Views

The EUROFI Magazine

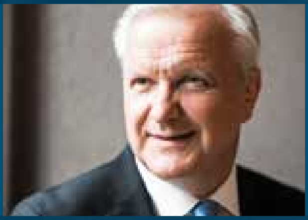
HELSINKI | SEPTEMBER 2019

Mika Lintilä

Towards a sustainable financial sector

The Eurofi Financial Forum 2019

Helsinki | 11, 12 & 13 September



Olli Rehn

Growth and Investment Union to boost Europe's economic revival

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Current challenges for the European banking sector

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The Eurofi Financial Forum

HELSINKI | SEPTEMBER 2019

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The Eurofi Helsinki Financial Forum

Over 900 representatives of the European and international public authorities and the financial industry are gathered in Helsinki to discuss the policy measures needed to strengthen the EU economy and financial system, the evolutions underway in the macro-economic environment and also on-going developments related to technology and sustainable finance.

The future of global regulatory and supervisory cooperation and possible options for enhancing policies dealing with third-countries will also provide major topics of discussion during this international Eurofi Forum.

As a new political cycle is about to start for 5 years following the European elections, a common theme throughout this event will be the priorities of the incoming Commission for financial services. Many important objectives for Europe are identified in the Helsinki programme: i.e. fostering more growth, developing long term investment and retail participation in capital markets, increasing capital mobility across the EU, leveraging technology, tackling money laundering and cyber risks...

Europe has many strengths to build on in this perspective: significant saving surpluses, resilient financial infrastructures, well capitalised banks and insurance companies, supervisory authorities with a reinforced role, a leadership in sustainable finance, a wide range of fintechs, a common currency in 19 Member States...

One particular challenge however at this point in time is that two key initiatives have already been launched to tackle the growth and integration issues that the EU is facing, i.e. the Banking Union and the Capital Markets Union, in addition to the broader project of the EMU (Economic and Monetary Union for the Eurozone), but the first phase of their implementation has not allowed the achievement of the expected results and it is not certain that a mere implementation or continuation of the proposals already on the table will be sufficient. Both of these initiatives need relaunching or re-engineering to a certain extent and they also need to obtain a stronger political backing from the Member States.

Another challenge is that the room for manoeuvre of the European financial industry is lessening. Additional regulatory requirements and lasting very low or even negative interest rates are reducing the profitability of many players and the appetite for long term investment. At the same time, actions that may help to improve scale across the EU, such as consolidation or cross-border development are difficult to achieve with persistent regulatory and supervisory fragmentation. Brexit is no help in this regard in the short term. And digitalisation is both an opportunity and a challenge (in terms of investment, required change, new competition, new risks...) for incumbent players.

How to address these different challenges will be at the centre of the discussions of the Helsinki Forum. In preparation for this, we have asked the speakers taking part in this event to express their views on these questions in this Magazine.

We are very grateful to the more than 200 speakers who have accepted to do so and we are sure that you will read their thoughts and proposals on these challenging questions with great interest. ●

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

David Wright

President, EUROFI

It is time for decisive action

As EUROFIs 20th anniversary approaches, we have the pleasure once again of assembling in the fine capital city of Finland, Helsinki.

On behalf of the members of EUROFI, its Secretariat and all participants, I would like to thank our hosts, the Finnish Presidency of the European Union and its institutions for their hospitality and warm welcome. We will have another memorable 3 days of important, high level discussions.

We meet at an important moment of change. A new European 5 year political cycle is nearly upon us, a new European Commission and European Parliament taking office. We wish them every success in their crucial roles.

At our latest meeting in Bucharest we debated some of the forthcoming European financial sector priorities for the next 5 years.

I detected a strong degree of consensus among the 1,000 participants or more who were present that Economic and Monetary Union must be completed, Banking Union solidified for some inevitable stormy days ahead and that Capital Markets Union needs to move to a new, invigorated phase with priorities selected on the basis of positive economic impacts with a highest level Tripartite political agreement (Commission, Council and Parliament) and robust, monitored delivery.

EUROFI can help the European Union's' new political leadership by being precise - identifying the key measures, the legal changes required, the desirable procedural modalities and a sensible timetable.

