms would be lifted out of the bank prudential framework and instead become subject to a dedicated prudential regime. The larger of these (class 2) would become subject to a new prudential regime structured around so-called “k-factors”. These aim to ensure that class 2 firms are able to absorb losses by setting capital aside to cover the main risks they face as a result of the services they provide to customers and by virtue of operating on capital markets. By contrast, the smallest investment firms (class 3) would only have to set aside sufficient capital to ensure that they could be wound down in an orderly manner in case of trouble.

The Commission proposals also revise the conditions governing third country firms’ provision of services in the EU. MiFIDII/MiFIR provides a framework under which the Commission may take a decision to recognise a third country’s prudential and market conduct framework as equivalent to EU rules for certain types of activities directed at professional clients. As the proposals change the EU prudential rules for investment firms, the equivalence test had to be adjusted to include these new rules. In addition, the Commission proposed other changes, including a more detailed and granular assessment of countries from which service provision is likely to be of systemic importance.

The European Parliament adopted its negotiation mandate in September 2018 and the Council followed suit in January this year. The co-legislators reached a provisional political agreement on 26 February. ●



# Jérôme Reboul

Deputy Assistant Secretary for Banking Affairs, DG Trésor,  
Ministry of Economy and Finance, France

## A regulation whose effects will have to be monitored closely

The definition of an appropriate prudential regime for investment firms is key to ensure the financial stability of the Union. From the start, France has been supportive of the objective of the Commission's proposal to tailor and streamline the prudential regime applied by some of these firms which contribute positively to the financing of the European economies, having in mind the Capital Market Union (CMU). However, it is unfortunate that the envisaged new rules are, in some respect, less prudent and risk sensitive than existing CRR rules for similar business lines. In our view, this could create competitive distortions and level playing field issues, as a credit institution and a class 2 investment firm carrying out the exact same activities on the exact same scale might face different own fund requirements. Besides, as of now, class 1, designed for systemic and bank-like investment firms above 30bn€ in balance sheet, is empty in the EU27. The introduction by legislators of a "class 1 minus" (above 15bn€) will ensure that large investment firms, that take risks directly on their balance sheet, will apply sound and robust standards.

Moreover, changing the definition of credit institutions to include class 1 investment firms, instead of amending the Single Supervisory Mechanism's Regulation, may have unexpected side effects (access to Eurosystem operations, access to Single Resolution Fund, disruption of the application of the "conglomerates" Directive). A thorough follow-up of those possible side effects will be necessary as they could also introduce competitive distortions. For example, class 1 firms turned into credit institutions would gain direct access to the Single Resolution Fund (SRF), while having contributed very little or even nothing at all, creating moral hazard.

As regards the third country regime, we need to make sure its implementation preserves the stability and integrity of European markets and the need for a level-playing field between market players.

The initial MIFID/R third country regime was in no way satisfying on that point, since it would have merely allowed third country firms to act under an equivalence decision on the EU financial markets without complying with rules equivalent to those of EU law. This would have resulted in a loss of sight for European regulators, leading to the defeat of core MIFID/R principles, such as pre and post transparency or trading obligation.

The initial proposal of the Commission addressed the risk of legal divergence by making sure the equivalence assessment would be more granular and could be reviewed periodically. To facilitate this decision by the Commission, the final compromise allows equivalence decisions not to cover all financial activities and services. Even though the final agreement calls for a dedicated reporting for systemic activities, one can argue that equivalence is still unfitted for bank-like actors, which may pose a systemic risk for the EU markets. When drafting the equivalence decision and designing the specific operational conditions, the Commission and the supervisors will need to be vigilant on systemic risk. The specific operational conditions will also play a crucial role in avoiding competitive distortion between EU firms and third country firms.

Only practice will tell us whether our efforts to shed light on supervisory blind-spots will prove enough. ●

# Developing and connecting securities ecosystems



## Jesper Berg

Director General, Danish Financial Supervisory Authority (Finanstilsynet)

### Pension reforms are the key to unlock the true potential of the CMU

The Capital Markets Union (CMU) is one of Europe's flagship projects and it has been a long-standing priority for the EU. That is for a good reason as the CMU's overarching objective is to create a financial ecosystem which supports Europe's businesses in flourishing, offers new opportunities for investors and savers and makes the financial system more stable and resilient.

No doubt that there have been some early successes for the CMU. The introduction of a new framework to reinvigorate securitisation markets and reforms of prospectus regulation were a promising start. However, more is needed. The CMU can never be a game changer without enough long-term savings as they match firms' long-term funding needs.

It naturally makes one look at the pension savings and life insurance funds. They make up a significant amount which could boost long-term investments. In the euro area, pension funds hold assets of almost € 3 trillion. Adding insurance companies (both life, property and casualty), the number grows by another € 8 trillion. Pension funds and life insurance companies would also benefit by having more long-term investments giving the similar maturity as their liabilities.

Hence, there is symbiosis between investing to generate competitive long-term returns and funding the investments that generate real economic value for future generations. Pension reform is the key to unlocking that symbiosis and developing capital markets in the EU.

Furthermore, if reforms are made the right way, they could also help to cure a severe headache for future generations. Most European countries have large future pension liabilities challenging the sustainability of their public finances. It partly reflects the heavy reliance on pay-as-you-go pension schemes. The power of such schemes depends on workers outnumbering seniors, i.e. on population growth. However, the tide is changing, and in most European countries there is an urgent need to build up a funded pension system. If politicians solve this problem correctly, it could also create the instruments to truly create a capital markets union.

There is already a trend away from traditional pension products. Products that resemble asset management products replace defined-benefit products. On the one hand, >>>

>>> this makes sense. Defined-benefit products have become too expensive in terms of the companies' capital needs, or alternatively offer too little capacity to take risk and thereby generate a better return in the long run.

The commitment of pension funds to their customers in such a regime would be looser than the commitment in traditional defined-benefit products. The advantage would be that the expected return – and thus future pensions – would be higher, as pension funds move their investments out on the risk curve. The disadvantage is that returns and pensions could be lower. This is important, as pension and life schemes produce the basic income of people who have little opportunity of other income.

Hence, politicians will have to decide on the outer limits for risks that are acceptable to the basic income of pensioners. Pension and life companies should be required to define their objectives in relation to generating basic income and the risks to which their investment policies expose these objectives. Supervisors will then have to supervise the consistency between the investment policies of pension funds and their objectives, in terms of return and risk.

A last observation a decade after the great financial crisis is that a well-functioning capital market based on long-term savings may provide a robust supplementary source of funding to bank lending. Hence, it may act as Allan Greenspan's famous spare tire for the economy helping to minimise the costs of the next financial crisis. This is important as the last crisis revealed the costs of having a bank-dominated EU financial system. ●

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## Hank Erbe III

Global Head of Strategic Relationship Management & Public Policy,  
Fidelity International

### Developing stronger SME market ecosystems in the EU

With two thirds of the EU working population employed by Small to Medium Enterprises (SMEs) there is a clear case for safeguarding the global competitiveness of this sector in particular. This in turn relies on ensuring that SMEs continue to find the funding they need to grow.

Robust new issuance of SME securities and the maintenance of healthy and liquid secondary market become vital for job creation and economic growth, especially against the backdrop of a decline in bank lending to SMEs.

And yet extreme fragmentation of the financial services landscape, and the ongoing reliance that SMEs have on bank rather than market funding, continue to be key concerns. Four years on from its launch, and with the end of the Juncker Commission approaching, obstacles to successful implementation of the Capital Markets Union (CMU) Action Plan still remain and still require policymakers' attention.

One policy objective should be more diversified sources of market funding for SMEs. Diversification increases competition and improves financial resilience. As things stand, however, the significant cost of public listing combined with the abundance of private equity has significantly extended the reliance SMEs have on private capital and bond financing. This not only concentrates market funding but does so into two channels that proved particularly susceptible to disruption during the financial crisis.

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>>> Regrettably, with a notable exception of Nasdaq Nordic North, EU27 listing markets for SMEs remain relatively small. With the largest and well-established SME equities platform - The LSE's Alternative Investment Market (AIM) - pending departure from the EU market, the near future for SME ecosystems is challenged.

Then there are the impacts - albeit unintended - that MiFID II seems to be having on the trading of issued SME securities. To take two examples, as feared, brokers do indeed seem to be cutting back on the research coverage they give to SMEs in particular; while market makers are reporting that they are finding it harder, more costly or both to generate liquidity pools under MiFID II trading and disclosure rules.

One could make several recommendations to address such challenges, from tackling structural inefficiencies to alleviating regulatory burdens to creating an interlinked pan-European network.

For our part, we continue to recommend the Commission to refresh the CMU agenda by creating a Task Force focused on IPO reform and subsequent trading conditions for SME securities in particular. Such a force should be comprised of professionals representing the entire ecosystem of SME capital formation - venture capitalists, institutional investors, experienced CEOs, securities exchanges, regulators and capital markets bankers. And its aim should be to provide recommendations for restoring effective access to the public markets for emerging, high-growth companies.

We believe that opportunities exist to introduce innovative FinTech into the issuance process, for example. But also, to make changes to existing rules to bring the existing regulatory structure (MiFID II) in line with current market realities (leadership trading platforms such as Euronext and NASDAQ OMX).

Both types of intervention would help re-establish access to the public capital that SMEs need to hire new employees, develop new products and grow innovative businesses in home markets and globally.

We would also recommend the creation of a pan-European network for capital market infrastructure. The deep pools of capital within the UK and Swiss markets simply cannot be ignored if the EU's CMU initiative is to take effective flight. Although the political climate may lean against the adoption of such proposals at this precise moment, as the dust settles policymakers will ultimately need to re-centre debate back onto the best interests of Europe's SMEs and savers alike.

If the CMU's ultimate objective - to "strengthen the European economy and stimulate investment to create jobs" - is still valid then we should start thinking realistically about its delivery. ●



## Carmine Di Noia

Commissioner, Commissione Nazionale per le Società e la Borsa (CONSOB)

### Building a financial ecosystem: some clues from Italian experience

An ecosystem is a community of living organisms in a particular environment that interact as a system. The efforts of the past years at European and national level

have certainly developed the European financial ecosystem.

The EU regulatory framework reached a commendable level of technical advance, under the CMU umbrella, aimed at boosting the ability of all businesses to access different sources of market-based financing, while keeping investors protected. In addition to the proper environment (rules and markets infrastructure), there is also a striving community of living organisms (companies and investors). What we need to work out is how all these players interact with each other.

In this sense, Italy represents an interesting point of observation.

Italy has many vibrant and dynamic companies. Net wealth of investors >>>

>>> remains stable and a significant portion of the financial wealth is held by affluent and sophisticated investors. Where we lag behind is the (historical) reluctance toward market-based financing, experienced on both side of the equation (companies and investors).

In recent years, Italian policy maker has undertaken important initiatives to strengthen capital markets. These include individual saving plans, the mini-bond market framework and the allowance for equity capital. It is also worth mentioning the ELITE project, a training program for unlisted SMEs provided by the Italian stock exchange.

Thanks to that, capital market is becoming an increasingly important source of funding for Italian companies, who have realized the importance of developing

alternative financing options and the danger of relying excessively on bank lending.

What remains to be done? By way of example, consideration should be paid to the following priorities:

1. Regulatory simplification. Regulation should be perceived as an asset, not a liability. Therefore, it is crucial to fix some unintended consequences of current regime and devise friendly regulatory environment. Two examples: imposing the same disclosure obligation of companies listed on regulated markets to those traded only on MTFs (even when issuing only a minibond of 1 million) may have the unintended consequence to squeeze SMEs out of the market. The currently disclosure regime set forth in the market abuse regulation (MAR) should be confined to regulated markets alone and should not apply to

MTFs. Secondly, prospectuses concerning securities issued by SMEs should be replaced with lighter documents reporting a limited set of key information items.

2. Develop a focused investor base. "Ad hoc" investors need to be developed. SMEs funding, for instance, should be boosted by favoring specialized instruments, as it has been the case for years in the UK: in this way, savers and institutional investors may invest fully aware of their illiquidity which is a feature, not necessarily a flaw. In this regard, one of the suitable instruments to be favored is ELTIF.
3. Educate entrepreneurs. We should keep raising awareness on the importance of thinking long term, opening up to different financing options (complementary to the banking one) and develop internally sound corporate governance. ●



## Lauri Rosendahl

President, Nasdaq Nordics

### Active local ecosystems are critical for economic growth

While cross-border trade, interconnected capital markets and collaboration across Europe is good, most companies still raise capital in their home markets. Based on evidence from Nasdaq Nordic's markets, I am convinced that efforts need to be put into developing active and dynamic local ecosystems around the companies.

Every successful and sustainable economy needs a dynamic capital market, where one of the core pillars is an active IPO market. IPOs generate capital for new

investments, R&D and job growth at a time when young growing companies need it the most. IPOs enable companies to move from private to public funding – with increased transparency and visibility as a result – while allowing early stage investors to recycle capital and fund new job creating growth companies.

Nasdaq Nordic has seen strong inflows of new listings in recent years, primarily to our junior growth market Nasdaq First North. Our Swedish market saw record years in 2015 and 2017, while Finland showed an all-time record in 2018. In total, 389 companies have listed across our Nordic markets since 2015, raising 19.4 billion EUR in total. Perhaps more importantly, 38 companies matured and switched from Nasdaq First North to our Main Market during these four years. The Nasdaq First North All Share Index have increased by 80 percent during the same time-period. A true win-win.

Nasdaq invests a lot of efforts in developing local ecosystems across the exchange markets we operate. The Nordic markets have well-functioning networks of financial advisors, small and micro-cap funds, and other players specifically supporting SMEs. Also, we have a strong equity investment culture where both institutional and retail investors are willing to take risk. These elements create a dynamic capital market environment that allows smaller companies to tap the benefits of public equity finance.

However, there is still work to be done. We need to ensure that all players in the ecosystem have a viable business case to work with. For instance, some equity research and analysts are struggling

as a result of MiFID II, leaving SMEs in a visibility gap. We also need further education directed to both issuers and investors about the benefits of public equity finance. Given the current low interest rate environment, European households need to be better aware of the potential upsides of investing in SMEs, rather than primarily keeping personal savings in bank accounts.

*"Efforts need to be put into developing active and dynamic local ecosystems around the companies."*

- LAURI ROSENDAHL

The SME Growth Market label introduced by MiFID II is a good initiative, and Nasdaq has applied for the designation across all our seven Nasdaq First North markets. I would welcome for EU and national institutions to prioritize further cooperation on measures, which can allow each SME Growth Market to play its part fully. For this, I believe a precondition for success is to recognize the different starting points of each local ecosystem, and allowing room for local adaptation of necessary measures.

In order to reach long-term sustainable growth across Europe, both SMEs and investors need better access to capital markets. By doing that, more companies will be able to raise critical capital for expansion, while both large and small investors are offered an opportunity to participate in the growth journeys. ●



## Guillaume Prache

Managing Director, Better Finance

### Employee share ownership: the single most powerful action to reach the CMU goals

The EU CMU project aims to rebalance the funding for the EU economy from banks to capital markets. The key requisite for this to happen is to foster retail investments into capital markets.

Following a proposal from BETTER FINANCE, the EC added a new CMU action in 2017 to “develop best practices in employee share ownership schemes” to develop the equity culture in Europe.

Even if it would just reach the level it enjoys in the US, employee share ownership (ESO) would be multiplied by 6 in the EU – adding two trillion € in equity market capitalization – and even by much more as far as SMEs (the main job creators) are concerned. This alone would boost the EU 28 market capitalization by about 20%, and thus get the CMU significantly closer to its goal.

But there is much more: studies show that people who have been exposed to employee share ownership plans often become shareholders of other listed companies.

Retail financial intermediaries have stopped promoting direct investments into listed shares and bonds for decades, in favor of more complex and fee-laden “packaged” products such as funds, life insurance and pension products, increasingly estranging EU citizens from the real economy assets their savings are supposed to fund. ESO is the only – but powerful – way left to enable EU citizens as employees to learn about shares, equity ownership and capital markets.

This is why the EC links this “CMU” action to the promotion of an equity culture.

The promotion of ESO is the single most powerful means to achieve the CMU’s priority goals, ... and more:

#### **Sustainable finance**

Over the last five decades the European economy has progressively gone from a people capitalism to a financial capitalism: in 1969 EU citizens directly owned 40 % of the EU economy (the shares of EU listed companies); today only about

10%. Financial intermediaries, on the other hand, have now seized a major share of our economy’s capital and voting rights: what one of the founders of the US SEC, Louis Brandies, and present-day Professor John Kay of the UK both call “other people’s money”.

Looking only at the time horizon, active asset managers (“other people’s money”), on average, hold their equity assets for less than a year; versus thirteen years for employee shareholders in France, for example. Other studies show that ESO also improves social responsibility and governance.

Not only are the interests and time horizon of agency owners too often poorly aligned with those of the end-investor and of the real economy in the long-term, but in terms of governance and democracy it means the EU economy is increasingly de facto controlled by financial intermediaries and not by citizens as long-term savers. It is a very serious – although underestimated – threat to democracy.

For all these reasons, it is all the more a pity that the EC has been dragging its feet for so long on ESO: Already in 2002, it announced the need for a European Action Plan on ESO, and concluded again from a “Pilot Project for the promotion of ESO and Participation” in 2014 that an Action Plan focused on an awareness-raising campaign should be launched.

EU Authorities have now a unique opportunity to make it right: The 2017 CMU Action on ESO (due to be completed this year) must follow-up on this 2014 “Pilot Project” at last. ●

## James Cunningham

Senior Advisor, Public Policy and Regulatory Affairs, BNY Mellon

### Securities eco-systems and the Capital Markets Union – a broader view

The topic of securities eco-systems is a core question for the Capital Markets Union project. It relates directly to the biggest single problem of EU capital markets, namely, the great differences in capital markets participation across member states, and the fact that

participation in some member states is very low.

Capital market participation depends heavily on the existence of capital market institutions, and of a strong capital markets eco-system, at the member state level. Such eco-systems depend heavily on sufficient volumes of activity, and on a sufficient diversity of market participants.

Eco-systems that have a greater diversity of market participant are more resilient to external shocks, deliver better quality outcomes, and have a strong positive impact on economic performance. Capital markets are heavily embedded in national economic, legal, and institutional structures, so that it is inevitable, and indeed desirable, that the different national eco-systems across the European Union be diverse. >>>



>>> But this raises two important questions: whether the existence of different national eco-systems creates obstacles for the single market and for the Capital Markets Union project; and whether pan-European single market initiatives are a threat to national eco-systems.

If we are not careful, the answer to both these questions is yes. It is well known, since at least the Giovannini reports, that national specificities can be an obstacle to market access, and to the creation of a single market.

For a weak, relatively undiverse eco-system, EU single market measures, such as MiFID and MiFID 2, can represent an external shock that weakens the eco-system. Yet market opening measures can also deliver increased volumes, and increased diversity, through the presence and activity of new market actors.

With respect to trade policy, it is a well-established proposition that a tax on imports also has the effect of being a tax on exports. The same reasoning applies to market access. Obstacles to access to an eco-system weakens that eco-system, and as a result makes it more difficult for actors in that eco-system to access other eco-systems.

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***"A major challenge is to build and strengthen national securities eco-systems."***

- JAMES CUNNINGHAM

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A major challenge is to build and strengthen national securities eco-systems, so that these eco-systems are not harmed by, but rather benefit from, pan-European market opening measures. The reports of the Giovannini Group and of the European Post Trade Forum have often been viewed as setting out an agenda for the European authorities to impose on recalcitrant member states.

We need to take a broader view. These reports set out many detailed steps – on securities account opening procedures, on tax documentation, on registration practices, and on access to market infrastructure – that member state authorities can take to facilitate access to their national capital markets for domestic and foreign investors and intermediaries, and thus to increase volumes of activity, and the diversity of their national eco-systems. ●



## Lee Foulger

Head of International Department,  
Financial Conduct Authority (FCA)

### The importance of open, connected, global securities markets

At Eurofi in September 2018, the FCA's Chief Executive Andrew Bailey made the case for balancing regulatory autonomy, global co-operation, and a commitment to international standards, in the interests of the effective oversight of open and mutually supportive financial markets. His arguments have remained relevant in the months since September – for the UK, the EU and across the globe.

Open and interconnected financial markets – including securities markets and the “ecosystems” that support their operation – will always remain vital to support trade in goods and services. Such markets help to diversify risk, increase efficiency and reduce fragility in the financial system, and help our companies access deeper pools of capital.

This is true of every aspect of the securities market's ecosystems – spanning regulated markets, other trading venues, market participants, issuers and other capital raisers, clearing and settlement arrangements, reporting and transparency frameworks.

Europe has created an impressive regional initiative to promote effective interconnected markets through Capital Markets Union (CMU), and I am proud to have been one of its enthusiastic parents. Key elements of CMU address precisely those aspects of securities markets

ecosystems I have just mentioned. MiFID II is of course paramount in setting foundation standards for securities markets, supported by such measures as EMIR, CRD/CRR, the Investment Firm Review, Regulations on Prospectuses and Benchmarks, sustainable finance proposals – to name but a few.

The FCA maintains strong support for these reforms, as our recent work to prepare for UK Withdrawal has underlined.

But CMU is a convenient term that should not imply that regional capital market ecosystems – however well founded – are the best way to promote open securities markets that meet the needs of those they aim to serve. They are a valid means to maintain agreed standards, but need to be inclusive rather than exclusive. It is imperative that we don't slip into a model of fragmented regulation, with competing philosophies and regulatory agendas.

Over recent months, the FCA's perspective on interconnected global securities markets has been well demonstrated by several initiatives. These include our preparations for UK Withdrawal based, where possible, on the recognition of home country supervisory standards; our discussions with our European counterparts on agreements to support future co-operation and information sharing; our first Mutual Recognition of Funds memorandum of understanding with the Hong Kong Securities and Futures Commission; and our agreement with the US Commodity Futures Trading Commission to ensure the continuity of derivatives trading and clearing activities between the UK and US.

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***"Connections should span securities market ecosystems across both European and non-European centres."***

- LEE FOULGER

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The priority going forward must be to maintain connections between different securities market ecosystems across the EU and with non-EU centres (and their regulators), and to resist any temptation to strengthen local frameworks in inconsistent ways.

We will continue to work with all our counterparts to develop and implement standards which are strong but flexible enough to enable competition and innovation. This remains our day-to-day regulatory approach, and our long-term vision for global markets and their ecosystems. ●



## Antonio J. Zoido

Executive Chairman,  
Bolsas y Mercados Españoles (BME)

### Status of the connection of securities ecosystems in the EU

Amongst the objectives of the Capital Markets Union, there was the aim to make it easier for companies to raise capital on public markets and to foster retail investment. While a lot of progress has been achieved, granting easier access to SMEs to financial markets was in the list of pending tasks as stated in the communication of last November.

BME has a long track record on initiatives to foster companies of all sizes, including SMEs, access to financial markets. In specific relation to SMEs, our MAB, the Alternative Equity Market, will turn ten years old next July. This market segment targets small companies trying to expand so that they can raise capital benefitting from the advantages offered by the market. I mean, we have a first-hand experience on how hard this task is.

Attracting issuer companies, and particularly SMEs, requires a holistic approach. Fiscal barriers have been identified for decades and debt-biased taxation is a common place in these discussions long since. However, the barriers still remain and discourage equity financing. To add difficulties to this, some fiscal proposals such as FTT will pose a serious danger to the European equity markets. We have explained the negative effects of this kind of tax in a detailed way, with hard data showing

the impact on equity trading. Still, it is surprisingly on the political agenda.

One of the negative impacts of FTT will be the shift of trading towards those non-FTT countries, which leads me to another barrier: cross-border differences in market supervision and regulatory enforcement. We need a playing field where supervision is uniform, with clear roles assigned to ESMA and the NCAs under the principle of supervisory convergence.

Finally, I cannot ignore one of the main sources of discouragement: overregulation. We have suffered a legislative fever during the last years that has resulted in a maze of norms and regulations, in my opinion, highly costly. The European Commission will carry out a study on the costs of compliance due to the financial regulatory and reporting obligations. It remains to be seen how efficient this regulatory framework will be in the coming years to make issuers access to capital markets easier. It is also unclear the final effect on the local financial ecosystems, although some indicators, such as declining IPOs, do not allow for optimism.

*"There is a long way to go before achieving friendly European financial markets, particularly for SMEs and retail investment."*

- ANTONIO J. ZOIDO

In fact, data suggest that compliance costs, which add to listing costs, discourage small companies listing in public markets and leads them to resort to private equity as an affordable source of financing. Although private equity has a significant domestic component, access to this source outside the home market has grown in the last years, with the corresponding exit from public markets eroding the local financial ecosystems.

But if we turn to retail investment, the prospects are not much better. A number of measures have been taken: the Consumer Financial Services Action Plan, the regulation on a pan-European personal pension product... However, retail investment is declining in the European securities markets. The retail share of the Spanish market fell from 30,5% in 2000 to 19,7% in 2017. It is obvious that things are not being done as they should.

In sum, in spite of the well-intentioned measures already taken and the proposals in the making, there is a long way to go before achieving friendly European financial markets, particularly for SMEs and retail investment. ●

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# Is the EU securities market structure adequate?



## Marc Bayle de Jessé

Director General Market Infrastructure and Payments,  
European Central Bank (ECB)

### A European securities market beyond T2S

The euro is celebrating its 20th anniversary this year. Over the past two decades we have seen significant progress towards creating an integrated European market for the single currency. Today, the single euro payments area (SEPA) facilitates retail transactions throughout the Continent, and TARGET2 enables monetary policy operations and interbank transactions in euro.

In addition to the free movement of cash, building a true domestic market also requires securities and collateral to be able to move safely and efficiently between countries in Europe. This idea has been driving our work in the area of financial market infrastructure and I am pleased to say that with TARGET2-Securities (T2S), our integrated IT platform which settles securities against central bank money, we have come a long way. Our efforts have also fed into the European Commission's action plan to build an EU capital markets union (CMU).

In fact, T2S has been a breakthrough in securities settlement and has laid the foundations for the CMU. Since its launch in 2015 it has unified a number of operational and functional aspects in the participating markets. It has also acted as a catalyst for the market to review and ultimately harmonise a number of post-trade processes and practices. It has thus contributed to dismantling at least ten of the 15 barriers to efficient EU cross-border clearing and settlement identified by the 2001 Giovannini report, such as national differences in information technology, operating hours and settlement periods. T2S has also shown that close collaboration between stakeholders from both the public and the private sector is the best way to deliver tangible results. Its inclusive governance structure was instrumental in pushing the T2S harmonisation initiative forward.

Building on the harmonisation already achieved in the area of securities settlement, we are now shifting our focus to post-trade activities related to securities and collateral management in order to address the remaining fragmentation across Europe. This work is driven by collaboration with key stakeholders under the umbrella of the Eurosystem's Advisory Group on Market Infrastructures for Securities and Collateral (AMI-SeCo). The aim is to achieve harmonised business processes, market practices and communication for the major categories of financial instruments used in Europe, such as debt and equities. A single set of harmonisation standards, i.e. a single rulebook, will establish rules and processes for financial instruments, thereby creating a level playing field for European stakeholders. These standards will be based on ISO 20022 messages and, therefore, the market is invited to already start planning for ISO 20022 implementation. >>>

>>> The Eurosystem has also made a commitment to address the inefficiencies in its own processes for collateral management. Currently, the 19 national central banks in the euro area use individual local systems to manage eligible assets mobilised as collateral. We intend to replace them with a single Eurosystem Collateral Management System (ECMS) as of November 2022, based on harmonised processes. The ECMS will manage the assets used as collateral in Eurosystem credit operations for all jurisdictions. Counterparties, central securities depositories and triparty agents located in different countries will benefit from the same harmonised system.

Despite this remarkable progress, a true single euro securities area is not a given just yet. To bring it closer to reality, it is important to ensure that none of the stages in the lifecycle of a security – issuance, trading, clearing, settlement and asset servicing – are affected by where in the EU issuers and investors are located. For instance, today the issuance and distribution of securities still relies on fragmented legacy standards, structural constraints and complex national market practices. Reflecting on ways to ensure a more efficient pan-European issuance and distribution channel could support the needs of European issuers and EU institutions and also have a positive impact on the establishment of a domestic yield curve for the euro money market.

All in all, we are continuously working towards the vision for a single EU capital market where cash, securities and collateral move safely and efficiently across borders and thus contribute to a stronger euro. ●



## Olivier Guersent

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

### CMU and the EU27 Securities Market Infrastructure

In 2014, President Juncker set the goal of having in place the building blocks for the Capital Markets Union by 2019. While several legislative actions await for co-legislators' adoption, five years later the Commission did deliver on all planned legislative and most of the non-legislative actions. The legislative proposals include a pan-European personal pension product (PEPP), ensuring true portability of personal pension rights, the SME listing package, making it easier for SMEs to raise capital on public markets, and measures to facilitate the cross-border distribution of investment funds.

At the time of writing this article, almost half of the legislative files that were planned have reached a political agreement; the remaining ones are in final negotiations with the co-legislators. The Commission expects the co-legislators to fast-track some negotiations, ensuring political agreement before the May elections. On top of this, the Commission has made progress on a large number of non-legislative actions (about 60 actions). Among those, there is an ambitious Venture Capital fund-of-funds programme to increase the size of VC funds in the EU and to encourage cross-border VC activity, as well as an EU strategy on supporting local and regional capital market developments. All of those building blocks contribute to deep and liquid, Union-wide capital markets.

However, regulatory reform is only one part of the required change. This is why, in addition to the legislative programme, the Capital Markets Union Action Plan and Mid-term review set out a number of non-legislative actions. These actions are important in their own right to boost investor confidence, strengthen key market infrastructure and open new funding channels. By the end-March, the Commission will report on >>>

>>> progress under the CMU project, including non-legislative actions in the areas of market infrastructure, distribution of retail investment products, drivers for institutional investment in equity and corporate finance for entrepreneurs and start-ups. They will contribute to deep and liquid capital markets.

Stimulating market-based funding, by creating the conditions for market infrastructure to develop safely, is among the CMU's main objectives. By strengthening the funding escalator, everyone, from sole entrepreneurs to SMEs, would benefit from greater availability of risk capital. Today's start-ups are the blue-chips of the future. At the same time, MiFID II/MiFIR and EMIR 2.0 ensure transparency and stability in our financial market structure all through the value chain, from trading to settlement. High-quality market infrastructure enables the CMU to unlock its potential in modern, ever more globalised, financial markets.

Better developed local capital markets will be able to reap full benefits from participation in the EU single market. Pursuing cross-border financial integration requires adequate market infrastructures, a strong regulatory environment and market participants ready for international business. With such foundations, the channels for cross-border listing and trade of securities may be broadened and connections among market infrastructures can be established. An integrated EU capital market should offer easy access both to the large pools of assets and investors at European level and to market financing at local level.

Following the departure of United Kingdom from the EU, the Capital Markets Union needs to protect its critical functions for the provision and supervision of capital market services by sustaining liquidity and limiting regional fragmentation. For example, new rules on central counterparties will ensure a more consistent and robust supervision in EU and third countries. European consumers, investors and businesses will also benefit from stronger and more integrated financial markets, thanks to the reform of the EU's supervisory architecture. Further steps will be needed to ensure that market infrastructure keeps up with growing transaction volumes, that information is accessible and comparable, that investor rights are protected and sufficiently harmonised and that there is a single point of entry into the EU for foreign financial service providers. The Commission will continue its efforts to establish a consolidated tape for post-trade data, which would allow a better understanding of the markets.

Looking forward, in a post-Brexit environment, the Commission aims to safeguard and to further improve accessibility to trading infrastructure for equity and non-equity, and where necessary, further streamline investor protection requirements. ●



## Jochen Metzger

Director General, Directorate General  
Payments and Settlement Systems,  
Deutsche Bundesbank

### New EU securities market structure? Look ahead, don't look back!

As crucial networks that underpin the EU economy securities markets have to be as resilient and efficient as possible. Regulation can contribute to reaching that goal. However, to be truly effective regulation has to be designed carefully and targeted precisely. Rushed regulatory measures can be counterproductive as they

risk being misguided – especially in times of rapidly developing new technologies such as DLT and tokenisation.

*"In EU securities markets regulation technology is the next frontier."*

- JOCHEN METZGER

To be clear, EU regulation enacted after the global financial crisis has strengthened securities markets: it increased transparency, it ensured stability, and it promoted cross-border harmonisation. In trading, MiFID II and MiFIR have increased transparency for investors and regulators. Similarly, EMIR is increasing the stability and the transparency of the crucial derivatives markets. Finally, CSDR is >>>

>>> enhancing the safety and efficiency of securities settlement infrastructures in the EU. But before rushing to design new regulation for those areas we should see how the securities market structure develops in light of these initiatives.

Both the successful Eurosystem platform T2S on the technical side and CSDR on the regulatory side act as strong catalysts for the transformation of market structures in the EU and thus drive needed cross-border harmonisation. These efforts for harmonisation are crucial because even if some Giovannini Barriers have been successfully dismantled in recent years others still persist according to the EPTF. Fragmented corporate actions and annual general meeting processes, and inefficient withholding tax procedures are just some of the remaining barriers

identified by the EPTF. Member states, supported by the Commission, need to implement solutions to overcome this. However, I am optimistic that CSDR will act as a powerful driver of harmonisation in coming years.

The CSDR enables CSDs to provide issuance services across borders regardless of where the issuers are based. The combination of T2S and CSDR will create incentives for CSDs to establish a comprehensive link structure and thereby foster cross-border investment and settlement. The legal and technical improvements together create the prerequisites for issuers to be able to choose their issuer CSD independently of where they are based. The broad access to T2S provided by over 20 connected CSDs guarantees the settlement of securities

against central bank money. Central banks, CSDs and regulators have thus created a highly efficient market (infra-) structure. However, adjustments on the part of CSDs and custodians need time to take full advantage of it.

Reasonable regulatory measures have enhanced the EU securities market structure in recent years. Now we should wait until they take full effect in the markets. Rather than target established market processes new smart securities market regulation should be aimed at emerging technologies such as tokenisation and DLT in order to bring the Capital Market Union into the age of the platform economy – technology is the next frontier in EU securities markets regulation. ●



## Alexandra Hachmeister

Chief Regulatory Officer,  
Deutsche Börse Group

### MiFID II – Reviving the success story

Winston Churchill once said: “Success is not final...” – Obviously, he did not have financial markets in mind back then. Nevertheless, this perfectly describes the evolution of market structure in the EU as MiFID II/MiFIR has fundamentally changed the rules of the game. Today, around 15 months after its application, our markets have become more stable

and transparent, and are subject to a more harmonised set of rules. As a passionate proponent of the political objectives of MiFID II to ensure transparency, integrity and investor protection, this is a clear and hard-fought success – albeit not one we should rest on.

MiFID II was designed when the United Kingdom (UK) was still a member of the EU. The UK’s withdrawal is a severe setback on Europe’s path towards more integration and cooperation in financial markets over the past years. Here, we will have to find new modes of cooperation to maintain the close links between our markets. However, we should not compromise on our high regulatory standards, which have become a hallmark of the EU’s financial reforms after the crisis. Sustainable economic growth can only be achieved on the basis of financial stability.

Nonetheless, this is about much more than just dealing with the implications of Brexit. The evolution of markets in financial instruments needs to be integrated in our vision for the future of the EU’s financial markets, within a multipolar, rapidly changing and highly competitive world order. Hence, we should not only raise the question: Did MiFID II succeed in making financial markets more transparent and efficient? Rather, we need to draw our conclusions on the more fundamental question: Did MiFID II establish a regulatory environment that allows EU27 financial markets to deliver on the higher-ranking goals of a healthy, sovereign and globally competitive EU internal market?

Let us zoom into one of MiFID II’s main features: MiFID II has further

unleashed competition in equity markets; the number of trading venues and systematic internalisers has climbed to heights never achieved before; hurdles for new entrants to this highly dynamic market are low. Investors avail of unprecedented levels of choice where, when and how to invest their money.

*“Sustainable economic growth can only be achieved on the basis of financial stability.”*

- ALEXANDRA HACHMEISTER

Interestingly, we can observe a growing disquiet with this development, and discussions arising on the side-effects for the orderly functioning of markets and thus on their ability to deliver on their overarching goals. To name just a few of these questions: How does the fragmentation of trading across 185 SIs, 126 RMs, 191 MTFs and 76 OTFs (for equity and non-equity) affect market quality in terms of stability, liquidity and diversity? How efficient is such a market structure in transforming relevant information into prices? How does this contribute to investors and companies re-gaining trust in financial markets?

I am very much looking forward to this Eurofi in Bucharest, as it will be critical to deepen our reflections to ensure that the upcoming legislative period at the EU level will lay the foundation for a globally competitive yet stable and resilient EU27 internal market for financial services. ●



## Märten Ross

Deputy Secretary General for Financial Policy and External Relations,  
Ministry of Finance, Estonia

### EU market structures still not resembling CMU

#### Does the EU27 have the appropriate market structure to support the implementation of the CMU?

Achieving the 'at-least-reasonably-well-functioning-CMU' has two dimensions: developing individual capital markets and then separately improving the cross-border pan-European element of it. The tendency is still that much of the market structures and policies are geared towards the first dimension and that is not necessarily supportive to well-functioning holistic CMU. This is not just about physical market structures, but more so about broader infrastructure, for example the legal framework for company restructurings or pension systems.

From general market structure point of view another question mark remains to be the persistent excessive role of the banking sector in financial intermediation. In particular, as its (increased) fragmentation remains a concern and probably limits the potential for cross-border financial activity in general. Therefore, it might be that such apparently distant policy topics as decreasing decisively bank-state doom-loop or solving NPL backlog could actually support also activation of the CMU. On the more positive side of this topic the line between the traditional

banking market and capital market has become more blurred over the time as deposit taking institutions are entering in the FinTech area and providing capital in a different and new form.

Institutional setup more broadly is also not yet fully appropriate. Revising financial market supervision as a tool to facilitate common capital market remains pretty much a work in progress. And while still notable home bias could mirror the factual developing stage of the European single market and politics in general, it points also to the lack of sufficient integration for the efficient capital allocation.

#### And does it have the appropriate securities market infrastructures?

There are notable recent improvements in market infrastructures. Including in retail payments that is not irrelevant for the securities market functioning.

However, if there are probably not much problems with major wholesale markets, then the question of excessive costs of financial intermediation might still be there. CMU could function reasonably well only if it will remove obstacles for cross-border capital raising for SME segment by reducing transaction costs, advisory fees but also account management fees. Ideally the CMU should support also integration on retail markets.

But present requirements and market approach are still too restrictive for them. For example, regulations for the registry keeping for funds and securities may fit poorly into advances in technological development. And in so called soft infrastructure – including requirements on market analysis, compulsory data or LEI-code type innovations – regulatory costs seem to be quite restrictive. At least if implemented strongly.

#### What further improvements might be needed?

In many central elements of the market infrastructure things seem to be quite advanced for the CMU to function. Although even on T2S project one could ask for further flexibility including in supporting the processing of corporate actions, including tax and general meetings.

From regulatory environment side better readiness to absorb fintech-related innovations remains the area for improvement. Present framework tends to regulate too much 'old structures' and ability to absorb technological advances into the main single market remains

work in progress. For example, securities' registry keeping regulation might still be 'no-technology-neutral' towards blockchain innovations.

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*"CMU could function well only if it will be able to reach out at least SME segment."*

- MÄRTEN ROSS

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Further improvements are needed in the setup of European supervisory framework as well. While rushing into centralization would not help CMU, clever step-wise strategy to the European system facilitating inter alia stronger implementation of the single market regulation is needed. This is increasingly the case also for anti-money laundering area as the lack of trust in this area puts (in)visible breaks also to the proper and efficient cross-border functioning of the securities market. ●

## Andrew Douglas

Managing Director, Government Relations (EMEA & APAC), The Depository Trust & Clearing Corporation (DTCC) and Chief Executive Officer of DTCC's European Trade Repository

### Further harmonisation needed to deliver on full potential of EU capital markets

As early as 1999, it was hoped that the introduction of the euro would naturally lead to a convergence among Europe's capital market and post-trade market infrastructures but it's fair to say that progress was a lot slower than anticipated. This led to the creation of the Giovannini Group whose mission was to identify barriers (later known as the Giovannini barriers) preventing efficient cross-border clearing and settlement in the EU. Fast forward almost 20 years, and a number of those barriers have been dismantled through the introduction of various initiatives such as TARGET2-Securities and regulations like CSDR, MiFID II and EMIR. >>>



>>> Looking at advances in post-trade practices more generally, we've certainly seen progress in derivatives reporting, designed to bring greater transparency to the market and therefore help identify the build-up of risk. There is a huge amount of data being reported at present – for example, DTCC's Global Trade Repository (GTR) alone processes trades relating to over 100,000 entities, with over 40 million positions translating into a billion messages each month. However, reporting practices are not without their challenges. There is currently a lack of harmonised reporting requirements across jurisdictions. Data fields and standards, in terms of what is reported, by who and when, are very different, which makes the aggregation and analysis of this key data extremely challenging for regulators.

Further, the sharing of data held by trade repositories has not happened to the extent originally intended not only due to inconsistencies in the data being collected but also because of restrictions around legal and structural access. DTCC identified these issues as early as 2012 and has since maintained a dialogue with policymakers and market regulators regarding the need to implement standards globally and are encouraged by the progress being made in this area.

Notwithstanding some of the advances that have been made in harmonising Europe's post-trade market infrastructure in the areas of clearing, settlement and trade reporting, a significant number of the Giovannini barriers remain. Indeed, the European Post Trade Forum (EPTF), established by the European Commission in early 2016 in the context of the Capital Markets Union (CMU) project, should be commended for its review into and recommendations for achieving

efficient and resilient cross border post-trade infrastructure in the EU.