- What are the key subjects, themes and measures that will ramp up the EUs' economic growth rate, sustainably, in the medium term?
- What measures will significantly improve long-term investor and consumer confidence in European financial markets?
- How can the profitability of European financial institutions be improved?
- How can sustainable finance become a European and global policy "winner" as much of the earth's environment continues to deteriorate at an alarming pace? What are the priorities?
- How can the EU revive its public markets - IPOs this year are the lowest for a decade or more. SMEs, particularly innovative potentially fast growth ones, are still underfunded. The EU has not

one company in the top 15 BigTechs in the world - many of whom are now commercially attacking the established financial order.

- How do the PEPP, Solvency II etc need to change to build a stronger equity culture in the European Union? Many feel the absence of pension funds in Europe is at the heart of the problem. In Europe, public financing of pensions represents 10% of GDP and private pension funds only 0.8%. In the U.S the situation is the opposite. U.S pension funds are the biggest financial market investors in the U.S with over 20 trillion dollars of assets. Many also feel the Solvency II capital charges for equity investments are too high.
- As Brexit decision making time could be very near at hand, what are the optimal third country financial policies the EU should follow with the UK and other third countries in the future? Surely policies based on compatible and comparable high level standards, procedural predictability and depoliticization are desirable along with strong bilateral supervisory cooperation and information sharing.
- How should the ESAs be reinforced further to ensure European institutional coherence for a real Capital Markets Union?
- What is the right European approach to growing levels of financial crime - money laundering, terrorist financing, tax evasion etc. The European Commission has recently listed dozens of new methods to launder money……Quoi faire?
- Has the time not come for the EU to exercise a much stronger leadership role on the world stage in the global financial institutions - far more coordinated and with one voice as multilateralism comes under growing pressure from the United States?

All these are very difficult political and strategic problems. The low hanging fruit has long since been picked. But half-way houses, lowest denominator outcomes, feeble compromises and de minimis fixes, will not solve the EUs structural economic and financial problems. Only by acting boldly and collectively will European economic welfare be enhanced.

Jacques de Larosière has recently written on Capital Markets Union "….In Europe there is a somewhat simplistic view that developing its capital markets will substitute for bank activity. This is profoundly wrong. There will not be efficient capital markets in Europe without strong banks able to compete internationally; banks able to prepare companies for listing, underwriting bond issuance, providing risk capital and the crucial links to investors, securitizing assets and facilitating the financing of mergers and acquisitions….". Economic and Monetary Union, Banking Union and Capital Markets Union, in short, are integrally linked and bound together.

He concludes by saying "…… a big range of issues must be tackled to deliver a real European CMU. It needs strong political leadership, courage and a serious plan founded on sound, fundamental economic principles. And urgency…".

I could not agree more. ●

Q&A

Mika Lintilä

Minister of Finance,
Finland

Towards a sustainable financial sector

WHAT ARE THE MAIN PRIORITIES OF THE FINNISH EU PRESIDENCY IN THE FINANCIAL AREA AND THE MAIN EU POLICY INITIATIVES THAT THE PRESIDENCY IS FOCUSING ON?

The Finnish Presidency of the Council of the EU will work to promote the Union's common values and strengthen its competitiveness and social cohesion as key priorities. A competitive and cohesive Europe depends on well-functioning internal markets, with deep capital markets, resilient banking sector and a strong crisis-resolution framework. It needs to be supported by a simple and effective economic policy coordination framework that recognizes the ultimate responsibility of each Member State over its economic policies. It also requires a fair and efficient system of taxation that supports economic growth, competitiveness and employment.

The Finnish Presidency will seek ambitious progress in our common fight against climate change. Sustainable economic growth, actions to mitigate the climate change and achieving compliance with the Paris Agreement are important priorities nationally, in the EU and in the context of our Presidency. Economic policy planning, fiscal policy including carbon pricing, budgetary planning, public financial management as well as mobilisation of climate finance are relevant and effective tools in financial sector to mitigate climate change. Climate change aspects need to be integrated into the Finance Ministers' work. As a concrete measure, we aim to develop, in cooperation with the Commission, an action plan for Finance Ministers on climate change. One of the key EU legislative files regarding climate change is the taxonomy for sustainable investments. We aim to reach a political agreement with the European Parliament on the file. We will also have discussions concerning climate change on the strategic long-term vision for a climate-neutral economy and initiatives related to taxation, such as energy taxation. The Ministry of Finance of Finland is also organizing with the Bank of Finland the Greener Finance for Sustainable Future Conference in October in Helsinki.