Europe, in its broader political sense, has undoubtedly come a long way in enhancing its post-trade infrastructure, for both securities and derivatives trading and processing, resulting in a more unified and efficient market for its participants. However, we need to continue to move forward. A fragmented approach leads to increased costs for the underlying clients and will severely hamper the ability to derive greater value from Europe's capital markets. ●

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# Integration and competitiveness of the EU fund market



## Wolf Klinz

MEP, Committee on Economic and Monetary Affairs,  
European Parliament

### Increasing the competitiveness of the EU investment fund market

Europe has significantly more investment funds than the United States of America. However, these funds are smaller and as a result more expensive and less competitive than their American competitors. What is more, the EU investment fund market is still predominantly organised as a national market: 70 % of all assets under management are held by investment funds registered for sale only in their domestic market. Only 37 % of UCITS and about 3 % of AIFs are registered for sale in more than three Member States.

The new legislative measures on facilitating the cross-border distribution of collective investment funds will significantly improve the integration and competitiveness of the EU fund sector. They will reduce fragmentation in the financial market in the EU and therefore improve its shock absorbing capacity through more private risk sharing.

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*"The EU needs to do more to fully integrate its capital markets into a single European capital market. The lack of such is not only hampering growth prospects for EU companies, it also falls short of cushioning shocks in case of crisis."*

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- WOLF KLINZ

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Key areas identified for action included procedures for meeting marketing requirements by national authorities, transparency on fees set by such authorities, the possibility to 'pre-market' across borders alternative investment funds, and the possibility to denotify marketing activities for AIFs and UCITS.

A key new provision quickly agreed on was to prohibit Member States from requiring a physical presence on their territory of such funds intending to market there. When

>>>

>>> it comes to pre-marketing, the European institutions managed to agree on a targeted approach by focusing on the main political goal: to make pre-marketing possible but keep reverse solicitation from happening. This was achieved, while simplifying the conditions for pre-marketing and limiting the administrative burden for the investment undertakings.

Concerning the provisions on the possibility for AIFMs and UCITS managers to cease marketing a fund, which has previously been active in a particular host Member, we were also able to achieve significant simplifications. The continuation of marketing will no longer be mandatory if it is not economically sensible from the point of view of the investment undertaking. At the same time it has been ensured that the investors remain very well protected. They will be offered a repurchase offer free of any charges and if they choose to remain invested, the financial undertaking must continue to fulfil the disclosure and reporting requirements as laid down in Union law.

The cooperation among the political groups and the European institutions was excellent throughout the legislative process. The European Parliament would have preferred to achieve more on limiting the fees supervisory authorities can charge, in particular in host Member States, in relation to the ending of cross border activities of fund managers by ensuring that those fees are consistent with the actual costs incurred by the competent authorities. Nevertheless, thanks to the agreed reforms, investors will be able to profit from strengthened investor protections clauses, reduced fees, and better access to more and larger funds.

From the point of view of the European Parliament, additional action is still needed when it comes to the pre-marketing of UCITS, by introducing as soon as possible the same conditions for UCITS as now agreed for AIFs. However, the job is not finished there. The EU needs to do more to fully integrate its capital markets into a single European capital market. The lack of such is not only hampering growth prospects for EU companies, it also falls short of cushioning shocks in case of crisis.

In contrast to the United States where almost 75 % of shocks are absorbed by private risk sharing due to more integrated capital markets, only 20 % of such shocks can be smoothed through cross-border risk sharing in the EU. Hence, the need for the use of taxpayer's money from public budgets in case of crisis is much higher in the EU. We therefore need to redouble our effort to build the functioning Capital Markets Union across the EU-27. And we must ensure our priorities evolve in tandem with political, economic and technological developments. ●



## Felicia Stanescu

Head of Policy Definition and Coordination,  
DG for Financial Stability, Financial Services  
and Capital Markets Union,  
European Commission

### Regulatory developments in the EU fund sector

A well-functioning internal market for investment funds is an integral part of a CMU. The growth of the European asset management sector has been significant over the last years reaching a total of € 9.7 trillion of AUM in UCITS and over € 4.9 trillion in alternative investment funds. Looking ahead, despite being increasingly organised on a pan-European basis the EU fund industry continues to face challenges in terms of integration and

competitiveness, including fragmentation, transparency and fees.

Almost half of all UCITS funds are offered only in the Member States where they are based and more than 90% of all AIFs are only offered in one Member State. The bulk of the cross-border supply of funds are directed to Member States with large markets to the detriment of investors in smaller Member States. This has negative implications on the choice for investors, competition, level of fees and net returns. The EU investment fund sector remains highly fragmented, and EU funds tend on average to be smaller in size than their US peers.

Transparency is an essential component for a more efficient EU asset management industry. Pre-contractual disclosure requirements and reporting to investors tend to increase transparency at every level for products and distributors. Getting a broader picture of the performance and cost of retail >>>

>>> investment contributes to better interpretation of the product information and facilitates investment decision. And it increases competitive pressure so that investors are offered the products that best fit their needs.

The proposal on the cross-border distribution of collective investment funds presented by the Commission, and recently agreed at political level by the European Parliament and the Council, aims to reduce differences across Member States, increase transparency, reduce costs for funds and improve cross-border functioning of the market.

The Commission has also started its review of AIFMD. The review is seeking to identify areas for potential improvements, and if warranted, propose legislative amendments. At this stage, the

Commission collects and analyses empirical evidence and will decide on launching a public consultation in the coming months.

***"Commission is a consistent advocate of policy actions to improve the operation of EU funds sector."***

- FELICIA STANESCU

This will be an important and complex policy work, and while it is premature to comment on the scope or precise timing of the evaluation, the Commission services will continue to openly and constructively engage with the stakeholders.

The Commission is a consistent advocate of policy actions to improve the operation of EU funds sector. Important EU financial services legislation has already been put in place. Some important initiatives, like a Proposal for a cross-border distribution of funds, a Proposal for a pan-European personal pension product (PEPP) and Sustainable Finance proposals - are well-advanced. The Commission will continue to execute its CMU-related actions and remains true to its mandate of promoting a single market for investment funds and ensuring fair, well-informed and transparent outcomes for investors. ●

Contributors: Ivan Kuznetsov and other colleagues of the Asset Management Unit of DG FISMA



## Jarkko Syyrilä

Head of Public Affairs, Nordea Asset and Wealth Management

### Stability of the EU regulatory framework is key for global competitiveness

The European asset management industry has seen a remarkable growth since the financial crisis. According to EFAMA statistics, the total assets under management in investment funds and discretionary mandates grew from EUR 10.8 trillion at the bottom of the crisis in 2008 to a record high of EUR 25.2 trillion in 2017. This is a strong sign of investors' trust in our industry.

A strong regulatory framework built especially around the 1985 UCITS Directive and its' later amendments has been a key cornerstone for the success of UCITS becoming the global gold-standard for investment funds. European asset managers compete strongly in the global market with the UCITS fund as a flagship product of the export capability of European financial services.

Since the financial crisis many EU regulatory measures have been adopted impacting also indirectly asset managers, most prominently MiFID II which is having key impact on distribution models and where the jury is still out on the long-term effects. Same goes for much of the EU legislation across all financial services, it is quite new, and needs time to take effect and markets to adapt before we can see its real impact.

For the new EU Commission and Parliament agenda there is no need for a regulatory overhaul in asset management. The most important regulatory measure needed for the competitiveness of the European asset management industry now is stability of the regulatory framework. The key safeguards to protect investors and integrity of the markets are in place. The vast amount of recent regulation needs time to bed down and careful assessment of the impacts. Targeted adjustments can be done, but mostly the way forward should be using tools of supervisory convergence coordinated by ESMA to achieve even better integration of the European fund market. Accordingly, the planned reviews of the UCITS and AIFMD should be evidence-based, carefully targeted and

aimed only at addressing material issues that cannot otherwise be addressed through supervisory convergence or Level 2 regulatory harmonisation.

PRIPs was meant to provide a key information document for retail investors on all savings products whether a securities/ banking/ insurance product, but is largely considered a failure by both the industry and consumer bodies. Performance scenarios and transaction cost calculations are misleading to clients. The new Commission together with the ESAs will need to review the PRIPs regulation thoroughly. It should not be extended to UCITS funds before the problems have been fixed. The PRIPs regulation as it stands is a reputational risk for the whole industry.

***"The vast amount of recent regulation needs time to bed down and careful assessment of the impacts."***

- JARKKO SYRILÄ

Key focus area in the new Commission's mandate will certainly continue to be sustainable finance regulation. Nordea Asset Management has already for many years had a strong emphasis on ESG and we are fully prepared to play our part and serving our customers when regulatory change brings sustainable finance more and more to the mainstream of asset management. ●



## Dennis Gepp

Senior Vice President, Managing Director  
and Chief Investment Officer, Cash,  
Federated Investors (UK) LLP

### How should Brexit impact the competitiveness of the EU fund sector?

Hard Brexit, Soft Brexit, Delayed Brexit, No Brexit; the one thing that will remain a constant after 29 March 2019 is that the global financial markets will continue to evolve and a significant role remains to be played by both the United Kingdom and the remaining 27 members of the European Union to ensure that the EU fund industry remains the global

standard. Despite over two years trying to work towards a sensible and workable result, much uncertainty remains in the EU Financial Services sector with respect to Brexit. There has been progress. MoUs have been agreed and temporary permissions regimes put in place – but is it enough? The powers that be in both the UK and EU need to embrace that the model for providing best-in-class financial products in the most cost-effective manner to benefit all European Investors remains a model where there is a free flow of knowledge, services, and funds between the UK and the EU post Brexit. France, Ireland and Luxembourg are without question the leading fund domiciles in Europe. Also, without question is the fact that the UK is the leading domicile for portfolio management and that other EU jurisdictions have taken the lead in servicing the funds industry.

The current EU model of funds domiciled in one jurisdiction, serviced in another and managed in yet another has developed over many years and has made the EU Funds industry the global standard. It encourages the selection of the best of the best regardless of geographic constraints. That standard is under a constant barrage of attacks by regulatory proposals aimed specifically at imposing enhanced restrictions on UK fund managers from providing their services to EU funds, when everyone either knows or should know that the financial services regulatory framework in the UK is equivalent in every way and will continue to be so post-Brexit. Under the fiction of ensuring that there is no extreme regulatory divergence post-Brexit, increased substance demands for

entities operating in the financial services sector have been put in place; potential restrictions on delegations are being put in place, and even individual NCAs are being subjected to enhanced regulatory scrutiny. The net effect of relentless regulatory initiatives (not designed with investor protection in-mind) is that the costs, needlessly redundant costs, of providing a diverse range of world class investment management products in Europe continues to rise, and in a global environment where spreads between products is narrowing, this is not a trajectory that will end well for investors in Europe who want access to a wide range of products, managed by the best portfolio managers, at a globally competitive price.

*“Without question is the fact that the UK is the leading domicile for portfolio management.”*

- DENNIS GEPP

Certainly, the EU will need to monitor the UK financial regulatory framework to ensure it remains equivalent – but the Day 1 assumption, without question, needs to be IT IS, just as similar determinations have been made for many other third-country regulatory regimes. Monitoring, post-Brexit, to ensure equivalence is very different than operating under an ill-advised assumption that the regulatory frameworks will materially diverge, and to further assume that any future variance is material. ●

## Jean-Paul Servais

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

### The integration of the EU fund sector: going the extra mile

Fostering the participation of retail investors in EU capital markets is a key theme of the Capital Markets Union (CMU).

Recent EU policy initiatives have aimed at closely integrating the EU fund sector. Cross-border distribution should

eliminate unjustified (regulatory) barriers in order to support fund managers in engaging more in cross-border distribution of their funds. The PRIIPs Regulation should improve the quality and comparability of information on the key features of investment (in particular on risk, performance and costs). The PEPP should establish a single market for personal pensions, allowing for the creation of pan-European personal pension products and enhancing the portability of such products.

The EU policy initiatives have delivered positive results in terms of the integration and competitiveness of the EU fund sector. Taking the example of the Belgian fund market, the number of foreign EU funds offered to the >>>



>>> Belgian retail investor has more than doubled since the financial crisis. For every Belgian fund, 5 foreign EU funds are now being offered to the public.

Further improving integration and competitiveness will first require adjustments to recent policy initiatives so as to improve their efficiency. For example, and with regard to PRIIPs, we are hopeful that the amendments of the level 2 legislation will lead to the publication of Key Information Documents that really permit a comparison among products. In order to improve the rules in credible way, it is important to take sufficient time to prepare the amendments thoroughly, given the technicality of the issues to be addressed and the need for consumer testing.

The remaining global challenges, however, go beyond transnational integration. EU policy initiatives should focus on the “last mile”, the final leg of the distribution phase that delivers the fund to retail end-users. For example, the closed architecture of distribution and intermediation channels could be a barrier to integration and competitiveness.

On the path towards integration, we should not forget to put the interest of the consumer at the forefront. The “one size fits all” approach has its limits when it comes to distributing products to consumers. We have to strike a balance between transnational integration and more diversified approaches to investors.

*“On the path towards integration, we should not forget to put the interest of the consumer at the forefront.”*

- JEAN-PAUL SERVAIS

In fact, retail investor participation is built on confidence and protection. More specifically, for investors a “good” product means, inter alia, that clear information is given to investors and that the target group understands and can accept the characteristics and risks of the products. For the supervision of these items, proximity of the supervisor constitutes an advantage.

Ex-ante supervision of distribution can substantially improve consumer confidence in products and increase their participation in long-term investment. To this end, it is key for the host NCA to be able to acquire all necessary information and intervene promptly to ensure consumer protection. The Belgian

experience since the financial crisis shows that the supervision of the product distribution played a key role in restoring trust in financial products. ●



## Frédéric Bompaire

Head of Public Affairs, Finance and Strategy, Amundi Asset Management

### Competition and competitiveness for the benefit of investors

The first competition for funds is to be found in the possibility for an investor to either run his money directly or delegate it through a mandate or via a fund. The key factors for promoting funds relate to the collective character of funds that allows cost sharing and economies of scale and enables to seize investment opportunities not directly accessible for smaller portfolios. Funds are very attractive also as they transfer the burden of accounting on the fund's administrator with the investor booking one single entry from the subscription to the redemption of the fund. Most important is the opportunity to benefit from the expertise of professional asset and risk managers that take investment decisions and monitor risk for the best interest of the end investors.

Several criteria evidence the highly competitive environment of the fund industry in Europe. First, the number of management companies. Each year the number of new creations and withdrawals proves that free access to the activity is

granted: it is one pillar of the definition of a free competitive world. It is important to keep this fluidity whilst ensuring investors' protection and requiring that management companies have an appropriate internal organization and sufficient resources. Second, the number of funds in Europe shows an extensive choice is available for investors. On the one hand it guarantees that there is no substitutability issue in the fund industry, but on the other hand it limits economies of scale for units' holders. Third, the trend towards lower management fees that is apparent in the EU over the last years is another indication of competition among asset managers.

*“Several criteria evidence the highly competitive environment of the fund industry in Europe.”*

- FRÉDÉRIC BOMPAIRE

Conversely, impediments reduce the competition and, hence, the competitiveness of the industry to the detriment of investors. We shall mention three examples. Retail distribution is not unified in the EU. We do not argue against the power of National Competent Authorities to supervise all documentation aimed at retail clients. We understand the requirement that it should be translated in the national language as a prerequisite for local distribution. However, we feel less comfortable when NCAs ask for information that is not foreseen in the UCITS and AIFMD directives or when they do not interpret them in the same manner; for example, the calculation of market exposure with the commitment methodology under UCITS Directive is not similar in all EU Member States. The second example is tax. Tax is a national prerogative, but when it creates an obligation for fund managers to calculate specific coupon rate for the holders of one Member State it could amount to anti-competitive manoeuvres. The last example is about comparability. The EU regulation considers transparency as a key factor for the development of competition. However, when we look at costs it is misleading to compare data: some funds will show a very low level of fees but those will not include the distribution costs that the investor will pay in some other way; the same applies with transaction costs that can be negative under the PRIIPS calculation methodology and that are meaningless if not linked to the turnover and the performance of the fund. ●

# The Eurofi High Level Seminar

## Bucharest April 2019



# ETFs: possible need for specific rules



## Gerben Everts

Member of the Executive Board,  
Dutch Authority for the Financial Markets (AFM)

### An efficient ETF market requires an effective arbitrage mechanism

Global markets for exchange-traded funds (ETF) continue to show considerable growth.

Global assets under management (AuM) reached approximately \$4.5 trillion ultimo 2018, distributed over roughly 6,500 ETFs. The US (AuM \$3 trillion) is by far the largest market, followed by Europe (AuM \$700 billion). The European ETF market differs significantly from the US ETF market. In Europe, retail investors account for less than 20 percent, whereas in the US this is approximately 70 percent. The rapid growth and developments in the ETF market may elevate risks to investors and raises questions about their impact on the functioning of the financial markets and corporate control.

The popularity of ETFs can be attributed to perceived advantages they offer to investors.

ETFs are seen (and marketed) as low-cost products that deliver diversification benefits, with intraday liquidity. ETFs combine features of open-ended investment funds with securities traded on exchange. ETFs operate on the primary and secondary market. They employ authorized participants (AP) and liquidity providers (LP) to set the price and enhance liquidity.

ETFs promise liquidity, but particular features and risks can result in disappointments if investors rely too much on the perception of unlimited liquidity.

Although ETFs still account for a small proportion of total market capitalisation, they represent a large portion of the daily trading volume in stock markets, fuelling the perception of liquidity. Specifically, ETFs are shown to increase the level of co-movement of the underlying securities. Given the market share of ETFs to the daily traded volume in the stock market, an increase in the co-movement of asset prices makes it more likely that investors experience capital losses simultaneously, potentially even leading to fire sales. Investor expectations should be aligned with the way ETFs operate and perform. Depending on market circumstances, liquidity can dissipate quickly, or trading costs could be higher than expected. Furthermore, a wide variety of exchange-traded instruments are often sold as ETFs, like ETNs, which could possibly result in an underestimation of liquidity risks in these instruments. Retail investors need to be aware of this. Solely focusing on the perceived benefits would ignore these risks. Whether the benefit of intraday trading is a prerequisite for retail investors who often invest in a diversified, passive portfolio, is a question one could legitimately raise.

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>>> The liquidity and pricing mechanism of the ETF markets depends on the effectiveness of the arbitrage mechanism applied by APs and LPs.

It is paramount that APs and LPs function properly and that the market infrastructure is facilitating participation by independent APs and LPs to safeguard efficiency of pricing. Open and effective competition among parties contributes to an active and efficient primary and secondary market, enhancing advantages ETFs offer to investors. To enable an effective arbitrage mechanism, APs and LPs must have state-of-the-art technology, often with high frequency traders (HFT) acting as AP/LP. Without such technology deployed by HFTs, the benefits for investors would not be as high. Furthermore, anticompetitive practices should be avoided. A limitation of the number of APs for an ETF could result in higher costs for investors and increase dependency on a single party.

The rapid growth of ETFs deserves a proper analysis and attention of regulators and institutions such as the ESRB and IOSCO.

European ETFs operate within the regulatory framework of UCITS, AIFMD and MiFID II, providing safeguards to investors, such as (cost) disclosure and investor protection. The growing trend of passive investment raises concerns vis-a-vis liquidity, shareholder rights and the effectiveness of corporate control and could potentially affect market efficiency. Apart from the attention on the contribution of an effective arbitrage mechanism to efficient markets, one must not neglect the impact of ETFs on corporate control. With significant percentages of individual shares owned by three ETFs issuers, one could wonder about shareholder influence over corporate control and their capacity to influence the outcomes of corporate decision-making. Therefore, market initiatives to take responsibility should be welcomed and stimulated. ●



## Gerry Cross

Director of Financial Regulation - Policy and Risk,  
Central Bank of Ireland

### Exchange Traded Funds – considering risks, vulnerabilities and safeguards

Ireland is the largest domicile for ETFs in Europe with total AUM at almost €400bn at end-2018. As regulator of this significant cohort, the Central Bank of Ireland is cognisant of the important role we play given the sector's global footprint. This is why at the Central Bank we have focused on the review of ETF related issues including the publication of our Discussion Paper and holding an international risk and regulatory conference in 2017 followed by a Feedback Statement in September 2018.

Other European regulators have also focussed their lens on ETF and internationally IOSCO has a strong focus on ETFs, all of which is very welcome. A global industry like ETFs requires a consistent global regulatory approach. It is appropriate and necessary that regulatory authorities highlight concerns and ensure they are addressed, considering the fast rate of growth and increased complexity in ETFs recently.

In 2018, IOSCO carried out an exercise to review and agree those ETF issues which warrant further attention by regulatory authorities. This work has now progressed to the establishment of two dedicated workstreams. One will focus on the review of investor / conduct related matters while the other will concentrate on market structural issues. The Central Bank of Ireland is co-leading one of these workstreams with the US Securities & Exchange Commission (SEC), and supporting the production of a joint workshop >>>

>>> between IOSCO and the Financial Stability Board (FSB) on ETFs and market liquidity. The purpose of the workshop is to highlight the potential risks arising from the way in which ETFs are traded, examine certain inconclusive matters relating to liquidity in ETFs and review the impact of ETFs on market liquidity generally.

Regulators have made it clear that they have concerns regarding the potential risks that ETFs pose. One of the core issues highlighted is related to investor expectations, and specifically the alignment of investor expectations and the actual functioning of the ETF, particularly during times of market stress. In order to understand this, regulators have to understand the structure and functioning of ETFs, such as the unique role of the Authorised Participant (AP).

Whilst APs are a key source of liquidity, there are no obligations on an AP to continue to operate during varying market conditions. Furthermore, the price arbitrage mechanism is key to the overall functioning of an ETF. A potential risk is whether the arbitrage mechanism can be relied on during all market conditions to ensure primary and secondary market prices remain closely aligned. The interface between the regulation of market participants critical to the functioning of the ETF and that of the underlying investment fund itself warrants further consideration to assess whether the calibration of requirements is appropriate. Further risks include potential interconnectedness and concentration risks, which may be driven by counterparty risk, AP dependence or the involvement of connected parties in the structuring of the ETF. Another consideration for regulators is the question of whether ETFs may give rise to “fragile liquidity” where investors invest significantly in an asset class where in most situations they would not otherwise invest due to liquidity concerns.

Securities regulators need to consider, whether existing safeguards related to identified risks are fit for purposes or, in fact should be strengthened. It is however also the responsibility of market participants to engage in this process in a constructive and meaningful way. Regulatory authorities have already provided high-level analysis of the potential risks that ETFs may pose, and as such, it is up to market participants to be ready to participate in forthcoming consultations in order to respond to these concerns. To date, the Central Bank has experienced a high quality level of engagement with stakeholders, particularly in response to our discussion paper. Academia also have an important role to play in the analysis of ETF risks. The IOSCO / FSB workshop will be a further waymarker in this work. It is imperative that such work leads to operable conclusions with regards to the risks that ETFs may pose and whether the current safeguards in place are appropriate to address these concerns, and if not, what policy enhancements are required to address remaining risks. ●



## Noel Archard

Global Head of SPDR ETF Product,  
State Street Global Advisors

### Unlocking the potential of ETFs for retail investors

The growth of exchange-traded funds (ETFs) is continuing at a remarkable rate and they are becoming an ever-more important part of the fund landscape in Europe. A natural by-product of their increasing popularity amongst European investors is the growing discussion on the potential need for a dedicated and specific regulatory framework for ETFs.

However, in our view, this is an unnecessary debate. In the EU, ETFs are highly regulated, primarily under the UCITS framework. The general consensus amongst industry participants is that this framework is robust, functioning well and, amongst other things, has promoted liquidity and investor protection. ETFs are also required to abide by the rules of the relevant exchange. In addition, we fully support the promotion of good market practices but given ETFs are primarily structured as UCITS, there is little reason why they should be subject to different standards relative to other UCITS managers.

Notwithstanding this view, the innovative nature of the ETF sector means it is important that policymakers are engaged and remain flexible, so they are able to adapt to market >>>

>>> developments. A recent example of where this was done well is the work undertaken by the Central Bank of Ireland and, more specifically, their approach to different dealing cut-off times for hedged and unhedged share classes, which is likely to have significant benefits for investors.

***"Policymakers can do more to help EU retail investors fully benefit from investing in ETFs."***

- NOEL ARCHARD

Looking more broadly, we believe that policymakers can do more to help EU retail investors fully benefit from investing in ETFs. The European Commission, in their 2018 study, recognised the various

benefits of ETFs, whilst simultaneously recognising the difficulty that retail investors in Europe have in accessing ETFs, particularly when compared to the US. While this can be partly attributed to the substantive differences between the European and US markets, there is significant scope to improve both access to, and distribution of, ETFs for retail investors.

In this regard, we welcome the efforts of European policymakers as part of the Capital Markets Union agenda, including the recently agreed proposal on facilitating the cross-border distribution of investment funds. Distribution is one of the key obstacles and efforts to move away from the current highly-restricted distribution model in Europe will allow retail investors to better utilise ETFs for their investment objectives.

As Europe makes the transition from establishing the post-crisis regulatory framework and looks to the future, now may be the right time to consider where further improvements can be made, in order to support broader policy objectives. This includes addressing unintended consequences of EU regulation. One particular example is the impact of MiFID II and the PRIIPs Regulation. While these respective pieces of legislation have generally had a positive impact, certain provisions have resulted in limiting the distribution of non-EU ETFs into Europe. Ultimately, this has reduced investor choice, even where the non-EU ETFs have better liquidity and lower costs. Of course, if policymakers wanted to be truly ambitious, we would encourage the development of a consolidated tape in Europe, which will further enhance liquidity and transparency. ●



## Niels Lemmers

Managing Director,  
European Investors' Association

### Are we heading to a fee-free European ETF market?

For ages, retail investors have been buying actively managed funds. That has changed. Disclosure has been scrutinized and standardised through regulation. Investment details of all kind of investments are available on multiple websites. Costs and charges related to returns are out in the open. Competition

results in fees going to zero. Countless scandals on overcharging and mis-selling also opened long closed eyes. There is no such thing as a free lunch. Finally, retail investors realised this cocktail of actions should benefit them. Hence the booming ETF market for retail investors. In January 2019 the EFT market had €675 Bn AUM, with an inflow by net sales of €7.9 Bn in the European ETF segment, adding to an inflow because of underlying market performance of €34.1 Bn (Data: Lipper Alpha – Refinitiv, 2019/2/17).

#### Cornerstone

ETF Investing is or should preferably be a cornerstone for the retail investors' portfolio. Facing lower fees, they are able to follow numerous markets and investment styles. This should build a solid fundament. However, the retail investor has to stay focussed while deciding which ETF ends up in their portfolio. Key aspects thereto: asset class, indices, market risk, costs, liquidity and size (AUM). Despite the severe issues retail investors encounter since the implementation of MiFID and PRIIPs with the exemption of UCITS products, overall the information has been made available through this regulation is supporting retail investors in their decision-making process. They are better informed and more 'street wise' when investing in different types of ETFs. Nevertheless, solving the unavailability of thousands of US-based ETFs and even European ETFs because of the fragmented European financial market, should be the main focus of the legislators and

regulators in 2019. Preferably without creating another, new framework. This will only add to the confusion.

#### Fee-Free

Recently, two new ETF's were launched in the US, free of costs and charges for at least the first year in operation – by online lending and personal finance platform SoFi. This introduction leads to a lowest cost range of 0.09-0.14% for US ETFs available for the average retail investor. Within Europe, the competition is heavy but did not result in a fee-free ETF. The shattered EU financial markets and their different regulatory regimes and compliance are the most frequently mentioned causes.

Should we applaud this final race to the bottom? Certainly, but only if the ETF is a viable proposition. Manufacturing an ETF comes at a cost. Some revenues can be made by securities lending. With the right collateral and contracts, this could be sustainable. Furthermore, the Fee Free ETF is a marketing tool and the starting point of a customer-journey through other products and services of the promoter. Experiences in consumer protection show that retail investors have to be conscious of the pricing of these other products and services. A 'waterbed effect' on the sole expense of the retail investor should be averted. Ultimately, relatively simple, low cost and transparent ETFs (and their promoters) are bound to prompt affection rather than rumbling concern. Optimistically the markets will lead this way. ●



## Frédéric Bompaire

Head of Public Affairs, Finance and Strategy, Amundi Asset Management

### Adjusting to retail trading in ETFs

Till now the ETF market in the EU is an institutional market. In contrast with the US, retail clients weigh around 20% of the ETF AuM in Europe. Hence, it is a fantastic reservoir for future growth. This development should not reduce the strong protection framework that applies to retail clients in the EU. Existing regulation is sufficient, and proportionality is necessary to take stock of the diversity of

the ETF world. In order to ensure investors protection, regulators should focus on two items: more clarity on listed funds and effective circuit breakers.

ETFs have the unique feature to be both a fund and the issuer of listed instruments. There is a good practice to name "UCITS ETF" those funds that are UCITS and listed on an exchange. But retail investors have not such a transparency on other types of ETPs. Trading venues should be more attentive to segment their offer and differentiate through specialised trading compartments at least in three ways: (i) UCITS ETFs, (ii) other ETFs which are AIFs either based in the EU or in a third country and (iii) all other ETPs (notes or certificates) which are not funds and do not benefit from the sectoral regulation applicable to funds. This is a first step to ensure fairness. A second, also relating to transparency, would be to classify ETFs according to the degree of discretion in their management. It is very useful for an investor to understand at first sight whether he is about to invest in an indexed ETF with an explicit reference to the index, in an active ETF managed in a systematic manner on the basis of predetermined investment rules that apply automatically, or in an ETF actively managed in a discretionary manner. We believe that smart beta would belong to the second category and do not see many candidates for the 3d category, we count them on our fingers in the EU today. The third point where transparency is required is liquidity. MIFID increased fragmentation of financial markets among different venues.

Like for other listed instruments ETFs suffer from the absence of a consolidated tape that centralizes all the transactions of a day on an ETF and makes these data public. Due to this lack it is very difficult for investors, and particularly retail investors, to understand flows and take informed investment decisions.

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***"More clarity on listed funds and effective circuit breakers."***

- FRÉDÉRIC BOMPAIRE

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We now turn to circuit breakers which we see as the most efficient way to effectively protect retail investors. The first level of protection should be installed in the distribution chain. Retail clients should have access only to those funds, and ETFs are funds, that are authorized to be distributed in their country of residence. With the development of internet trading platforms, investors can navigate and sometimes reach a page where they have the possibility to deal on ETFs not authorized in their country. We see it as a major issue in terms of investor protection exactly like the presence of circuit breakers on ETF trading venues. Standard "limit down" mechanism that applies on stock exchanges is insufficient for protecting investors. It overlooks the reality that the key factor for an ETF is not its absolute change in price due to offer and demand but the high correlation of its performance with the benchmark. ●

# NEXT EUROFI EVENT

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# CEE region financing and investment gap



## Peter Paluš

Head of the Financial Unit, Permanent Representation of the Slovak Republic to EU

### Need to route investments towards new trends for economic development

Looking to the coming future, fourth Industrial revolution will shape economy landscape and our daily lives. Beside opportunities it brings along threats if we are caught vulnerable. Therefore, we need to prepare and think carefully about stack of investment policies which would mitigate weaknesses and fully exploit favourable circumstances.

Immense challenge emerges from the backbone of Slovak economy, particularly our historically strong automotive industry. Ignoring ongoing transformation from traditional car industry and fossil fuels to eVehicles and sustainable energy sources may endanger vast labor force – according the OECD 40% of jobs are in Slovakia at risk of automatisisation while e.g. only 4% in Norway – thus, investments to innovation, R&D, digital infrastructure, energy efficiency and education are necessary.

Having proper access to – supply side – finance is one prerequisite to succeed. EU cohesion funds, European Fund for Strategic Investments, the EIB and national promotional bank provide enough resources to fulfil reforms. However, we identified bottlenecks on demand side – lack of high-quality projects and know-how which match current needs.

What can policy makers do to unlock full potential of financing and keep up with recent development trends? One does not need to start from scratch, Commission's country report caters solid proposals:

- increase attractiveness, efficiency and competitiveness of the research and innovation system;
- attracting and retaining qualified researchers in the smart specialization areas;
- increase cooperation between the business and academia;
- mobilizing knowledge and technology transfer;
- support companies to move up in global value chains;
- increase productivity facilitating participation in industry led and research driven international clusters;
- training and reskilling for smart specialization areas at all levels;
- improve energy efficiency in public and residential buildings and small and medium sized enterprises.

We should react promptly, change is at horizon otherwise we might find ourselves in productivity trap with high social costs. ●



# Debora Revoltella

Director Economic Department,  
European Investment Bank (EIB)

## Addressing the financing and investment gap in CESEE

Most CESEE countries are modest or moderate innovators (EC classification), even if there is substantial heterogeneity in the evolution of innovation performance across countries and some hot spots of innovation hubs. Low innovation performance is associated to relatively low investment in intangible assets that remains very dependent on European Structural and Investment Funds and foreign R&D investors, skills shortages, a low smart-digital penetration and an operating environment that prevents scaling up of technological advancement.

As a result, a stronger role for innovation to increase productivity is a key element of the new growth model for CESEE, to escape a middle-income trap. To this end, stronger investment, skill development and a system of financial intermediation that supports investment and innovation are crucial.

Launched 10 years ago, the Vienna Initiative is a private-public coordination platform to address macro-financial issues in the CESEE region. In this context, two new working groups have been looking at markets gaps and priority policy areas for investment and innovation in the CESEE region. The working groups have looked at the role of private and public sector, as well as the shaping of IFIs intervention for the purpose.

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*"IFIs have been playing an important role in supporting access to finance of the private sector in CESEE."*

- DEBORA REVOLTELLA

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In the context of the new Multi Annual Financial Framework, the recommendations from those working groups aim to provide a contribution to shape the next generation of IFI products, leveraging on the financial instruments concept, assessing the needs and characteristics of the local investor base and strengthening the cooperation among IFIs.

IFIs have been playing an important role in supporting access to finance of the private sector in CESEE. Looking ahead, IFIs can continue to play a catalytic role in the transition of the region's economies towards a new growth model, based on productivity growth through human capital development and home-grown innovation. A proper tailoring of IFIs product in this direction is crucial.

The new reports identify the key policy priorities for action in this context:

1. To support lending to SMEs and MidCaps, capital relief products are at the moment more in need than liquidity. Impact Finance Products covering first loss risks (e.g. COSME, PF4EE, SME-Initiative, etc) or pre-bankable finance (e.g. EDP, IDFF, Future Mobility) are particularly relevant.

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2. Compliance with the minimum requirement for own funds and eligible liabilities (MREL) targets will pose challenges for the banks operating in the region in the coming years.
3. Due to a shift in demand towards local currency products, IFIs should consider further broadening their domestic currency-denominated product palette.
4. EU-funded venture capital programmes boosted the entire VC ecosystem and start up world in the region. Similar initiatives in the future would bring further benefits by focusing increasingly on qualitative results.
5. Venture Debt (VD) is a product offered by banks and specialised funds as a complementary source of later stage risk financing, alongside existing VC funding or equity solutions. The Venture Debt market is relatively underdeveloped in Europe and in nascent stage in CESEE region. There is further potential to develop commercial banks' offering of Venture Debt, with the support of IFIs.
6. IFIs could provide a more targeted financing option for the corporates of the region by adapting their product offers to the specificities of CESEE, potentially by providing smaller ticket sizes, more flexibility in the loan structures, quicker decision-making etc.
7. Using grants in combination with financial instruments is an efficient way to support investments with high socio-economic impact, and such combinations have a high potential for use in CESEE.

The framework for financial instruments proposed by the EC for the next MFF (InvestEU) addresses a number of issues. It is important that the fruitful regular dialogue between the private and public sector parties continue, to maximise the benefits and impact of financial instruments in the market. Better and more accessible data on IFI product supply could help to maximise overall impact and could promote better coordination among IFIs. ●

Contributor: Aron Gereben, Senior Economist, European Investment Bank (EIB)



## Benjamin Angel

Director, Economic and  
Financial Affairs,  
European Commission

### Re-igniting investment in CEEs

Investment remains at the top of the policy agenda in Europe. EU funding, both grants and financial instruments, is providing a significant contribution to public investment in the CEEs, helping to mobilise private investment, strengthening national, and local authorities, and civil society.

#### **What is the magnitude of the financing and investment gap in the CEE region?**

Investment in the CEE region has been above the EU average, fluctuating around 20 - 25% of GDP with humps in the late 1990s and before the crisis. Still, some factors suggest a significant investment gap.

First, the capital endowment of CEE economies remains well below the EU average. Hence, as these countries converge to their economically more advanced peers, a prolonged period of higher investment to GDP ratios appears necessary.

Second, the investment ratio is still below the pre-crisis level in a number of countries. The part of crisis-induced fall in investment may have been structural, with implications for the capital stock and potential growth. The crisis brought rising uncertainty, increased risk premia and a reversal in external funding, which have not fully recovered.

*"Three most important challenges facing the CEE countries."*

- BENJAMIN ANGEL

Third, following the transition period, and in readiness for EU membership, the region undertook far-reaching reforms, which made it more >>>

>>> attractive for investment capital. However, more recently, reform progress has slowed, or even reversed. The region's success in attracting private (including foreign) capital and in absorbing EU structural funds is key for a transition towards knowledge based economies, increasingly specialised in high value added goods and services.

#### Are there differences across countries and across sectors?

There are some large differences, determined by both regional and idiosyncratic factors. To take one example, total investment in the Czech Republic has stood 5 pps above the EU average due to the weight of the manufacturing sector in the economy, which requires high equipment investment.

At the same time, although being a transit country places great

demands on the country's infrastructure, investment in this area has been below EU average levels.

#### Do the current financing models in the region need to evolve? How?

Within the CEE, as in the EU, most financing is through banks. Equity and corporate bond financing is limited, institutional investors tend to be much smaller than in Western Europe and the CEE Region have lower access to venture capital. The development of capital market financing via Capital Market Union is thus particularly important for the EU CEE Member States.

The composition of investment has also tended to tilt towards tangibles. Increased investment in intangibles such as human capital and research would support technology uptake and increase innovation, notably by domestic SMEs.

This is key to improve productivity and long-term growth that would benefit society as a whole.

#### What are the main challenges that need addressing in this perspective?

I would say that the three most important challenges facing the CEE countries are:

- reducing administrative and regulatory burden that tends to hamper investment, particularly for SMEs.
- fostering public sector efficiency, digital innovation and the quality of institutions. This would help to establish a predictable framework and reduce uncertainty.
- investing in education, skills and new talents. The lack of adequately skilled staff is a key obstacle to many investments, including in innovative and technological companies. ●



## Steven van Groningen

President and Chief Executive Officer,  
Raiffeisen Bank Romania

### Joint forces to overcome the financing and investment gap in CEE needed

Investments are essential in order to maintain and to improve the economic growth potential. In addition, for CEE countries, investment needs are even more stringent than for EU developed countries given their low levels of existing capital stock. Amid a benign global environment and in the context of

the EU accession process, CEE countries faced strong foreign capital inflows in the years before the crisis inception in 2008 and investments boomed. Post crisis period is more challenging in terms of investing given that foreign capital inflows are scarcer and economic and political uncertainties that companies have to face have amplified, reducing so their appetite for investment. CEE countries not only have to modernize their underdeveloped infrastructure, but they also have to take care about investments in innovation (R&D activities) and in human capital as a key requirement of the new digital economy. With large funding needs, all available funding sources should be used: loans from domestic banks, loans from borrowing from abroad, EU funds, capital market, public-private partnerships and private equity funds.

Romania, for example, faces at a moment a large gap in terms of capital and economic development relative to the Euro area core countries. Country's funding needs for investments projects are impressive, as they have been accommodated in the recent years only to a small extent. Spending on R&D, education and healthcare is currently still among the lowest in the EU. Romania needs to make quality investments, particularly in infrastructure, for today and tomorrow. Foreign capital inflows have remained reduced over the past years as private sector, especially the banking sector, was in a deleveraging mood following a surge in indebtedness before 2008. Similar to other CEE countries, Romania's financing is too

banking dependent. Other actors and new forms of financial intermediation will have to meet the credit needs of the economy. Having access to diverse funding structures is a main pre-condition for unleashing the growth and closing the gap to core Europe.

*"Investments are essential to improving the economic growth potential of the CEE region."*

- STEVEN VAN GRONINGEN

Uncertainty related to the course of governmental and fiscal policies can hamper the appetite of companies for investments as is currently shown by the example of Romania. Fiscal space has been recently used to substantially increase wages in the public sector and pensions, which leaves a limited room for increase of public investments going forward (after they were cut in the last years). The recently introduced bank levy and the very elevated capital requirements for pension funds might restrain further financial intermediation. There might be significant positive implications for fiscal sustainability and long-term growth, if these decisions are reassessed.

Foreign investors role in the CEE development has been and will continue to be tremendous. Just as before, we need to join forces and commit to continue along this successful path and remove all the obstacles for financing and investment together. ●



## Lucian Anghel

Chairman,  
Bucharest Stock Exchange

### Romanian capital market developments

The Romanian capital market has started in 2014 an ambitious reform in order to be upgraded to emerging market status by global index providers and, since September 2018, it is only one step away (as far as market liquidity) by the FTSE Russell classification. As per the FTSE Russell country classification review, the Romanian capital market was maintained on the Emerging Market Watchlist and is one step closer to obtain the upgrade. The single outstanding criterion is Liquidity – sufficient broad market liquidity to support sizeable global investment. FTSE upgraded from 'Not Met' to 'Restricted' the Liquidity criterion, following an improvement in broad market liquidity.