The Finnish Presidency will also seek comprehensive action to protect Europe and its citizens against internal and external threats. Financial sector provides services that are essential for the functioning of our societies, yet it may be vulnerable for many forms malicious interference. Finland will launch a discussion on the resilience of our financial infrastructure against hybrid threats. Fight against money laundering and terrorist financing will also be one of the key topics during the Finnish Presidency and the work will continue on the basis of the Commission's post-mortem reports. The Presidency will invite the ECOFIN Ministers to adopt Council conclusions on a strategic agenda on the AML.

Finally, only a healthy banking sector can finance the investments needed for technological innovations and actions to mitigate climate change. Determined efforts are therefore needed to continue reducing risks in the European banking sector. The Finnish Presidency is committed to continue the work on the strengthening of the Banking Union, in coordination with the High-Level Working Group on EDIS, and will seek to advance the negotiations on the proposals still on the table related to non-performing loans.

WHAT SHOULD BE THE MAIN PRIORITY FOR THE INCOMING COMMISSION IN THE FINANCIAL SERVICES SECTOR: DEEPENING INTEGRATION, BOOSTING GROWTH OR STRENGTHENING FINANCIAL STABILITY?

Europe is in its seventh consecutive year of economic growth. Much of this is thanks to determined reform efforts over the past years. Yet, risks to the favorable economic development are evident, which underlines the need to continue with the reform efforts – both at the national as well as at the Union level. At the same time, beyond the immediate risks to economic growth, the Union faces broader challenges to its prosperity, cohesion and security.

To attain sustainable economic growth, the EU must work systematically to establish a fully-fledged banking union, a robust crisis management framework and a more resilient capital market. The banking union is an important element in a more stable EMU. The remaining building blocks of the banking union are well known. However, the legacy issues need to be tackled before further risk sharing is possible. Political acceptability requires a sufficient degree of fairness, and that means that banking union needs to look like proper insurance, not one-sided subsidisation. The ongoing work at the High-Level Working Group on EDIS provides an opportunity to agree on necessary reform agenda for the completion of the banking union.

A proper Capital Markets Union (CMU) is needed to complement the banking union. It would deepen the market integration across Europe thus boosting growth and also contributing to a more resilient EMU through private sector risk sharing across member states. We expect the new Commission to continue this work beyond the Finnish Presidency, for instance in the sustainable finance area, in anti-money laundering as well as ensuring resilience and stability of key market infrastructures against operational risks.

Finally, the Commission is preparing a comprehensive review of the economic governance framework (focusing on the six-pack and two-pack) by December 2019. The Ecofin Ministers should contribute to this review with their experience of implementing the current framework in Member States. This backward-looking discussion could cover also the Macroeconomic Imbalances Procedure. Moreover, the Ministers should discuss possibilities for reforming the fiscal rules with a view to make them simpler and more easily understandable and implementable.

WHAT IS THE WAY FORWARD FOR THE CMU? DOES THE PROJECT NEED REFOCUSING OR REDESIGNING?

Although much has been achieved, substantial work remains to be done in the context of the CMU. The Finnish Presidency considers it necessary to have an updated plan on how to pursue the CMU further. There are still legal or regulatory barriers against smooth movement of investments and related services. The Finnish Presidency will launch work towards a new roadmap for the next phase of the CMU for the next institutional cycle.

Legislative files related to CMU that are still on the table need to be finalized and the Finnish Presidency aims to conclude the negotiations on taxonomy for sustainable investments and crowdfunding and advance the negotiations on central counterparty recovery and resolution.

In the future work on the CMU, the Finnish Presidency would like to emphasize the angle of retail clients, who should benefit from digitalization and the removal of technical and legal barriers to accessing financing or financial products. In addition to enabling the service-providing entities to improve their efficiency as well as quality of their services, CMU 2.0 should focus on building retail client confidence through providing EU-wide high-quality, user friendly and cost effective retail financial services and products.

Through well-functioning capital markets private investors contribute to spreading the investment risks across the economies, which are currently too much reliant on bank lending. This would also contribute to a more resilient banking sector and more broadly the European Monetary Union in general.

WHAT ARE THE MAIN OBSTACLES TO THE DEVELOPMENT OF THE GLOBAL ROLE OF THE EURO? IS THIS A PRIORITY?