The global index provider MSCI published on June 20, 2018, its latest Global Market Accessibility Review. The report stated that Romania continued its efforts to improve the liquidity and participation in the stock market by lowering trading fees and encouraging more market makers to boost market activity, and that notable activities for the Romanian equity market also included the launch of Issuers Reporting Information System, where listed

companies were able to release their communication to the market efficiently. Therefore, Romania's accessibility criteria were upgraded on 3 notes: market regulations, information flow and trading.

Although Romania is the second largest country in the region after Poland, the local exchange has a market capitalization/GDP ratio 3.5 times smaller than Warsaw Stock Exchange, and about 15 times less retail investors. This is a direct consequence of the low degree of financial education of the population. We are working with the capital market stakeholders, FSA and relevant authorities to implement measures at national level that support financial education, stimulate savings and diversify investments.

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*"Taking steps for increasing liquidity on the way towards emerging markets."*

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- LUCIAN ANGHEL

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Internally, Bucharest Stock Exchange is focusing on developing the market infrastructure by launching the local CCP solution, attracting private IPOs and bond listings as well as foreign investors in Romania. The CCP solution, approved by the shareholders in January 2019, is a prerequisite for launching the derivatives and further broaden the market offering.

On attracting entrepreneurs towards listing, Bucharest Stock Exchange is running in 2019 the 3rd edition of Made in Romania project, targeting 15 companies for the growth of the Romanian economy and their success stories.

About attracting foreign investors in Romania, Bucharest Stock Exchange has extended in the last years the range of targeted investors as well as the geographical region, initiated and took part in more roadshows and investor conferences, launched InvestingRomania.com information portal.

In parallel, the projects on qualitative improvement of the market are quasi permanent, like increasing the degree of corporate governance compliance for listed companies, within the framework of an EBRD supported project. ●

## Sergiu Oprescu

Chairman of the Board,  
Romanian Association of Banks

### Closing gaps – between reality and outlook



Just as there is an intrinsic link between the degree of financial intermediation and the level of financial literacy, likewise the economic GDP growth and the optimum level of financial intermediation are directly correlated. In Romania's case, the degree of financial intermediation is set at 26% and the level of financial literacy is 22%.

As opposed to 8 years ago, financial intermediation has fallen by one-third. However, the banking system has the availability and resources to accelerate lending.

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*"Financial literacy and financial integration – solutions for reducing gaps in EU."*

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- SERGIU OPRESCU

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At the same time, a correlation can be identified between member states competences and the way it is being used in implementing European directives and financial literacy. If the level of financial literacy is below average, then the deployment of European >>>

>>> directives with certain deviations from free market financial principles, is easier. This generates a negative impact on the development of the banking system, the level of financial intermediation and financial integration.

Thus, this type of less perfect legislative implementations generates complications and sometimes even obstacles in promoting European fundamental values, such as the free movement of capital, services, etc.

Transposing and deploying these directives into national legislation can be made with errors, should we not take into account the level of financial literacy when legislating.

I believe that there is enough room to lower barriers that fragment national financial markets, thereby increasing financial integration in the European Union so that all states benefit from the same level playing field. Integration is generated by calibrating rules and practices.

Monitoring and sustaining a European program designed to increase financial literacy, is the solution for a better financial integration. As such, the cornerstone of this attuning should be to introduce in school curricula as a mandatory discipline for all European Union citizens, financial education.

Intrinsically, the fine tuning at the level of national competences, is recommended, when transposing and deploying European regulation.

The more affected some EU economies are by regulatory differences and lack of financial integration, the more negative consequences are there for the European family to annihilate: poverty and social exclusion, migration phenomena, etc. By removing these obstacles and the delay in the standardization of regulation, we reduce the risks of a future crisis. European Union countries have to move forward in the same direction and financial intermediation and financial literacy are the solutions to reduce gaps.

By fine tuning individual national competences as regards legislating/regulating, we can end integration efforts' fragmentation in the financial sector, as well.

In conclusion, it is necessary to adopt measures designed to increase and reduce the financial literacy gap across Europe in order to create a level playing field and strengthen the financial integration policy at European level. ●

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# VI. DIGITALISATION AND FINTECH

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## Issues at stake

Technology offers new opportunities that could lead to a radical change in the financial services sector and its value chain. All financial activities are concerned and can potentially reap the benefits of digitalisation and fintech. Although many current applications mean improvements of existing services and processes, technology also facilitates the introduction of new business models and the entry of new players into the market, e.g. in the payments area.

These new technologies may however pose new risks notably in terms of data privacy or cyber-security and may increase the role of non-financial third-party providers. This raises new challenges in terms of regulation and supervision that are currently being addressed at the EU and global levels and requires the definition of appropriate market standards and rules.

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# Fostering digital distribution and fintech innovation



## Märten Ross

Deputy Secretary General for Financial Policy  
and External Relations,  
Ministry of Finance, Estonia

### Single market still looking for Fintech push

**To what extent and in which areas does EU Fintech action plan help (or not) to address both the challenges and specificities of the EU?**

EU Fintech action plan was a sensible set of actions to help Europe consolidate fintech initiatives into the single market. It included many important elements – assessment on how blockchain would fit into regulation, how to organise sandboxes, a proposal to regulate crowdfunding etc. And specifically how to handle it in the complex single market universe.

However, the plan is only helpful if it also delivers decisions and actions. And on that the jury is still out as notable parts of the plan are still ‘work in progress’.

**Is digital disruption helping to speeding up integration of EU markets for financial services despite existing differences in habits, languages and legal frameworks?**

Yes and no. There are areas that would have not been witnessing present level of cross-border activity without these advances in technology. Like some portions of retail payment market and also certain business lines of crowdfunding.

However, more broadly the promise remains yet to be delivered. One reason is that in some elements the technology has never been the prime constraint on integration. While home bias is surely somewhat influenced by limitations on information exchange (that digital technology helps to overcome somewhat), the root cause for that seems to be deeper inside the way how business life is arranged inside Europe. Particularly in SME world. For example, the way the business transactions are arranged and recorded on country level tend to support more fragmented market. Taking advantage of technological advances could help overcome these to some extent. But for the serious change stronger socio-political will is probably needed.

**Do digital initiatives taking place have a sufficient cross border dimension?**

With some exception the answer is rather ‘not enough’. There are good examples in the area of main payment infrastructures that have led to reasonable cross border integration with good quality, including in retail payments. And it might be, that main initiatives on data handling and protection beyond strictly financial field are containing sufficient cross border dimension already.

>>>

>>> However, in many parts of the market which could benefit much from digital innovations the cross-border dimension remains limited. For example, blockchain innovations or crowdfunding-type businesses are promising for integrated cross-border handling of securities' transactions and company registry keeping. However, the regulatory environment is still not moving decisively to provide sufficient clarity for the market to develop and even less so to provide clear European dimension to it. True, obstacles might be complex and overcoming them unavoidably time-consuming. But that should not limit the effort.

#### **How to describe the EU digital landscape in the financial area, compared to other geographies globally?**

It is seemingly easy to say it is not EU but rather other regions (eg China or Asia-Pacific) that have set the global pace on a digital economy, including in cashless payments. However, there is no absolute proof or comprehensive data, which region contributes most with regard to providing most advanced digital financial services.

An estimation of a digital landscape of a region depends on the characteristics which are set as a priority. Europe as a region is versatile but simultaneously uniform: the biggest digital innovators may not be of European origin, but consequently the general level of digitalization and innovation is relatively high. EU single market and common background of regulation could provide a unique starting point for EU technology competence and also smaller countries can play a role in the general status of the region.

EU digital landscape in the financial area is therefore full of potential. Using digital financial services and mobile banking has completely changed our understanding of banking sector and the provision of financial products. But the fact that everything is so comfortable and easy to use also includes dangers, e.g. cybersecurity threats. ●



## **Pēteris Zilgalvis, J.D.**

Head of Unit, Digital Innovation and Blockchain,  
Digital Single Market Directorate, DG Communications Networks,  
Content and Technology & Co-Chair of the FinTech Task Force,  
European Commission

### **The EU FinTech Action Plan is celebrating its first birthday**

Digital innovation has increased the pace at which the financial services world is evolving. Financial services have undergone other digital revolutions, but what is unprecedented now is the speed and scale of this transformation. Think a few years back: digital banking was already at your fingertips. Today, your customer's experience has improved, your personalised assistant or robo-advisor helps you with financial and service choices, your payments are ever faster. Tomorrow, one can expect further investments in blockchain, advanced artificial intelligence and machine learning, the Cloud and cybersecurity in the realm that we call FinTech.

Europe is well positioned to reap the fruit from the innovation that the FinTech revolution is delivering to the market. In March 2018, the EU Commission FinTech Action Plan presented a set of actions in FinTech-related sectors such as big data, cybersecurity, blockchain, crowdfunding and cryptoassets, interoperability and standardisation, along with boosting financial and IT skills while ensuring financial stability, protection of consumers and investors, and market integrity.

>>>

>>> One year later, several EU FinTech Labs have been organised with national regulators and supervisors addressing important issues such as cloud outsourcing, artificial intelligence and robo-advice, providing a safe space to put questions to solution providers in regard to technology that is already on the market and ready to be introduced in our financial sector where justified. The next FinTech Lab is expected to address blockchain and other Distributed Ledger Technologies. Standardisation gap mapping activities are being carried out by standardisation bodies at the EU level (CEN-CENELEC, and ETSI being active on blockchain); Europe encourages emerging consortia to avoid market fragmentation and develop PSD2 compliant APIs.

We've seen innovation facilitators, hubs and sandboxes being created in many European countries. ESAs and national regulators have been eager to spread best practice and build expertise across borders. That's the objective of FIN-TECH, an EU-funded project encouraging universities, regulators, supervisors and the FinTechs, to join forces to develop coordinated training support on risk management and new technologies for national regulators and FinTech companies across borders, with the aim of diminishing burden on the compliance side (RegTech) and enhancing converging supervisory practices (SupTech).

Meanwhile, the Commission has rolled out an EU strategy on blockchain based on active stakeholders' engagement through the EU Blockchain Observatory and Forum (1500+ contributors) and the commitment from Member States and EEA countries to build the European Blockchain Service Infrastructure. 27 Member States, Norway and Liechtenstein have formed the EU Blockchain Partnership and are engaging to deploy cross-border digital services on blockchain together starting in 2019. Together with the Member States, the Commission is assessing the regulatory framework with a view to ensuring legal clarity and an enabling environment for technological and other innovation.

The Commission has also witnessed global interest in the International Association for Blockchain Trusted Applications (INATBA), a global multistakeholder association to promote trust and interoperability of blockchain and DLT technologies in different sectors and to enhance regulatory dialogues at the international level. Based in Europe and global from its outset, it already consists of big and small innovative companies and foundations from at least three continents (Europe, Asia and America).

These were just a few examples of the actions in the FinTech Action Plan and Digital Single Market that are progressing. The spirit they share is of policy, innovation and technology moving together, while leveraging EU values to design human-centric services to address our societal needs and to improve our economic competitiveness. ●



## Eduardo Arbizu

Global Head of Supervision,  
Regulation and Compliance,  
Banco Bilbao Vizcaya Argentaria (BBVA)

### The data battlefield in digital finance

The transformational wave that financial services are experimenting is driven by a number of factors. The main one is the combination of mature technologies like mobile, cloud and big data analytics with new emergent technologies like DLT, AI or IoT. This has a deep impact

on our clients' expectations in terms of convenience, efficiency, customization and security. In addition, other shaping factors appear, greatly facilitated by technology, like the surge of new entrants and new business models mostly based on platform models, and the underlying trend towards decentralization. This context is pushing financial institutions towards a transformation that is much needed to compete effectively in the digital ecosystem.

The entry of brand-new players has been gradual. Fintech startups have first unbundled banking, initially offering niche services like payments and personal finance management, but stepwise entering into lending and asset management. As of today, some >>>

>>> players are rebundling services, turning into integral financial solutions platforms or even getting a license to become fully-fledged banks. We do not need to wait for the future to see significant changes in the industry, because they are already happening. Incumbents, however, must still shift their mindset to make an opportunity out of the unavoidable change. Providing that a level playing field exists, investing, acquiring or partnering with the best fintechs allows to accelerate the digital transformation of the core, and to improve the value proposition to customers by embedding financial services into digital ecosystems.

As it is increasingly being acknowledged by authorities like the BIS or the FSB, BigTechs are a totally different issue. Although it might seem that this is a competition based on new technologies and business models, the real battlefield has to do with the most valuable asset when retaining and improving the

relationship with clients: data. Data is the glue that allows the creation and nurturing of digital ecosystems. BigTechs use them to link their increasingly diversified services around every customer. Data also fuels two-sided marketplaces, accelerating the transition to the uberisation of services, which in financial services is initially manifested in P2P lending or crowdfunding platforms.

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*"A cross-cutting regulation on user-requested data sharing would be desirable."*

- EDUARDO ARBIZU

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In this battle, regulatory asymmetries unlevel the playing field. As an example, PSD2, which forces to open transactional payments customer data to

third parties and applies only to financial institutions, poses a clear case of uneven playing field. A cross-cutting regulation on standardised, secure data sharing based on requests by users would be desirable in order to empower users, increase innovation and ensure a fair competition.

Regulatory authorities in Europe and other progressive jurisdictions have sent clear signals that consumers should have greater control over their data. To the extent that a company is able to gain the trust of its customers, and therefore their consent for the lawful and proper use of their data, it is their responsibility to ensure the protection of such data, something especially relevant in a world of information sharing.

Regulation must ensure that all sizeable actors comply with these obligations and that liabilities are properly allocated even in decentralized environments in which data flows can become difficult to monitor. ●



## Levin Holle

Director General, Federal Ministry of Finance, Germany

### EU regulation as an enabler for a European Digital Single Market

One of the great successes of European integration has been the creation of a strong single market which has also proved to be competitive internationally, while at the same time preserving the

diversity and values of the many people who make up the European Union within a common and mutually agreed legal and economic framework.

Digitalisation could be an enabler for an even closer and stronger European Union, as it is a cross-border phenomenon by its very nature.

Digitalisation brings an increase in cross-border services, including significantly lower transaction costs. Unilateral responses by Member States to address some of the effects of digitalisation should therefore be carefully weighed against the fact that such responses tend to hamper cross-border services and could create barriers within the single market.

The European Supervisory Authorities have recently addressed several areas where this effect is already materialising. In the area of crypto-assets, for example, a harmonised European approach is not yet in place. At the same time, the ESMA Advice on Crypto Assets has discovered a number of gaps and issues in European capital market regulation. Consequently, individual Member States are considering unilateral ways to address this issue mainly for two reasons, namely to foster innovation and to protect their investors. An agenda for creating a single digital financial market should be a key priority for the next European Commission.

A European approach to another digital phenomenon, crowdfunding, is

currently under discussion. The new EU rules on crowdfunding are intended to facilitate the cross-border provision of certain crowdfunding services within the European Union and increase investor confidence in such services by implementing appropriate investor protection requirements. These rules should fit in with the overall regulatory and supervisory approach that is aimed at achieving stable, transparent financial markets and comply with the principles of proportionality and subsidiarity.

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*"A swift response addressing the most urgent issues is key to staying competitive."*

- LEVIN HOLLE

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These developments show that the European Union is well-placed to address and embrace digitalisation and stay ahead of international competition. With regard to the tokenisation of capital markets, harmonised European rules could put the EU in a pole position internationally.

In a digitalized market environment where minimum viable products, time to market and winner-takes-all markets have become paradigmatic, a swift response addressing the most urgent issues is key to staying competitive internationally. ●



## Hanna Heiskanen

Senior Advisor on FinTech and Policy,  
Financial Supervisory Authority,  
Finland (Finanssivalvonta)

### Important steps after the fintech action plan - priorities for the Commission

The Fintech action plan is a good starting point for harnessing the opportunities of fintech and for accelerating the adoption of new technology. It will be the important duty of the next Commission to make conclusions based on studies and assessments that are carried out according to the action plan.

Supervisors' role in fostering innovation is one of the key items discussed in the action plan. Today, nearly each European supervisor has an innovation hub to provide a dedicated point of contact for firms to raise enquiries and to seek guidance on regulatory requirements. There are only a few European regulatory sandboxes i.e. schemes to enable firms to test innovative financial products or services.

Sandboxes are open for only a limited number of firms based on pre-defined entry criteria. This raises several questions. Does the entry into a sandbox programme provide the selected firms competitive advantage compared to other firms? Does it indicate that companies providing similar products are less innovative? Do companies that are admitted to sandbox programmes gain easier funding from venture capitalists?

Supervisors' primary role is to evaluate whether a service is compliant with regulatory requirements - not to indicate, which service it finds the most innovative. Going towards EU level sandboxes would be too premature when taking into consideration all of the unresolved issues. Instead, everyone would benefit from yet increased cooperation between all types of innovation facilitators and discussion on lessons learned.

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*"Going towards EU level sandboxes would be too premature."*

- HANNA HEISKANEN

---

Detailed technical regulation or product harmonization through technical standardization have not typically been among the tasks of financial supervisors. But will they be in the future? Today, supervisors are receiving an increasing number of requests to enhance the harmonization of technical interfaces and even products. It will be an important role of the next Commission to facilitate discussions regarding financial supervisor's role in technical regulation. Will supervisors keep their principles-based approach or should they move into a more detailed direction?

Adoption of new technology is another key item in the action plan. The question when to adopt new technology is challenging. Firms and supervisors learn from new technologies through experiments and trials. But in critical functions, such as payments systems, you simply cannot experiment with evolving technology. The technology has to be mature enough. Therefore the questions is, where and when to experiment. It is crucial to find controlled ways of testing new technology, such as distributed ledger technology. The next Commission could foster discussion on identifying potential technology trials.

Finally, when working with innovations, it is vitally important to ensure a level playing field for all firms. Each supervisor should interpret directives and regulations identically. Same type of authorisation should be required for similar activity in all member states. It is important that the Commission ensures that the ESA's are empowered to tackle cases where supervisors' approaches differ in a too large extent. ●

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# DLT and crypto-assets



## Joachim Wuermeling

Member of the Executive Board, Deutsche Bundesbank

### Blockchain technology: hype or hope?

Judging by businesses' media activity in 2018, one could be forgiven for thinking that almost everyone is involved in one distributed ledger technology (DLT) project or another. There are at least two reasons why activity has been so brisk. First, Blockchain and DLT are indeed ingenious technologies. Second, they have made it to the top floor of banks and have become a vehicle for showcasing credit institutions' innovative prowess.

But compared with the years before, the excitement has worn off a little. The most famous DLT prototype, the bitcoin network, which was incidentally mistaken for a new era of finance, not only fell out of favour as bitcoin lost value. It also laid bare some of the technical constraints and trade-offs involved in open Blockchain applications. At around 350,000 payment transactions per day, it only proved capable of processing a tiny fraction of the usual daily transaction numbers (the German payment sector alone registers 75 million daily transactions). So scalability has become a concern for DLT applications. Also, the huge amounts of electricity consumed by the bitcoin network signposted the potential inefficiencies of DLT. Not just that – it also raised a fundamental question about Blockchain technology: when exactly is it certain that a transaction is final? In the bitcoin network, finality is merely a matter of probabilities.

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*"DLT is a matter for forging solutions that can also be deployed in the real world."*

- JOACHIM WUERMELING

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Many of these issues have been mitigated as DLT applications have evolved. Overcoming the decentralisation paradigm has been important in this regard. Taken to extremes, a decentralised approach – like the one used by the bitcoin network – does not meet a core principle of financial regulation, which requires a specific entity to assume accountability for risks involved in financial services. In a fully decentralised network of miners, where anyone can come and go as they please, no individual node is responsible for the network to work properly, and there is no accountability in the event of theft or manipulation. The financial industry has acted accordingly, dismissing complete decentralisation as an objective. Ledger solutions are usually designed as "closed" and "permissioned" networks, meaning that the network is composed of a small number of authorised entities only. This might have taken away at least some of the original spirit, but it is a sign that Blockchain is growing up and overcoming technical constraints.

>>>

>>> Institutions are pushing ahead with DLT-based applications for good reason. Leaving aside any ideological intentions, there is still a chance that DLT and Blockchain can deliver results which outperform traditional architectures. Improvements could take the shape of better transparency for all contractual parties, simplified reconciliation, traceable and manipulation-proof data, superior operational resilience, and the possibility of using smart contracts to execute processes automatically.

In the end, this could all help save money, time and resources in a variety of business areas, from settling cross-border transactions to setting up Blockchain-based markets and assets. But success will only come if technical, economic and governance issues have been properly addressed. So it can be said that DLT and Blockchain research is no longer a matter of conquering the entire financial sector, but of forging solutions that not only boost process efficiency, but can also be deployed in the real world.

However, the future of DLT and Blockchain in the financial sector also depends on politics. For example, some DLT projects are being held back by legal concerns. That's because widespread acceptance of DLT-based processes is contingent on creating legal certainty in what is, in some cases, still uncharted territory, and this has also led to a patchwork of regulatory requirements across jurisdictions. With that in mind, DLT's fortunes will depend on political will as well. This is no reason for European politicians to blindly give their wholesale backing. But as the concrete value added offered by specific solutions becomes visible, regulators should not hold back on implementation.

Whatever the future holds, financial supervision will remain technology-neutral and will neither hinder nor advocate innovation. But if DLT boosts efficiency and safety in the financial sector, that would surely be a welcome step in the right direction. ●



## Klaus Löber

Head of Oversight, European Central Bank (ECB)

### DLT, crypto-assets and digital coins – raising to the challenge

Crypto-assets market capitalisation reached its peak in December 2017 before the speculative bubble did inevitably burst. The price of crypto-assets has not recovered since then and, although Bitcoin and the like will continue to exist for some time, the idea that they could replace or compete with sovereign currencies has been largely discredited. However, crypto-assets continue to be supported by a dynamic ecosystem of innovators, entrepreneurs and investors that try to bring about newer generations of crypto-assets such as so-called stable coins or secured token offerings. Attention is also given to ways to represent cash in digital tokenised form, to provide substitutes for traditional account-based settlement. For central banks and other public authorities, it is important to closely follow developments regarding tokenised assets and their underlying technology.

Crypto-assets bear various risks that need to be considered and addressed by relevant authorities. Given their often-pseudonymous nature and the absence of regulated intermediaries, crypto-can serve criminal activities. In that regard, the work of FATF and the forthcoming entry into force of the 5th Anti-Money Laundering Directive that will hold crypto-currency exchanges and wallets accountable is welcome. In addition, the use of crypto-assets may pose consumer and investor protection issues. Central banks along with other public authorities have repeatedly issued warnings that investing in crypto-assets is at the users own risk. Increasingly countries take initiatives to regulate crypto-assets. >>>

>>> The objective to create a safer environment is well intentioned but regulation should avoid incentivising inherently risky crypto-assets activities. Although crypto-assets currently do not represent an immediate threat to financial stability, it is important to make sure that the financial sector remains shielded from potential contagion, for instance by applying a conservative prudential treatment to crypto-asset holdings.

While crypto-assets have so far not proven their economic and social value proposition, the underlying technology known as distributed ledger technology and the tokenisation of assets and cash may have potential applications besides crypto-assets warranting separate analysis. Many financial institutions and central banks, including the ECB, are exploring their potential and the limitations. At the international level, standard setting bodies such as the Committee on Payments and Market Infrastructures develop analytical tools and steer the reflection on risk and opportunities of new technologies and of new variants of assets and cash in tokenised form both for financial activities and regulatory compliance.

The key feature of DLT lies in the possibility for systems involving multiple participants to propose, validate, and record state changes consistently without relying on a central trusted third party. By replacing central account keepers with a distributed consensus mechanism, DLT also enables “tokenisation” of assets. Efforts to create digital settlement assets, often called digital coins, in particular in the wholesale sector, come with promises to enhance settlement efficiency. Often, these initiatives are presented as alternatives to traditional settlement in central bank and commercial bank money. Decentralisation and tokenisation represent potentials to explore as well as challenges that need to be addressed. From a technical point of view, experiments show that, to date, use cases in finance and banking can be conceptually and technically designed in a DLT environment, but that, at the current stage of development, DLT is not mature enough to meet the financial industry’s requirements in terms of safety and efficiency. From a legal and regulatory point of view, DLT and tokens raise a series of questions related to legal qualification, governance, finality, interoperability or operational risk management, to cite just a few.

With its Fintech action plan, the European Commission has initiated the reflection on the implementation of regulatory measures that support technological innovation without compromising the financial sector’s security and integrity. In particular, it has set up an expert group to assess whether there are unjustified regulatory obstacles to financial innovation in the financial services regulatory framework. ●



## Leonardo Badea

President, Romanian Financial Supervisory Authority

### Distributed Ledger Technology – the kid is growing up!

We have a saying in Romania “he grows in a year as much as others do in seven”! This is exactly what it comes to my mind when I look at how Distributed Ledger Technology (also known as DLT) has developed over the past years.

Looking at the financial sector, we have to keep in mind as a general matter of fact that it is a highly regulated sector. Indeed, DLT can bring a lot of benefits to the financial sector, but we have to be

aware that any new technology that is implemented has to pass a lot of “hoops” before it is adopted on a large scale. Most regulators point out that any distributed ledger technology has to comply with the current regulatory framework. And this is the challenge at the end of the day.

*“There is a lot of potential for implementing DLT in Central and Eastern Europe.”*

- LEONARDO BADEA

If we take a look at the stock exchanges, we can spot many areas where DLT can bring improvements. Of course, DLT can be used for clearing and settlement processes, in post-trade, it can be used to streamline the document flow and even to reduce the involvement of intermediaries with the use of smart. >>>

>>> There is a bright future for DLT in the insurance business, as well. DLT can be used to reduce the costs and increase the effectiveness of regulations for insurers, such as KYC and AML. Another area where DLT can be used is the prevention of risks and fraud detection.

But we have to keep in mind that although DLT can bring a lot of advantages, it will raise a few questions on its own. Of course, the lack of a central database might raise questions about what could happen in case of a failed or erroneous transactions. Cyber threats pose a concern to DLT since it is a decentralized network while another major concern regarding DLT is represented by the legal challenges, quite substantial in the case of cross border transactions.

In CEE region, an example of how a country is quick to adopt and to implement DLT is Poland. The Central Securities Depository of Poland implemented an e-voting solution which ensures a greater transparency regarding the history of their Annual General Meetings and the voting results. Another example in Poland is the bank PKO Bank Polski, which is using DLT to ensure compliance with EU law by organizing the bank's communications with its clients (documents, communications) in a repository based on DLT.

We should not forget Estonia neither, one of the most developed and active countries when it comes to implement new IT technologies in the benefit of its population. It has implemented

a digitalization project at country level which reached its climax in 2014, with the introduction of the e-residency program.

So, clearly, there is a lot of potential for implementing DLT in Central and Eastern Europe, with countries from this region being in the center of the new technological revolution. Without any doubt, CEE is quite renowned for its highly skilled and trained workforce. Even more, it is visible that the region is surpassing the stage of being only an outsourcing region and is adopting a more complex role of working together on solutions with their partners, being a potential strategic player in the business. ●



## Alan Marquard

Chief Strategy & Development Officer,  
CLS Group

### The optimal model for the application of Distributed Ledger Technology

Successful application of Distributed Ledger Technology (DLT) occurs, if and only if, there is a clear understanding of a business problem. While there has been no shortage of PoCs, not all have been successful in improving existing ways of working – often because the application of DLT was a solution looking for a problem. When it comes to DLT applications in the financial market infrastructure space, safety and resiliency should be the priority

rather than speed to market. If a PoC does not move to production, this is not a failure of DLT but an acknowledgement that DLT's application does not benefit a particular process.

Further, in certain cases, DLT may be used to improve an existing process that is run on a mature technology stack. A significant amount of integration may need to take place between the new technology and the legacy infrastructure, equating to a significant investment in infrastructure build and resources. Firms will need to proceed with caution as they consider the best way to enable interoperability. Without interoperability there will be duplication of effort and unnecessary cost, as well as a delay in time to market.

Defining rules and technical standards is another must. Clear technical standards are required if interoperability is to deliver maximum benefit to the industry. A digital ledger network of thousands of firms requires well-understood rules and technical standards for the ledger's operations and integration with any legacy technology or systems. Without clear rules and technical standards, there is a risk that participants establish multiple parallel business networks that do not communicate with each other; preventing scalability and wide-spread adoption, while creating silos and duplication.

Technology maturation also takes time and typically undergoes at least two stages before it reaches maturity: 1) the research and development (R&D) phase, where investment is made and the prospects of failure are typically high; and 2) the ascent phase, where costs have been recovered and the technology begins to gather strength. The maturity phase

marks the point at which the technology is delivering a high and stable income. DLT is only now moving to the ascent phase, and it has a long way to go before it can be considered mature. Further, when it comes to systemically important financial market infrastructures like CLS that have adopted DLT for activities such as netting, the journey from R&D to ascent has probably taken even longer due to a strict testing programme designed to ensure its resiliency, reliability and safety to the market.

*"...in the financial market infrastructure space, safety and resiliency should be the priority..."*

- ALAN MARQUARD

The reach and power of a network makes the DLT proposition attractive to users. Once that network is formed, immediate questions arise: who is going to run, operate, and integrate the network? In financial markets, these questions can only be answered via the formation of a partnership between a market infrastructure and a technology company. The market infrastructure understands the business problem to be addressed and has experience in managing operations at scale, while the technology provider has the experience of running technology and operations.

The absence of any one of these components will prevent the financial industry and regulatory community from realising the benefits that new technologies such as DLT can deliver. ●



## Guillaume Eliet

Head of Regulatory,  
Compliance & Public Affairs, Euroclear

### DLT integration in the securities financial market – What lies ahead

DLT technology has been widely praised for its potential to fundamentally change the way in which companies, including market infrastructures, perform their business and interact with their clients. This change will have a number of positive impacts for society, including increased competition, improved efficiency and wider access to financial services.

Blockchain is aligned to our group innovation strategy in terms of exploring new applications and finding new business models to invest in and expand. The areas of opportunity for DLT – or any new innovation – are found at an intersection where technology opportunities meet the rethinking of business models, within the boundaries of regulatory constraints.

Although opportunities are big, there are inevitable challenges that need to be addressed.

First, there is the question of how new technologies such as DLT and crypto-assets should be regulated. As FinTech start-ups generally do not operate like financial services companies, they tend not to be subject to the same regulations that govern the traditional players in the financial system.

As a regulatory level playing field between crypto and fiat securities is crucial for investor protection, market integrity and financial stability reasons, existing national or EU laws and regulations might need clarification or adaptation. This will be a crucial task for EU and Global authorities as having a regulatory framework providing legal certainty to the market participants is essential to foster new technology that provides efficiency and safety to the market. The recently published ESMA and EBA reports on crypto-assets and ICO form are an excellent contribution to the debate in the frame of the EU FinTech Action Plan. As regulation can act as a brake to innovation, authorities will have the difficult responsibility of striking the right balance between innovation and financial stability.

Second, even when these regulatory questions are addressed, there are the operational and technological challenges related to migrating a system that has matured over dozens of years into a new environment. For example, how can a DLT platform offer level 1 DvP settlement in central bank money? How can a DLT platform ensure settlement finality? These are, among others, key questions that are to be answered before embarking in widespread transition to such technology.

*“Providing legal certainty to the market participants is essential to foster new technology.”*

- GUILLAUME ELIET

As a financial market infrastructure aiming to ensure financial stability throughout the cycles, Euroclear takes an active role in the development of this new technology while making sure it is developed and governed with a long-term financial stability concept in mind. Euroclear is for example one of the shareholders in a start-up called LiquidShare, which designed to develop a post-trading DLT infrastructure for the Small and Medium Enterprise (SME) market in France. LiquidShare is entering into a pilot phase on Euronext's markets. More than 15 participants representing all the parties involved in the life cycle of an SME security are now ready to use its pilot platform. The aim is to improve SMEs' access to capital markets, improving the transparency and security of post-trading operations. ●

## Morten Bech

Head of Secretariat, CPMI, Bank for International Settlements (BIS)

### Crypto Winter

When Eurofi met in Tallinn in September 2017, it was springtime for cryptos. Distributed ledger technology (DLT) was all the rage. DLT was going to revolutionise the financial system overnight, and the price of bitcoin was growing exponentially. How quickly things can change. The Bitcoin hype is over, and winter is sweeping across crypto land. The ice cold winds blowing are wiping out

investors and entrepreneurs without deep pockets. Initial coin offerings (ICOs) are down, and industry icons are jumping ship. Crypto exchanges have become targets of cyber-criminals, and confidence across crypto land is plummeting. Nobody knows how long the winter will last or whether it will ever end.

*“The Bitcoin hype is over, and winter is sweeping across crypto land.”*

- MORTEN BECH

Many central banks around the world are experimenting with DLT<sup>1</sup> as the basis for the next generation of interbank payment and settlement systems. Coldly,



the results so far uniformly show that the new technology – at this stage – does not improve on the current state of the >>>

>>> art. In fact, central banks whose systems are at the end of their technology cycle are going “conventional” rather than venturing into uncharted territory. Using high-powered game theory, Hyun Song Shin of the Bank for International Settlements (BIS) has argued that DLT is not suited for large-value payments.

Yet, in a few places on the border between crypto land and the traditional financial sector, “the cold never bothered me anyway” echoes. The World Bank has issued a bond using DLT. The Australian Securities Exchange is moving closer to using DLT for post-trade processing. JPMorgan recently announced the introduction of JPM Coin. But all these projects are baby steps relative to the grand visions from years past.

To the optimists, the journey of DLT is similar to that of the internet. It will take a long time for the “killer applications” to break through the clouds and shine. Perhaps completely decentralised cryptocurrencies were simply a bridge too far for a nascent technology and the underlying economics was not completely understood. Nevertheless, as happened with the internet, lessons are being learnt, and there are probably a multitude of other problems where the technology can be useful.

As with any new technology, the Committee on Payment and Market Infrastructures (CPMI) has tried to see through the hype and will continue to focus on the merits of DLT and its implications for the efficiency and safety of financial market infrastructures. The Committee first published on cryptocurrencies (or digital currencies, as they were known back then) in 2015. Since then, we have, together with our friends at the International Organization of Securities Commissions (IOSCO), published an analytical framework looking at DLT in payments, clearing and settlement<sup>1</sup>. Clearly, financial market infrastructures based on DLT do not come without risks, and careful consideration should be given to their design. For example, it is important to ensure interoperability to avoid market fragmentation and other inefficiencies. The CPMI-IOSCO Principles for Financial Market Infrastructures (PFMI), however, remain the relevant international standards regardless of technology. ●



**Yuko Kawai**

General Manager for Europe, Bank of Japan

## Does Blockchain/DLT have a future?

In Japan, applications of blockchains/DLT and its technological developments are not greatly different from elsewhere, which is not a surprise given the technology's cross border nature.

Let me start with the Crypto assets/tokenization. This application by far has been most successful in terms of the economic value creation, while the hype stage seems to have passed and many tokens lost their values off from historical highs. In Japan, the regulator, Japanese FSA has established a regulation to have the crypto asset exchanges registered with and monitored by them. The exchanges are required to have the high standard of risk management and to comply with AML and consumer protection rules in order to be authorized to trade crypto assets. This framework made the image of the crypto-friendly-country and Japan has attracted massive trading flows and also criminal thieves, from which we have learned and still learning a lot. One of the learnings is that the basic principles of blockchain could become hurdles when things go wrong. We may need to agree on the legal nature of crypto assets/tokens in order for the stolen assets to be claimed back under the current legal regime, but such may not be enough. When the illicit theft is written in the blockchain which is irrevocable, how can the original owner claim the bona fide ownership?

Aside from crypto assets, while many parties are working on the researches (e.g., Bank of Japan-ECB joint researches on DLT), PoCs and practical applications, I am not yet aware of any specific examples successfully put into production in the meaningful scale in Japan.

While the features of blockchain/ DLT technology are dreamed to improve the incumbent inefficiencies, the original package of technologies has deficiencies, such as the lack of finality or the issue of scalability. While there has been so much effort and some innovations seem to bear hopes, still the development is under way.

The evolution of permissioned chains (a.k.a. private chains) intends to bring in the features required for specific applications. Permissioned chains can be loosely defined as the blockchains/ DLT supported by the limited and known members, who are permissioned by the designated authority.

A naive question would be, what is the merit of using blockchains/ DLT in the permissioned environment with a central node, which sounds almost like a bank payment system with a central authority such as a central bank. Some of the chains are said not to have the “block” nor “chain” structures, which may simply sound like the shared ledger, or the common database.

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***“You may say I am a dreamer  
but someday the technology  
may unite the related parties  
more tightly.”***

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- YUKO KAWAI

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Having said all the above, I personally believe that there has been and will be a significant meaning in discussing and developing the blockchain/ DLT technologies. The process has made the incumbents, including the central banks, to think and rethink about the inefficiencies of the existing framework. Also, the new ecosystem has emerged to bridge the finance industry with the techs, and the shared-ledger-feature of the technology invites nonfinancial parties to the same table. You may say I am a dreamer but someday the technology may unite the related parties more tightly to make the financial transactions and other social contracts more efficient with better information sharing. ●

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1. See H S Shin, “Distributed ledger technology and large value payments: a global game approach”, lecture at the University of Cambridge, 22 January 2019.  
2. See CPMI-IOSCO, Distributed ledger technology in payment, clearing and settlement – an analytical framework, February 2017.

# Cloud and tech outsourcing



## Denise Garcia Ocampo

Senior Advisor - Financial Stability Institute,  
Bank for International Settlements (BIS)

### Enabling the potential of cloud computing through effective oversight frameworks

In an economy where consumers expect speed, tailored offers, attractive pricing and user-friendliness from products in every industry, the financial sector is no exception. Financial institutions are increasingly relying in digital technologies to be able to respond timely and efficiently to customer expectations. To achieve this, financial institutions require significant computer resources to be able to analyse large volumes of data, identify patterns and trends in that data and process the necessary algorithms.

In this context, cloud computing is an IT model that enables financial institutions to use digital technologies under an efficient, scalable and flexible scheme. Through a cloud computing model, institutions have access to available-on-demand shared networks, servers, storage, applications and services that can be rapidly scaled up or down and accessed anytime and anywhere. Benefits will depend on the use and type of model being deployed, but in general cloud computing may bring savings in IT costs, access to qualified talent and tools, flexibility and facilitation of innovation.

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*"Contagion in the event of a large-scale operational failure and possibly posing systemic effects."*

- DENISE GARCIA OCAMPO

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However, the use of cloud computing may increase a number of risks for financial institutions. To begin with, operational and reputational risks. These risks are connected with failures in data security and privacy, system availability, continuity of operations, auditability and compliance with legal requirements. Moreover, business continuity of financial institutions and resiliency of third-party service providers are major concerns when relying on cloud computing, given that cyber-attacks and outages may impact the provision of financial services.

There are also key concerns related to concentration risks. A growing number of financial institutions as well as other IT third party providers are relying on a relatively

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>>> small and highly dominant pool of cloud service providers, increasing the threat of contagion in the event of a large-scale operational failure and possibly posing systemic effects in the financial sector. Access and audit to third party providers and data is another key concern, since location in different jurisdictions may complicate the effective oversight of cloud computing activities.

Against a background of potential benefits and risks, a recent FSI Insights paper “Regulating and supervising the clouds: emerging approaches for insurance companies” analysed the prudential approaches taken by selected financial sector authorities to deal with cloud computing. The analysis showed that authorities usually apply their frameworks for general outsourcing, governance, risk management and information security to cloud computing. Some authorities include cloud-specific sections in these frameworks, while a meaningful number have issued cloud-specific recommendations or supervisory expectations. Regardless of the approach taken, cloud computing arrangements are subject to regulatory requirements only if they are deemed as material. However, the criteria for deciding whether such arrangements are material vary across jurisdictions.

Regarding the supervision of cloud computing, these arrangements are generally part of the oversight of operational risks and authorities follow a risk-based approach. Before an institution enters into a cloud servicing agreement, some authorities require notification, while others prescribe a consultation or approval process. At the very least, most authorities expect informal communication from financial institutions on their material cloud computing plans. Authorities are also using thematic reviews and informal contacts with cloud providers to complement their oversight of the cloud computing business.

With respect to future cloud computing challenges for authorities, the FSI paper highlights the following:

- (i) reviewing regulations to strengthen the institution’s governance and risk management requirements;
- (ii) developing supervisory tools to assess concentration risks of cloud providers in individual and aggregate levels, as well as a cross sectorial analysis;
- (iii) implementing tools to assess operational resilience for both institutions and their IT third party providers; and
- (iv) enhancing cross-border cooperation, particularly in terms of information-sharing, as an essential element for the effective oversight of cloud computing risks and the implementation of orderly resolutions. ●



## Levin Holle

Director General, Federal Ministry of Finance, Germany

### Cloud computing: challenges to regulation by new IT infrastructures?

Internationally competitive economies cannot evolve without the division of labour. This goes hand in hand with the breaking up of value chains and is especially pertinent to information technology. The necessity of a division of labour is particularly striking when it comes to cloud computing.

In times of intensifying digital financial innovation, cloud computing services offer several advantages: the basic layers of information technology, i.e. running the underlying machines, storage, operating systems and even applications, have become increasingly standardised, leveraging economies of scale and significantly lowering the cost of operation as a consequence. This effect allows financial institutions to devote more attention to the development of custom-made financial applications that >>>

>>> are tailored to fit specific business models. Additionally, cloud computing makes it significantly easier for small new companies, e. g. FinTech companies, to enter the financial services market: They can source the IT services they need at prices they would not be able to achieve themselves if they had to set up the complete infrastructure on their own. Cloud computing is thus enabling competition and new business models.