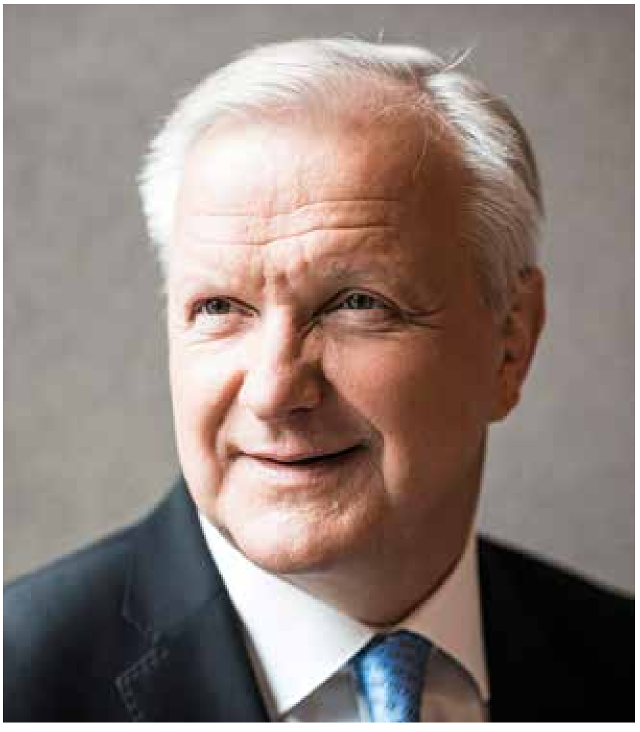
The global role of the euro mainly reflects the economic strength and financial stability of the EU. To this end, the focus has been in finalizing the Banking Union and making further progress with the Capital Markets Union. Strengthening the international role of the euro should be considered more of a positive spillover effect of this than an aim in itself. ●

Q&A

Olli Rehn

Governor,
Bank of Finland

Growth and Investment Union to boost Europe's economic revival



HOW MAY SUSTAINABLE GROWTH AND ECONOMIC CONVERGENCE BE FURTHER DEVELOPED IN THE EU? WHAT ARE THE PRIORITIES FOR THE NEXT FIVE YEARS IN THIS AREA?

Apart from managing immigration better and reinforcing external and internal security, our key policy challenge in the coming years is to boost an economic and industrial revival of Europe. The prolonged presence of pervasive uncertainty in the world economy, especially the expanded trade war, underlines the importance to concentrate on Europe's economic and industrial revival.

It should put focus on enhanced productivity through economic reforms and through a revitalisation of the Single Market. Moreover, it should strive for an ever stronger public and private investment in innovation and research. Furthermore, Europe's economic revival needs to be combined with the greatest challenge of our generation: tackling and mitigating climate change. It calls for a consistent strategy from the EU on how to pursue economic and ecological transformation of our societies and enterprises, from fossil fuels to renewable energy, from the production of waste to circular economy.

The single market needs an additional boost and deeper integration. A well-functioning financial system is fundamental for growth. The completion of the banking union and enhanced efforts towards the capital markets union are essential building blocks of both the integrated single market and a more resilient monetary union.

Economic reforms need to be substantially stepped up in euro area countries to increase resilience, reduce unemployment in a lasting way and boost productivity. The power of monetary policy is limited and can become overburdened without the support of other policy areas. Growth requires more investment, research and innovation.

For sustainable growth sufficient public sector contribution is needed. It is important to invest in public infrastructure, including digital infrastructure and boost environmental investments. Sufficient public investment can also boost private R&D.

We should also continue to work for a Europe that promotes growth beyond its own borders through free-trade agreements, despite the current headwinds; for a Europe that combines entrepreneurial drive and a stability culture; and for a Europe that guarantees civil rights and social justice in the digital age.

These are the concrete, functionalist goals for sustainable growth and job creation – and fundamentally for human development – that do really matter to our citizens in Europe, which should always be our yardstick. They should be supported by rock-solid financial stability that can be enabled by completing the banking union.

TO WHAT EXTENT IS A FURTHER CUT IN INTEREST RATES LIKELY TO PRODUCE HIGHER INFLATION AND A REBOUND OF ACTIVITY IN THE EURO AREA? HOW TO ADDRESS THE POSSIBLE SIDE EFFECTS?