However, cloud computing – like all forms of outsourcing – inherently reduces the level of control exerted by the respective financial institution, even if they retain the responsibility. Furthermore, the use of a limited number of global cloud providers by multiple financial institutions could lead to concentration risks, which could, in the long run, have implications for financial stability. This creates new regulatory challenges for financial institutions as well as for competent authorities. Since reliance on cloud computing is rapidly increasing, a closer look at dependencies between the financial sector and third-party IT service providers is important.

In a bid to address these risks, the European Banking Authority (EBA) recently issued a recommendation on outsourcing to cloud service providers. Additionally, the German Federal Financial Supervisory Authority (BaFin) has published guidelines for compliant cloud service provider outsourcing. The German FinTech Council's recommendations propose a European tech licence for cloud computing service providers offering services to financial institutions.

If we want an innovative European single digital market, it is essential we embrace the advantages of cloud computing while also mitigating the risks. A harmonised approach to cloud computing tackling these issues would contribute to the EU's competitiveness. ●



## Nausicaa Delfas

Executive Director, International,  
Financial Conduct Authority (FCA)

### Cloud and technology outsourcing: issues for regulators

Regulators across the world have long focused on the importance of robust controls and oversight by regulated firms and markets of their outsourcing arrangements. Such outsourcing has historically covered a range of business support services and activities: from human resources to IT infrastructure, payments to platforms, through to back-office functions. But as technology has developed, so have opportunities to outsource functions, the way in which outsourcing is delivered, and the range of third parties who offer services.

So, to an extent, outsourcing to the Cloud and to other third-party technology service providers is just another form of outsourcing. But Cloud and technology-related outsourcing do pose their own challenges for firms and regulators: including where these involve business-critical services, or where they could pose concentration risks. Despite the common basic features of the Cloud, there are also a range of different deployments (e.g. public, private or hybrid) and service models.

Using Cloud services can bring benefits such as: cost reduction; increased deployment speed; global scale; better performance and improved resilience. But it can raise new risks, such as the potential for lines of responsibility to get blurred between >>>

>>> the firm and its vendors; loss of control regarding data encryption, access, destruction and residency; and vendor concentration risks.

One of the largest sources of disruptive incidents reported to us relates to services provided by third party service providers. Contractual arrangements with third parties are often complex and longer term because of the services provided (and supply chains often extend across borders); and third-party providers can sit outside the regulatory perimeter for some of their activities (or may be covered by other regulators in the case of e.g. utility or communications services).

The FCA was one of the first regulators to issue guidelines to clarify how our existing outsourcing standards apply to the Cloud (FG16/5) and similar services. Existing requirements and guidance are broadly that:

- regulated entities must take responsibility for their third-party service providers;
- firms cannot contract out of their regulatory obligations and are expected to manage risk;
- firms must take reasonable care to supervise the discharge of outsourced functions by a third party, and should take steps to obtain sufficient information from its contractor to enable it to assess the impact of outsourcing on its systems and controls.

Such high-level principles remain valid. The FCA has recently published, with the Bank of England, further consultations focused on operational resilience issues (DP18/04). We expect firms to plan for “when” rather than “if” a disruptive event occurs – with focus on firms’ “impact tolerance”, and their recovery and response, as well as defence.

We continue to closely monitor the risks from the provision of cloud services to the financial sector – and we continue to contribute to international work on outsourcing, such as the current review of IOSCO principles on outsourcing by markets and market intermediaries, and recent EBA guidelines on outsourcing in banking. ●

**EUROFI PRESIDENT** // David Wright

**SECRETARY GENERAL & PUBLISHER** // Didier Cahen

**ASSOCIATE PUBLISHERS** // Jean-Marie Andrès and Marc Truchet

**EDITORIAL COORDINATORS** // Virginie Denis and Cristian Matei

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# Data protection, fairness and sharing



## Sébastien Raspiller

Assistant Secretary, Ministry of Economy and Finance, France

### Financial services and data: a regulator's perspective

The decision adopted in early February by the Bundeskartellamt to limit data pooling practices, which means combining user data from different sources, by Facebook without the user's consent is the first decision made by a national authority combining data protection and competition regulation. This decision certainly emphasizes the need for the public authorities to take into account the evolutions of the market practices of dominant actors of the digital economy regarding competition law. The situation may be somehow different in the financial sector, given the diversity of its actors, although competition matters, precisely for this reason.

#### **What are the main opportunities to further leverage data from both customer's and financial institutions' points of views?**

It is commonly admitted that data is the 21st century's oil and the main resource in a digital based economy. This is true as well for the financial services, which will certainly undergo major transformations.

As the digital shift is fueled by data, it is of paramount importance for the financial services providers to secure the access to both customers' personal data and general data. From a commercial standpoint, the use of data can serve as a catalyst for the development of new business models and new products and enhance the delivery of financial services to customers. For instance it may help develop insurance solutions targeted for SMEs. The financial institutions' internal management is also expected to be disrupted with the use of data and data analytics in a wide range of applications such as the fight against fraud in the financial sector or the implementation of the anti-money laundering regulations. From the customer's perspective, the benefits expected from a growing data based financial services offering are a higher diversity associated to a greater individualization of services, enhancing satisfaction.

#### **How is data sharing impacting innovation opportunities?**

In a growingly digitalized economy, the special features of data as intangible and highly mobile resources make data sharing an important stake for the emergence of innovative actors and new markets. In the financial sector, data sharing refers to the process of making data available to the consumer itself (portability) but also multiple third parties (interoperability) in order to offer a wider range of products and services.



>>> By making easier for financial institution to access new and reliable information, data sharing fosters innovation and new areas of competition.

It is the role of public authorities to encourage financial institutions to develop data sharing strategies and interoperability in order to spur innovation and new business models. Regulatory initiatives have already been taken at the EU level such as the facilitated use of API to ease interoperability of data within the implementation of the PSD2 framework, or the right to data portability created by the General Data Protection Regulation (GDPR) which allows individuals to obtain and reuse their personal data for their own purposes across different services. Moreover, actions could be taken to foster the use of distributed ledger technologies as relevant tools to data sharing models.

#### What are the main risks data face and related consequences?

The emergence of data as key resources for the digital economy and financial institutions has at the same time contributed to expose these actors to a whole new set of risks. Even if firms have been exposed to cyber risks and cyber-attacks for a couple of decades, the growing part of data in these companies' value and business renew the approach of managing such risks.

First, financial institutions are faced with common cyber risks, which can either be malicious or accidental, such as a destruction or corruption of data bases, leaks of confidential information or thefts of intellectual property. Second, the loss of reputation due to data leaks or public revelations of prohibited uses of data are increasingly growing risks. Third, regulatory requirements and compliance to data protection regulations constitutes a major risk that should be taken into account in the data managing strategies as regards the powers now held by supervisory authorities. ●



## Leena Mörttinen

General Director, Financial Markets Department,  
Ministry of Finance, Finland

### New realities of the information economy

The honeymoon with the information platform economy is over. The pendulum swinging back from the state of naïvely sharing data with everybody to a state of uneasy paranoia of who is manipulating us. The “surveillance capitalism” is now a suspect in providing means to hostile players to use our data against us and our societies.

How can we ensure that our identities and societies are kept safe? Financial services are a good reflection point for this debate. After all, my bank knows everything about me. There are important boundaries that deserve attention. These lie between the big tech companies, banks, the individual and the state.

The first conflict is the growing competition on data. Both banks and big tech need this resource. However, banks are in the business of trust. Unlike a social media platform, they cannot sell our innermost thoughts to political consulting firms.

Creating a level playing field between banks and big tech is a huge challenge. In the financial sector, we are used to regulating balance sheets, not data and its use. This is about to change as we move from regulating entities to regulating activities. As lawmakers, we will pay more attention to effective consumer protection. However, we need a better understanding of the challenges particular to quickly evolving

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>>> platform business models and technological advances. The EU General Data Protection Regulation is a first step and it affects banks and big tech alike.

The second difficult boundary lies between the business and the state. Financial infrastructure is critical for the stability of any society. After the last financial crisis, we have improved the capabilities of both companies and authorities to withstand economic shocks. We also need to ensure that we are equally well prepared to systemic risks stemming from severe operational incidents. We trust cashless payment services to be available 24/7. If the flow of money were to stop due to a major cyber-attack, panic would ensue within hours. The aim of the EU financial services legislation is a fully integrated financial system. Irrespective of this, every member state should be able to ensure the continuation of critical services depending on the threats that are particular to its geography.

Finally, we have to redefine the boundary between the individual and the state. Also here banks have become the pressure point. With an increasing concern of money laundering, banks will face new and tougher regulation and supervision to ensure that the critical infrastructure is not used for illegal purposes.

However, with tougher supervision, authorities need to think carefully how to ensure the individual's fundamental right for privacy. Bank account information shows who we really are. When should the authorities be allowed to use it? Our liberal western values do not go well with continuous state surveillance of citizens. We should be careful that we do not end up falling into this model without careful ethical consideration.

Money is data and it must be kept safe and flowing while preventing the destabilizing use of our infrastructure against us. We need a new regulatory framework and deep ethical discussions to be able to find answers to the questions posed by the new realities of the information economy. Security will come at a high cost. The only way to make this worth the while of our financial institutions is a deeply integrated banking union and a well-functioning capital markets union that provide the scale economy benefits. If we do not succeed in this, we will likely remain a data colony with mainly imported services, and if we are not careful, with imported values as well. ●



## Joe Cassidy

Partner, KPMG

### The future of data ethics and the value of trust

Data analytics, including intelligent and autonomous systems, have become part of our everyday lives – and ubiquitous in all sectors, including financial services. However, if these increasingly public-facing and high-profile systems are to continue to serve the public interest, and deliver fair and transparent outcomes, we need ethical principles, policies and guidelines to govern their development.

Recent regulation of data protection (i.e. GDPR) and privacy constitutes a good start, but a holistic view of data ethics covers more than just compliance. It should encompass the growing volumes of customer data, access to and storage of

data, and data flows (often across national borders) between financial institutions and third-party service providers.

The increased use of the spectrum of intelligent and autonomous systems (including Machine Learning, and the use of Artificial Intelligence), to automate decision making on customers is clearly an area policymakers are rightly concerned about. The results of these decisions can be life changing for customers – in areas of life insurance, finance, healthcare access and even travel. Consumers are also likely to become increasingly aware of the value of their data, and of the ways in which it is being used, leading to denial of access issues and possibly data manipulation by consumers.

Intelligent and autonomous systems requiring little or no human intervention can greatly boost the efficiency and effectiveness of organisations, for example by improving fraud detection and supporting cost reduction. But while such systems help the organisations to 'work smarter', they might not automatically optimise fair outcomes. For >>>

>>> example, where the 'black box' is designed to lead consumers towards pre-specified outcomes that benefit the provider rather than the customer, and where similar strategies based on similar data sets lead to herding behaviour or ignore situations that are not captured in the data.

Organisations may struggle to identify the limitations of these systems at an early stage, and to ensure their outputs are free from prejudice, whether conscious or unconscious. However, core principles should include respecting an individual's ability to make their own free choice; operating with transparency and delivering data outcomes within the boundaries of a

glass box; and installing an organisation-wide approach to data ethics together with clear principles of accountability – in order to demonstrate a robust governance framework that places the ethical use of data at the top of the agenda.

*"A holistic view of data ethics covers more than just compliance."*

- JOE CASSIDY

It's logical that the use of personal customer data combined with the autonomous, ML and AI systems must

be subject to challenge and be open to legal and regulatory scrutiny in order to establish much higher ethical standards. This is a very significant debate and for data analytics to be a force for good it will require a co-ordinated effort from both industry and regulators.

Now is the time for all stakeholders to build on existing international and cross-sector work, focusing in more depth on the specific customer impact risks and challenges. Rather than create an entirely new set of ethical principles, our aim is to move the debate forward with foundational actions. ●



## Nina Arquint

Head Group Qualitative Risk Management,  
Swiss Re Management Ltd.

### A multi-faceted approach needed to address data challenges

We are in midst of a "data revolution" of our society and our economy. To harness the full innovative potential that big data and AI provide, financial service providers must ensure that consumers trust them to handle their data transparently and fairly. While studies show that financial institutions currently enjoy higher levels of consumer trust than other users of data, this trust must be safeguarded by continued

responsible business conduct. At the same time, financial institutions, and insurers in particular face multiple challenges with regards to using data in a way which is in the customers' best interest.

Fairness in utilising data is at the heart of what insurance has done for so many years. Insurance is first and foremost transforming data into an assessment of riskiness. It means fixing the price at which individuals can enter a pool of insured, and can benefit from the protection that the insurer generates for its pool members. To be able to facilitate a fair risk assessment, the insurer needs access and permission to use the data of those that need the protection of the pool. As more restrictions are applied to the use of data for setting premiums, the risk of adverse selection increases which undermines the concept of insurance. All this raises legitimate questions about solidarity and fairness in insurance. This is a necessary and unavoidable discourse, which at the end of the day is one about values. Societies must inevitably decide to what extent solidarity should be enforced.

The frequency and severity of ethical issues has increased over the past few years indicating the need for companies to address their digital responsibilities. Ethics is not a universal concept, and values may often be in competition with each other. The firms have a clear reputational incentive to address these ethical issues, and to be transparent about this. Regulators should monitor this process and, where necessary ensure that good industry practice is adhered to.

Outsourcing and the ability to share data across borders enables

customers to access innovative services in many areas. New, often fragmented regulatory requirements that limit cross-border data sharing or restrict outsourcing could hinder the industry in the development of a compelling digital service portfolio. Insurers are not only subject to the harmonized European Data Protection Regulation, but are additionally being examined by insurance supervisors on how they use (big) data.

*"Data challenges are best addressed in close collaboration between the industry and regulators."*

- NINA ARQUINT

Regulators must find the right balance between protecting consumers, while not standing in the way of innovation to the benefit of consumers. In doing so, they have the chance to support firms in dealing with the challenges mentioned above. Instead of placing restrictions on cross-border data sharing, regulators can play a role in supporting the development of internationally harmonized data protection rules. Regarding outsourcing and cloud use, regulators should ensure that insurers have processes in place to identify, manage and mitigate relevant risks. By all means, regulators should not impose excessive requirements or outright bans which would subject insurers to unreasonably higher standards than others. Finally, regulators must also acknowledge that some of these challenges cannot be addressed via the regulatory process alone. ●

## Simona Șandru

Head of Complaints' Department,  
National Supervisory Authority  
for Personal Data Processing, Romania

### Data protection - a good economic "asset"

The protection of personal data has become during the last two decades one of the most important issues to have in mind in the business environment, whenever this kind of information is considered to be an added value for the success on the market.

Taking into account the present globalized and technologically-driven economic relationships where intrusions into private life are most likely to occur without the knowledge of the concerned individuals their legal protection has to be a cornerstone for any rule-of-law government.

*"We think that responsible implementation of the GDPR by all players involved will achieve both its objectives: defending the individuals' fundamental rights and functioning of the internal market."*

- SIMONA ȘANDRU

In this regard, the European Union (EU) adopted numerous pieces of legislation aiming at ensuring a high level protection of personal data processed by every single actor involved in professional or commercial activity: natural persons, micro, small and medium-sized enterprises, large companies, groups of undertakings, public bodies, and other types of organisations ("data controllers" or "data processors", as the case may be). The exceptions from the established legal framework are just a few and require a strict and limited interpretation and application.

The Regulation (EU) 2016/679 (the General Data Protection Regulation, known as "GDPR"), which entered into force in 2016 and is fully applicable in all Member States as of the 25th of May 2018, but also the Convention 108/1981, modernised by the Council of Europe in 2018, set an even higher level of protection requirements for the EU residents' personal data. These legal

instruments tend to impose the European good model of human rights' protection as an international standard model for data protection.

For this model to work, it is essential to have some mechanisms of control put in place; this role is undertaken by the independent supervisory authorities established in every Member State (and also at EU level), which are equipped with equivalent investigative, corrective, authorisation and advisory competencies. In order to ensure a coherent and consistent approach across the EU, some legal issues, especially those related to the cross-border processing operations, shall be dealt with by a newly set up body, the European Data Protection Board (EDPB), composed of representatives of all EU supervisory authorities.

The EDPB's vibrant activity is already available for all the interested parties, whether controllers or individuals, in the issued papers aiming at ensuring a proper and detailed explanation of different notions of the GDPR (such as consent or transparency). Additionally, the EDPB has developed guidelines in order to help organisations in adopting binding corporate rules and codes of conduct or adhering to certification mechanisms. These tools have been introduced by the GDPR as alternative safeguards for the protection of personal data, as regards the transfers from the EU to third countries and international organisations, and also in other contexts, regarding the implementation of security policies, for instance. ●

## Konstantinos Botopoulos

Advisor to the Governor,  
DPO, Bank of Greece

### Data challenges for central banks

With the advent of the GDPR, the new "Constitution" in the field of data protection, another landscape has emerged. Although the modifications vis-à-vis the old regime and the new provisions are not all revolutionary per se, the effort required by those competent for the protection stemming from the GDPR has changed both in scale and quality.



The name of the game is now "self-regulation" but also "holistic protection". The public authorities have less scope for intervention, which has been taken up by the newly established DPOs (Data protection Officers). The role of the latter is global and central: although DPOs are not to be held responsible for any omissions or problems occurring under their watch, they are responsible, in the practical sense, of the necessary arrangements, most notably of technological nature, the cooperation within institutions and with the competent authorities and the overall "ticking of the system".

Such system, complex and demanding by nature, constitutes a world of its own in the case of big institutions, such as banks and even more Central Banks. The quantity and sensibility of data, the juxtaposition of competences, the numerous contacts with outsiders, the intra-European nexus, and the quasi-systemic importance of preventing leaks – all those elements require not only a concentrated effort but a considerable change of culture. Within Central Banks, and around the DPO, the most common form of organization consists of a DPO-office, for which should be chosen persons with administrative, legal, IT and risk-management capabilities, and a cycle of representatives of the various departments of the Bank, providing the necessary connection with the practitioners dealing with data.

At the Bank of Greece, we have also established a Steering Committee comprised of the Heads of the departments most involved and discussing strategic directions and challenges. Cooperation and collaboration are of the essence, as well as the creation of a collective conscience within the >>>

>>> Bank that data protection is a must both from a legal and a reputational point-of-view.

The next level, the European harmonization of practices, is being put into place through the European Authority which has been created by the GDPR and, especially for Central Banks, through expert groups meeting regularly. It is still too early to judge the effectiveness of such forums and the overall impact of the GDPR in the central banking sector. It could provide an occasion, however, for enhancing the technological capabilities of the Banks, getting rid of unnecessary data, promote a more open relationship with citizens and advance European banking integration. Only thus would the effort, the cost and the administrative burden imposed by the GDPR be justified and fructified. ●



## Patricia Plas

Head of Public Affairs, AXA Group

### GDPR: one year after its implementation

2018 marked the beginning of data privacy awareness initiatives all over the world. A recent survey reveals 66% of the French population affirms being more conscious of data protection than before and about the same percentage now say they have heard about General Data Protection Regulation (GDPR). This is substantial.

How is this framework perceived? The results are positive overall even if we are still in its early stages. Consumers' awareness of their rights regarding the protection of their data has increased the community's vigilance. The European data protection authorities have all seen the number of complaints and sanctions increase: 317 complaints were filed with the Belgium APD in the first 6 months of GDPR compared to 13 in 2017; over 10,000 data breaches were reported to the Dutch, German and British authorities. These provide an opportunity for the entities involved to rethink their organization. The first GDPR sanction was initiated by the French CNIL resulting in Google being fined €50 million in January. In addition, the European Data Protection Board has been active in briefing organizations, like SMEs, on their obligations under the GDPR. Throughout Europe, there is a clear-cut "pre" and "post" GDPR era; history will refer to GDPR as the turning point where privacy became tangible.

As European companies have no choice but to invest heavily in protecting all the personal data they handle while companies in other countries experience less constraints, some do see GDPR as a competitiveness blocker first. Yet, GDPR's growing successes are raising data privacy's appeal in other jurisdictions, notably because GDPR has an extra-territorial scope allowing it to protect EU residents regardless of where the data processing occurs or how cross-border data flows are arranged.

*"The question of data protection is gaining ground in other jurisdictions."*

- PATRICIA PLAS

Although such legal rigor on the handling of personal data exists in practice only in Europe, the question of data protection fueled by GDPR's release in great pomp, is gaining ground in other jurisdictions. This may reflect a global shift towards greater privacy protection under the emergence of a caring coherent approach to the free movement of data in the EU and possibly beyond.