In policy-making, it is usually better to be safe than sorry. This goes particularly for monetary policy. As a consequence of the recent slowdown, central banks have put monetary policy normalisation on hold and instead started to prepare an accommodative policy stance if needed. This holds true for the ECB as well.

The ECB Governing Council is determined to act in case of adverse contingencies and also stands ready to adjust all of its instruments, as appropriate, to ensure that inflation continues to move towards the Governing Council's inflation aim in a sustained manner.

The ECB has a wide range of monetary policy instruments in its toolbox. We can push the policy rate into negative territory, employ forward guidance on the future policy path, purchase a significant stock of assets from a variety of asset classes to lower yields and offer banks targeted loans to ease their funding costs. These measures work as a package, with significant complementarities across the different instruments.

Lower rates, or rather the total package of unconventional monetary policy measures, have improved financing conditions and enhanced the macroeconomic performance of the euro area. Negative rates together with our forward guidance of future policy rates have pushed down the short-end segment of the yield curve that determines the pricing of loans to non-financial corporations. It follows that the control of this segment of the curve directly influences the level of lending rates.

At the same time, there may be negative side effects. The Governing Council will continue to assess the case for mitigating measures, which is especially relevant as the time period of negative rates has been extended and if there were further rate cuts.

WHAT ARE THE REASONS FOR THE REDUCTION OF CROSS-BORDER CAPITAL FLOWS IN THE EUROZONE SINCE THE SOVEREIGN DEBT CRISIS? WHY HAVE EU INITIATIVES TO FURTHER INTEGRATE FINANCIAL MARKETS AND DEVELOP CROSS-BORDER INVESTMENT NOT HAD MORE EFFECT IN THIS RESPECT?

Despite the positive financial integration developments after the adoption of the euro, an unfortunate fact is that we are still missing a pan-European capital market. Pre-crisis financial integration turned out to be unsustainable and there was serious fragmentation in several market segments during and after the global financial crisis.

The post-crisis reintegration trend has shown some positive signs in terms of prices, but not in quantities. In banking, there has been a reduction in the cross-country dispersion of funding costs and lending rates, but cross-border retail lending has remained stubbornly weak.

The subdued development of cross-border capital flows is partly explained by the slow recovery of the euro area economy after the financial crisis. The crisis had a severe and long-lasting drag on investments in particular. Financial institutions have had to focus on safeguarding profitability and solvency under challenging conditions and less on increasing cross-border activities.

However, the key underlying factor for the weak development is remaining shortcomings in the EMU financial architecture. While we have made good progress in strengthening the regulatory and supervisory framework and enhancing the institutional setup, the EMU financial architecture is still not sufficiently conducive to cross-border integration and there remain incentives for ring-fencing and home bias.

The EU initiatives to boost investment have been providing easier access to EU funding, with the Juncker Plan having triggered some EUR 400 billion of investments and the new InvestEU Programme promising to build on its success in the years to come. However, we need more private financial risk sharing to support innovation and efficient allocation of capital, and to improve macroeconomic stabilisation.

HOW TO SUSTAINABLY IMPROVE CAPITAL ALLOCATION ACROSS THE EU?

The crucial issue is the completion of the EMU financial architecture. While a banking union is efficient in sharing demand shocks, a capital markets union, via increasing cross-ownership, is necessary to help absorb supply shocks.

There has recently been good progress in taking CMU-related EU legislation forward but significant further steps are needed to create a well-functioning CMU. Harmonising insolvency rules across jurisdictions in the EU would be a major step forward. However, it is difficult and will require long-term efforts. The next steps could focus on harmonising certain basic concepts, such as preconditions for triggering an insolvency procedure, definition of insolvency, and creditor hierarchy.

Overall, progress in establishing the CMU has been slow and there is a need to reinvigorate the project. With this in mind, I think it would be useful to reassess the narrative we attach to the CMU. A new concept – "Growth and Investment Union" for example – might put a more positive spin on the project. ●

Q&A

Ryozo Himino

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

Regulatory responses to issues raised by Libra

IN OSAKA, THE G20 LEADERS REFERRED TO THE EXISTING AND EMERGING RISKS OF CRYPTO-ASSETS AND ASKED THE FSB AND OTHER STANDARD SETTERS FOR ADVICE ON "ADDITIONAL MULTILATERAL RESPONSES AS NEEDED." HOW STRONGLY SHOULD THE GLOBAL REGULATORY COMMUNITY BE ALERTED BY THE LIBRA WHITE PAPER?

I am not prepared to comment on whether the Libra project is a viable one or not, but I do not believe it will be the last one of its kind. Although we need a better understanding of its technology, business model and governance, the Libra proposal seems to have many interesting features and the regulatory community should benefit a great deal from carefully studying various issues it poses. Libra will help us to think about many key challenges of the future of finance in a more specific manner than before.

COULD YOU ELABORATE ON THE MANY INTERESTING FEATURES?

I would cite six. First is that it intends to become a private currency unit. Libra could become a unit of account, a store of value, and a medium of exchange without being a sovereign currency.

Second is (relatively) stable value. Libra is to be backed by a reserve composed of bank deposits and short-term government securities in major currencies.

Third, it may tap a large global customer base. Facebook's network alone reaches 2.4 billion and Libra Association members such as PayPal, Spotify and Uber have 1.3 billion users in total.

Fourth is a big tech business model. Libra could work as an element in a big tech platform's business model of offering free s ervices to access personal data and to generate high switching costs and network externalities.

Fifth is real sector involvement. The Libra ecosystem may extend beyond the financial sector and include players such as Uber and Spotify.

Sixth would be a decentralized system. It has been claimed that Libra will be transformed into a system based on permission less blockchain within five years of its launch.

BUT NONE OF THOSE ARE NEW. BITCOIN IS A NEW NON-SOVEREIGN CURRENCY UNIT AND BASED ON A DECENTRALIZED SYSTEM. TETHER HAS A STABLE VALUE. VISA AND MASTERCARD HAVE ENORMOUS CUSTOMER BASES AND INVOLVE THE REAL SECTOR. ALIBABA AND TENCENT HAVE INCORPORATED PAYMENT SERVICES INTO THEIR BUSINESS MODELS.

You are right, but no one else has proposed a project which combines all of these six things so far. The combined effect may make Libra a totally different creature.

When motorcycles were invented, regulations on bicycles and motors alone could not have ensured traffic safety. Similarly, the existing regulations might not suffice to address key policy issues Libra poses.

WHAT WOULD BE THE KEY POLICY ISSUES?

They could range from issues related to financial stability, safe payment systems, customer protection, and

AML/CFT to issues involving monetary policy, taxation, data protection, and competition policies. In Chantilly, G7 ministers and governors referred to monetary sovereignty and the international monetary system.

Although some aspects are partially addressed by the past or ongoing work of the FSB and other standard setters, there may be issues which have not been anticipated by those who drafted the existing regulations and standards.

Moreover, even if individual policy issues are properly addressed, new issues arising from a cross-sectoral nexus may remain unaddressed, resulting in a fallacy of composition. We need both an individual and a holistic review of the policy issues.

SHOULD REGULATORS AROUND THE WORLD MAKE A UNIFIED RESPONSE TO THOSE ISSUES?

I do not know if we need a unified response, but at least we do need cross-border coordination. With the help of Facebook's strong global platform, an entity located in a jurisdiction with lenient regulation may be able to provide Libra related services to the whole world without establishing local legal entities.

One possible idea may be creating a supervisory college on Libra, but even that might not be enough. The Libra white paper envisions that the system will be decentralized in five years. If that happens, the regulators may be left without anyone specific to regulate or enforce laws upon.

SO YOU'RE SAYING THAT THE GLOBAL REGULATORY COMMUNITY WAS ILL-PREPARED TO DEAL WITH THOSE IMPORTANT ISSUES?

No, Japan as the 2019 G20 presidency asked the FSB to prepare a crypto regulator's directory, analyze gaps in existing regulations and standards, and start thinking about decentralized financial technology which eliminates intermediaries. We also asked the IOSCO to produce a handbook for crypto platform regulators. The directory, reports and handbook were submitted to the G20 finance ministers and governors and were welcomed in their Fukuoka communique. Japan hosted a high-level symposium in Fukuoka and had a session with a panel composed of big tech companies and a big bank.

I would not say that we were fully prepared for the emergence of Libra, but at least we had started to address all of the key issues well before the Libra white paper was published.

ARE YOU PRIMARILY CONCERNED ABOUT LIBRA? DO YOU SEE ANY POSITIVE ASPECTS OF IT?