In January, the Commission adopted its adequacy decision allowing for the free flow of personal data between the EU and Japan creating "the world's largest area of safe data flows". China itself is in the early stages of creating a data protection

regulatory system to police Chinese social networks in response to consumer pressure. The United States have started discussing data privacy at the federal level, a conversation that would not have come about without GDPR, which directly inspired a privacy law passed in California in 2018.

What remains to be seen is at what pace and to what extent any genuine convergence can be achieved as diverging strategies in AI could for instance also impact its evolution. Meanwhile the EU, as in other policy areas, is sending a clear message: getting access to the fast-growing EU data economy - €739 billion by 2020 likely to be boosted by the recent regulation on the free flow of non-personal data - means complying to the highest-privacy standards. ●

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# Priorities in the payments area



## Madis Müller

Deputy Governor, Eesti Pank (National Central Bank of Estonia)

### The shifting payments landscape – what to expect from the market and the legislature

The saying that time is money fits well for today's fast and virtually inter-connected world, where everything has to be instant and immediately to hand. As the economy and our lives undergo this digital transformation, the ways we do business and use banking services are becoming more efficient than ever before. Simplicity and security have always been the key requirements of banking and payment solutions, but consumers and businesses now expect even more. New payment solutions are expected not only to enable the instant transfer of funds, but also to be integrated with our lives and the business environment.

**Demand is growing for solutions that make the entire payment chain more efficient.** This applies to payments between people and to those in e-commerce, as well as to payments at any physical point of interaction where goods are sold or services rendered. The trend is away from cash and cards and towards digital wallets, including mobile ones, that aggregate accounts and payment instruments while delivering a seamless user-experience. The technology is there for us to be able to make purchases by walking through a store, taking the goods we want, and leaving without having to stop to pay at the checkout. We could even let a virtual assistant take care of the grocery shopping and delivery of it.

**The industry needs sufficient time to self-regulate and agree on rules and standards that will facilitate the development of efficient payment solutions at the pan-European level.** The recently updated legal framework improves customer protection, encourages innovation and fosters a level playing field for payment services providers, or PSPs. These PSPs need to keep the momentum in the rollout of SEPA instant payments and the implementation of the changed legal requirements, and adjust to the new reality of open banking introduced by the PSD2's payment initiation and account information services that will go live in September this year.

**Building new and interoperable payment solutions on top of SEPA instant payments and open banking will strengthen the European payments industry.** Moreover, doing so will help keep funds safely in the regulated financial system and avoid a sudden outflow into global platforms that use closed-loop e-money or crypto assets as a means of instant payment in their digital marketplaces. This, however, assumes that SEPA instant payments become the default option for making euro credit transfers and that the new payment solutions are as easy to use as cash or card payments. To make this happen, the PSPs and merchants at both the national and European levels are cooperating on steps towards finding the best possible instant payment solutions that will fit in the digital wallets of consumers.



>>> Nevertheless, history has shown that even if the industry does come up with a pan-European scheme, some regulation might be warranted for it to be made into a new standard. The migration to SEPA payment instruments in 2014 is an example of how setting an end-date through regulation can benefit everyone. It established the common norm for payments that is now used by over 500 million people every day. With the introduction of SEPA instant payments, consumers and businesses throughout Europe expect this common norm to be upgraded. It now seems that this upgrade will happen through self-regulation in the market, though we do not yet know this for sure.

Ultimately, all payments across borders in Europe need to function smoothly, securely and under equal conditions. To achieve that, several issues still need to be discussed between the legislator and the industry, such as SEPA payments from and to non-EU countries, and equal conditions for banks and non-banks using SEPA payment systems. ●



## Marc Bayle de Jessé

Director General Market Infrastructure and Payments, European Central Bank (ECB)

### The development and roll-out of pan-European instant payments

Over the last decade, instant payments have been implemented in a number of national communities in the EU, e.g. in the United Kingdom, Denmark and Sweden. Other communities have put forward their plans for developing national schemes. To ensure that the introduction of innovative payment products and services does not reintroduce fragmentation into the European retail payments market, the Euro Retail Payments Board (ERPB) pushed for the development of at least one pan-European solution for instant payments in euro. Taking up the call, the European Payments Council developed the SEPA Instant Credit Transfer (SCT Inst) scheme.

Since the launch of the SCT Inst scheme in November 2017, about half of all payment service providers offering credit transfer services in the SEPA countries have joined the scheme. The uptake varies greatly from country to country. In a few countries, the vast majority of citizens and businesses can now make and receive instant payments. In others, no payment service provider is offering instant payment services yet.

A positive example of a country that has achieved broad reach in a short amount of time is Spain, where the payment service provider community cooperated on SCT Inst implementation as well as on a common person-to-person mobile payment service. It has been reported that the payment service providers participating in instant payments

now represent 90% of the payments market, and that close to 8% of credit transfers in Spain are processed as instant payments (Source: Iberpay).

Over the next few years, it is expected that instant payments become the new norm across Europe. To get to that point, however, considerable efforts are still needed to ensure that all payment service providers join the SCT Inst scheme, are reachable for transactions at the pan-European level and offer their customers attractive SCT Inst based services for different use cases.

Having a pan-European wide reach is essential for instant payments because customers of any payment service provider should be able to send and receive payments to and from customers of any other payment service provider in Europe. The Eurosystem supports the goal of establishing pan-European reach for instant payments by offering TIPS, which settles instant payment transactions in central bank money across Europe, 24/7/365 and within a few seconds. Availability of instant settlement in central bank money in our digitalising society is key to preserve the confidence in the euro and its sovereignty.

*"The Eurosystem supports the goal of establishing pan-European reach for instant payments by offering TIPS."*

- MARC BAYLE DE JESSÉ

For instant payments to live up to their full potential, attractive end-user solutions are required allowing retail payment customers to initiate and receive instant payments in a convenient way, suitable to the specific situation in which these payments take place. Technological progress is global. Hence, it seems almost anachronistic if innovative payment products and services are restricted to national >>>

>>> markets. Even if the roll-out of new products and services starts at national level, they should not incorporate any intrinsic barriers preventing their domestic pan-European expansion. Instead, services offered should provide for pan-European reach in their initial design, taking our economic

area as domestic basis. SCT Inst, being a pan-European scheme, offers an opportunity for European payment service providers to develop innovative solutions with pan-European reach, thereby allowing them to compete with global players for intra-European payments. While Europe is open to

global, non-EU payment service providers that fulfil the European regulatory requirements, it is in the interest of the retail payment service users of Europe to provide for healthy competition from pan-European payment service providers that offer innovative, safe and user-friendly solutions. ●

## Pia Sorvillo

Director of European Affairs, Visa

### Driving forward the payment landscape transformation



By September this year, virtually each digital transaction in Europe will have to comply with new rules, designed to enhance payment security. We all know

that security is key for digital commerce to exist and thrive, yet we also know that is equally key to strike the right balance between security and convenience. This is especially true in a world where consumers are empowered to make purchases across a range of connected devices and expect a secure and seamless payment experience. Any hurdles at checkout risk annoying consumers and losing business for retailers.

We should be mindful that consumers expect both high levels of convenience and safety.

The payment industry has been preparing carefully to try and meet the September deadline, despite the outstanding questions on the interpretation of the very complex EU regulatory framework. Visa – amongst others – has engaged closely with regulators across Europe to support understanding of the potential impact of the strong customer authentication (SCA) rules for the payment ecosystem.

At the core of Visa's approach to delivering SCA is our 3-D Secure (3-DS) platform and Verified by Visa service. We are also helping banks and merchants to integrate biometric authentications measures into their banking apps and websites, so that consumers can simply log in on their connected device and use their fingerprint, their voice or even use

facial recognition to complete a purchase. Biometrics are the next logical step in the authentication of payments, as they typically match convenience with security.

However, we are concerned that a substantial number of small merchants is not 3-DS enabled to date. In fact, industry intelligence indicates that as many as 75% of all online merchants in Europe may be unaware of the SCA requirements that will come into force in September.

So, what happens to all these small merchants that are not aware or otherwise ready to implement SCA?

As from 14 September 2019, merchants without 3-DS can still send transactions to acquirers for authorisation. However – without the rich data available through 3-DS – neither the acquirer or the issuer will have sufficient information to assess the actual risk of fraud to decide whether the transaction could be exempted from SCA under the Transaction Risk Analysis. And even if the transaction were to fall under other exemptions (e.g. low value or 'white-list'), without insight into the actual risk of fraud, no acquirer or issuer is likely to process these transactions without SCA. In fact, these transactions will most likely be all declined. Visa is working to raise awareness on the huge business disruption risk small merchants are facing. ●

## Brett Loper

Executive Vice President, Global Government Affairs, American Express

### Taking stock of the Interchange Fee Regulation

Some three and a half years since its introduction, we can now start to take stock of the impact of the Interchange Fee Regulation (IFR) on the E.U. cards market. Built on competition investigations by the Commission and the National Competition Authorities,

the Commission's ambition was to help construct a single market for card payments across the E.U., creating a level playing field to allow more competition and spur innovation in payments, to the benefit of merchants, consumers and payment providers alike.

Judged against these goals, the IFR has fallen short. Well short. At best, its impact on competition has been mixed. While we may be witnessing a nascent move to pan-European acquiring, no new pan-European payment schemes have entered the market. If anything, we have seen a marked reduction of competition in several Member States, and a reinforcing of the strength of the two-dominant card schemes. >>>



>>> The IFR has also failed to deliver lower prices for merchants and consumers in a meaningful way. The major expectation was that merchants would see reductions in the cost of accepting cards, which in turn would be passed on to consumers through lower retail prices for goods and services. And while the capping of interchange has certainly impacted the issuers' revenues, the small and medium-sized merchant community in particular is arguing that they have not received the full interchange reductions and have been impacted by increased scheme fees and other costs.

From a consumer choice perspective, the IFR has also brought a raft of unintended consequences, with a number of card issuers withdrawing or scaling back various benefits of card usage, and introducing or increasing cardholder fees or annual charges in response to the interchange cap.

Moreover, with different surcharging regulations in every Member State, this highly fragmented and confusing landscape has left consumers vulnerable to discriminatory surcharging practices which are both unintelligible and unenforceable.

*"The IFR has also failed to deliver lower prices for merchants and consumers in a meaningful way."*

- BRETT LOPER

Going forward, to avoid the unintended consequences that have impacted the effectiveness of the IFR, regulation has to move away from the one size fits all approach, and towards one where alternative payment providers, new

entrants and smaller competitors do not suffer unwarranted and stifling regulatory burdens, that only serve to entrench the duopoly card schemes. Critically, when the Commission begins to consider the next round of payments regulation, the priority needs to be on enabling real choice for consumers and merchants. Concretely, rules around additional transparency need to be evaluated, mandating card schemes to disclose more clearly all types of fees merchants pay. This would provide merchants (especially small ones) with a more accurate picture of the total cost they bear and would allow them to better compare the costs of different schemes.

Not least, from a consumer perspective surcharging should be completely banned across the E.U., to achieve the Commission's long-held aim of a truly common regulatory regime in the single market. ●



## Florence Lustman

Chief Finance and Public Affairs Officer,  
La Banque Postale

### Reconciling the security of means of payment with their accessibility

Means of payment are at the core of trust-based relationship that banks have historically built with their clients, on the one hand, and with the political and regulatory authorities, on the other. Banks know how to manage these issues and have consistently

invested in new means of payment and payment infrastructures that are increasingly convenient, efficient, fast and secure.

But this model could be battered by a triple revolution: technological, economic and regulatory. Many new means of payment have emerged in the last decade, with a focus on real-time, if not the elimination, of the act of payment, be it contactless, instant payment, mobile payment or payment via IoT. New economic players, such as large internet-related groups and FinTechs, have burst onto the scene. Lastly, from a regulatory standpoint, several European texts have prompted changes in the payment's ecosystem and its underlying economic model.

This disruption of the payment ecosystem raises an important question: who should pay to develop both new and aging payment infrastructures and to secure new means of payment? The issue arises because the cost of these innovations is not limited to a particular new tool developed by a particular actor. Their cost must include banks' investments in their core banking and IT infrastructures to guarantee security and address new risks. The question becomes even more acute when it comes to instant payment. It's expensive to build, maintain and monitor a system that runs 24/7/365! To continue to invest in security, banks need to be able to rely on an economic model where the revenues contributed by means of payment is not merely "marginal".

The distribution of value in the payment chain raises other regulatory,

economic and even political questions within Europe. It is therefore worth asking whether the systemic risk incurred by the new means of payment is properly understood, given the major changes resulting from the proliferation of new players. Why not provide for "resilience plans", as is the case for cash? Questions may also arise about the impact of the 2015 MIF regulation: have the lower interchange fees really been passed on to consumers as anticipated? One thing is clear: we need to take time to conduct thorough impact analysis before committing to new regulatory developments. Last but not the least, we also need to think about the Single Euro Payments Area's dependence on non-European players who share neither the same goals nor the same values. This applies in particular to personal data processing; banking data are particularly sensitive and could be mined and disseminated.

While the new means of payment require extra vigilance, they also pose a societal problem that has not been adequately taken into account: many of our fellow citizens are likely to abandon means of payment if their level of sophistication becomes a deterrent. In addition, for some — the elderly and the vulnerable — cash is still preferred on a day-to-day basis. La Banque Postale is paying particularly close attention to this issue and has notably continued to distribute cash at its counters. This is how we are ensuring that digitally-excluded citizens are not excluded from the banking system and that all are free to choose their means of payment. ●



## Stephen Lindsay

Head of Standards, SWIFT

### Digital ecosystems, APIs and Standards

The importance of digital ecosystems continues to grow. McKinsey advises that 'Staking out a position in ecosystems is important, because enormous value could be up for grabs ... by 2025, some \$60 trillion in annual revenue could be redistributed across the economy—one-third of that year's total'. Ecosystem business partners interact constantly through Application Programming Interfaces (APIs) and banks that will play a role in digital ecosystems need to adapt to this way of working. PSD2 requires European banks to implement APIs for access to account and payment initiation, and although the focus is initially on retail banking we can expect the same technology to be adopted quickly for other segments.

PSD2 therefore acts as an important catalyst to prepare the banking industry in Europe for the challenges of a digital future, where expectations of the new connected businesses will be for simple and seamless integration of banking services, from basic payments to financing and beyond.

Although sometimes considered anathema to ideals of innovation, standards will be key to the evolution of digital ecosystems. Business standards specify common definitions and structures for financial information exchanged by business partners. Without them, individual service providers will expose proprietary definitions and formats, resulting in fragmentation and an avoidable legacy of cost, complexity

and friction. Several organizations are already working to standardize PSD2 API specifications. As a bank-owned cooperative with a longstanding mission to promote standardization, SWIFT supports this work and encourages further industry cooperation to define flexible but interoperable API specifications for common services. ●

1. McKinsey Insights: Winning in digital ecosystems

## Ashley Fox

MEP, Committee on Economic and Monetary Affairs, European Parliament

### PSD2 vs GDPR - The need for clarity



As data grows as a commodity, business models start to adapt and naturally so too does legislation. Arguably, the General Data Protection Regulation (GDPR) and the Payment Services Directive (PSD2) will have the greatest impact on the payments industry in the coming years. Whilst PSD2 forces banks to open up customer payment account data to third party providers (TPPs) in a bid to increase competition, the GDPR aims to regulate how this sharing is done. Whilst the two pieces of legislation have the same objective of putting the control of data back in the consumers' hands, they were drafted independently of each other and there are instances where they are not entirely consistent.

Under Article 67 and 94 of PSD2, banks are required to provide TPPs with access to customer payment account data on the proviso that they have 'explicit consent'. This has created a number of issues.

Firstly, under the GDPR, there are six grounds for processing data and consent is one of them but there is also permission where the processing of the data is necessary to perform a contract. In this scenario, the processing of personal data is necessary to perform the contract that is payment initiation. Given this, there should be no need for the consumer to provide consent. Nevertheless, PSD2 does increase the level of protection needed and requires for 'explicit consent'. Yet, what 'explicit consent' actually is has not been defined. There is a lack of certainty as to what additional details are needed to make consent 'explicit'. In private discussions with the Commission in Brussels, it has transpired that explicit consent may take the form of an additional clause to the contract that specifies the purpose for which the data will be provided. However, private conversations in Brussels will not provide clarity to banks and TPPs in Romania.

With the failure to provide clarity on this matter, there is the potential to undermine the objectives of PSD2. As we saw almost 18 months ago in Poland and the Netherlands, banks were restricting access to customer payment data to TPPs in the fear that they would breach the GDPR. However, this instead led to raids on their buildings due to complaints from TPPs that they were not being given access to data as per PSD2.

*"The future of the payments sector relies on the safe and free flow of data."*

- ASHLEY FOX

This will not be the last time something like this will happen. There are still a number of outstanding questions. For example, should the onus be on banks or the TPP to obtain consent? Who is responsible in a breach? and should banks be expected to perform due diligence before sharing customer data?

As long as there are inconsistencies such as these and as long as either legislation fails to establish primacy, it is likely that banks will take a more conservative interpretation so as to avoid the fines of up to 4% of global turnover as per the GDPR and subsequently stifle competition.

The future of the payments sector relies on the safe and free flow of data. Where there is a lack of clarity over the interpretation of PSD2 and the jurisdiction that GDPR has over the payments industry it will be difficult 'to create safer and more innovative European Payments'. ●

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# About EUROFI



The European Think Tank dedicated to Financial Services

- A not-for-profit organization currently chaired by David Wright who succeeded Jacques de Larosière as Chairman in April 2016.
  - A platform for exchanges between the financial services industry and the public authorities addressing issues related to the evolution of financial regulation and supervision and the economic and monetary context impacting the EU financial sector.
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## MAIN ACTIVITIES

The main objectives of Eurofi are to help industry and public decision-makers reach a common understanding of possible evolutions required in the regulation and supervision of financial services and to open the way to legislative or industry-driven solutions that may enhance the safety and effectiveness of the EU financial sector and its contribution to economic growth.

Eurofi acts in a general interest perspective, facilitating exchanges of views between diverse financial industry players and the public authorities. These discussions are prepared by objective fact finding and issue analyses.

Eurofi has two main types of activities conducted by **Didier Cahen**, Secretary General of Eurofi, **Jean-Marie Andrès** and **Marc Truchet**, Senior Fellows:

### *Events and meetings:*

- Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) gathering industry leaders and EU and international public decision makers for discussions on the major on-going regulatory projects in the financial

area and the role of the financial sector in fostering growth as well as the economic and monetary environment.

- These events are regularly organised in association with the EU Presidencies in parallel with informal ECOFIN councils and in some cases with the G20 Presidencies. They are organised with the support of **Virginie Denis** and her team.
- **Additional workshops** involving the members of Eurofi are set up to exchange views on regulatory issues. Bilateral meetings are also regularly organised with representatives of the public authorities and other stakeholders (e.g. end-users, experts) to fine-tune assessments and proposals.

### *Research and documentation:*

- Assessments and proposals taking into account economic, risk and end-user impacts are prepared with the support of cross-sectoral working groups comprising members of Eurofi.
  - Topics addressed include prospective and on-going regulatory proposals at the EU and global levels, industry trends as well as the impacts for the financial sector of the economic challenges the EU is facing.
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## MAIN TOPICS CURRENTLY ADDRESSED

- **Measures and instruments needed to ensure an appropriate financing of the EU economy:** impacts of Brexit on the financing of the EU, impact of on-going monetary actions, measures to support bank financing (securitisation), diversification of the financing of SMEs and infrastructure projects, proposals for developing a long-term investment perspective, climate change agenda
- **Prospects of digitalisation and fintech:** digital transformation in the banking and insurance industries, fintech and blockchain applications in the capital markets and investment, related regulatory challenges
- **Prospects of further EU integration:** implementation of the Banking Union, priorities for implementing a Capital Markets Union, possible evolution towards a fiscal union and further economic integration in the Eurozone, evolution of the EU regulatory and supervisory authorities (ESRB, ESAs).
- **Optimizing the EU financial services internal market:** payments, review of the IORP directive, regulation of

CRA, prospects of further banking integration and of digital banking

- **Evolutions of the prudential and regulatory framework of banks and insurance companies:** fine-tuning and implementation of banking and insurance prudential frameworks, recovery and resolution of banks and non-banks, culture and conduct measures
  - **Capital markets and investment product regulations:** Capital Markets Union, regulation of securities, derivatives and commodities markets and infrastructures, recovery and resolution of CCPs, cybersecurity, SFT and collateral requirements, asset management regulations, investor protection regulation (PRI, MiFID, IMD...), regulation of shadow banking
  - **Financial regulation at the global level:** feasibility of bank crisis management at the global level, coordination of capital markets regulations at the global level, systemicity of non-banks non-insurers
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# NEXT EUROFI EVENTS

**11, 12 & 13 September 2019**  
**Helsinki - Finland**

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**22, 23 & 24 April 2020**  
**Zagreb - Croatia**

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**September 2020**  
**Berlin - Germany**

## EUROFI MEMBERS



**eurofi**

[www.eurofi.net](http://www.eurofi.net)