In Osaka, leaders confirmed that technological innovations can deliver significant benefits to the financial system and the broader economy. Regulatory review exercises should aim at a transparent framework which calibrates requirements according to the risk posed by the activities and reduces discrepancies resulting from the current entity based regulations. Those efforts should contribute to establishing a sound environment for technological innovation. Debate over Libra may help us to reach such a result.

The Libra proposal identified unmet customer needs, and presented a solution which would potentially make business sense for the provider. I suppose this is something the financial industry should learn from.

We talk about "same risk, same regulation," but we have not seen what such a regulatory framework would look like.

It might be useful to start by looking at the issues which lie beyond the traditional perimeter of national regulations or international standards.

For example, most banking regulations do not treat the combination of digital wallets, MMF and payment services as a bank, even if it functions almost like a bank.

The FSB report on crypto-assets in May noted that gaps may arise in cases where crypto-assets are outside the perimeter of market regulators and payment system oversight. We may want to pay attention to the gaps so as not to let Libra and other future projects fall into them.

Existing and proposed crypto-asset related regulations address exchanges and wallet providers. However, governance over the design of crypto-assets is beyond the current regulatory perimeter.

Rigidity arising from entity- or product-based regulations seems to limit our capacity to deal with such issues, even though we will confront such issues more often as innovations continue moving forward.

ONE YEAR AGO, IN AN INTERVIEW WITH EUROFI MAGAZINE, YOU ARGUED THAT THE GLOBAL REGULATORY COMMUNITY SHOULD TRY TO FIND REMEDIES FOR CONFLICTING REGULATORY DEMANDS. THE JAPANESE G20 PRESIDENCY THEN SELECTED ADDRESSING MARKET FRAGMENTATION AS ONE OF ITS PRIORITIES FOR 2019. HOW DO YOU ASSESS THE PROGRESS SINCE THEN?

The FSB and IOSCO produced reports on market fragmentation. I chaired the FSB workshop on fragmentation and Jun Mizuguchi, my colleague at the JFSA, co-chaired the IOSCO group jointly with Chris Giancarlo, who then was the U.S. CFTC chair. My comments thus may be somewhat biased, but the reports went further than I had expected one year ago. The G20 leaders in Osaka declared, "We welcome the work on market fragmentation, and will address its unintended, negative effects, including through regulatory and supervisory cooperation." I think this is a very strong message.

SO DO YOU EXPECT THAT MARKET FRAGMENTATION WILL BE PROPERLY ADDRESSED IN THE COMING PERIOD?

In the first stage, we brought back market fragmentation on the global agenda, and set good programs to be pursued in the second stage, which is starting this autumn. The FSB report discusses possible mechanisms and approaches to prevent and alleviate unintended, negative fragmentation. It also proposes work on ring-fencing. The IOSCO report, which is narrower but deeper and focuses on the wholesale securities and derivatives markets, proposes a future work to extract good or sound practices from members' current practices on deference. We now need to turn the programs into specific actions. The second stage is the pivotal one. ●

Q&A

Andrea Enria

Chair of the Supervisory Board,
Single Supervisory Mechanism,
European Central Bank (ECB)

Current challenges for the European banking sector

HOW TO ADDRESS THE DEEPENING OF THE FRAGMENTATION OF THE EU BANKING MARKET OBSERVED DURING THE PAST FEW YEARS DESPITE THE IMPLEMENTATION OF THE BANKING UNION? WHAT ARE THE MAIN ROOT CAUSES OF THIS FRAGMENTATION?

With the banking union we have taken a big step towards a more integrated market. Banks are now supervised in the same way across 19 EU countries and are resolved through European procedures where necessary in the public interest. However, the banking market remains fragmented along national lines. Banks are not in a position to consider the whole euro area as their domestic market. There are many reasons for this, but two stand out. First, notwithstanding major progress in creating a single rulebook, many chapters are still leaving ample room for national discretion. Second, in the absence of common crisis management tools, countries resorted to ring-fencing measures during the crisis. The obstacles they put up still hinder the free flow of capital and liquidity within cross-border banking groups.

So as far as integration is concerned, the banking union remains unfinished business. For one, banks cannot reap the efficiency gains from becoming more European, making it harder for them to overcome their profitability issues. Moreover, in a fragmented market the banking sector tends to amplify local shocks, rather than helping to absorb them as would an integrated market. So, by moving ahead on integration, we could help to solve two pressing issues: we could help banks to become more profitable, and the market to become more stable.

But how can we move ahead? At the moment I am afraid that the lack of trust between Member States is giving rise to a classic prisoner's dilemma: everybody would benefit from completing the banking union with a proper safety net – including a European deposit insurance scheme. Likewise, everyone would benefit from removing national regulatory barriers and ring-fencing measures. At the same time, however, everyone is concerned about being made liable for losses generated in other Member States. Even the development of a step-by-step roadmap to finalise the banking union is proving difficult.

In the meantime, I think European authorities, like the ECB, need to do their utmost to improve the practical functioning of the current system. Jacques de Larosière, former Managing Director of the IMF, and François Villeroy de Galhau, Governor of the Banque de France, recently proposed the use of intragroup guarantees to allow for greater pooling of capital and liquidity within cross-border banking groups. Their suggestion should be carefully considered, also in the recovery and resolution planning process.

WHY ARE EU BANKS LESS PROFITABLE THAN EQUIVALENT US ONES? WHAT IS THE ROLE OF DIFFERENT UNDERLYING FACTORS E.G. MARKET STRUCTURE, REGULATION, MACROECONOMIC CONTEXT ...? WHAT IS THE ROOM FOR MANOEUVRE IN SOLVING THESE DIFFERENT ISSUES?

European banks are indeed struggling to remain profitable. For a number of them, return on equity is still below the cost of equity, and price-to-book ratios are stuck well below one. And compared with their counterparts in the United States, European banks are clearly lagging behind.

Low profits are not solely a concern for shareholders; they mean less capacity to build up capital buffers and attract new investors. Banks might also feel the need to embark on a search for yield, which will ramp up risks and undermine sustainability. These are sources of concern for supervisors.

I believe it is wrong to single out regulatory reforms, and in particular the toughening of capital requirements, as a main driver of low profitability. The Basel reforms have been rolled out across the world – including in the United States – and have not hindered a significant recovery in profitability, especially in those countries that have frontloaded the adjustment to the new required capital levels. Hence, addressing the low profitability issue by deregulation, as some argue, would be a mistake. Such an approach would merely undermine stability.

European banks' profitability is instead significantly constrained by some structural factors, excess capacity being one of them. In Europe, fewer banks exited the market than in other jurisdictions and the necessary restructuring has often been delayed for too long, as shown by the difficult discussion on policies to address the significant legacy of non-performing loans. Also, owing to some extent to the existing obstacles to market integration, the scale of the restructuring process was sub-optimal. The limited consolidation that did take place fell mainly within national borders. At the same time, banks with non-viable business models have been able to stay in the market and exercise downward pressure on interest margins.

But there is also room for action by bank managers. Looking beneath the aggregate, we do see diversity: some banks are doing well, others are not. Each company is the master of its own fate – as a general rule at least. First and foremost, let's not forget that banks need to finish cleaning up their balance sheets as poor asset quality has been a major drag on profitability. Next, it is crucial that banks enable themselves to steer their profitability by knowing exactly what drives their revenues and how their cost-efficiency could be improved. And they must not only be able to take sound strategic decisions; they must also be able to execute them. And here, we still see some shortcomings – loan pricing is just one example.

IS THE LACK OF CONSOLIDATION OF THE EU BANKING SECTOR A MAJOR ISSUE AND HOW TO EXPLAIN IT? IS FURTHER CONSOLIDATION POSSIBLE IN THE SHORT OR MEDIUM TERM?

The debate on overbanking is not new, but it is still relevant. The European banking sector is indeed quite large and has excess capacity. Competition is intense and margins are low. A large banking sector also means that less use is made of other sources of funding – such as capital markets. This, in turn, makes the economy less able to absorb shocks.

Consolidation is necessary to absorb the excess capacity created in the run-up to the crisis. The banking sector must become leaner. The only question is how this can be achieved. Of course, cross-border mergers would have the benefit of contributing to greater risk diversification and better integration in the banking market. But domestic mergers could be important too, as efficiency gains could be relevant in the context of overlapping distribution networks. This is not a decision for policymakers: the ball is in the banks' court. I acknowledge that there could be some regulatory impediments, especially in the case of cross-border mergers. However, as a supervisory authority, the ECB stands ready to accompany consolidation. I often hear that supervisors are part of the problem; I am keen to prove that this is not the case.

CONCERNING AML/TF IN THE EUROZONE, WHAT ROLE SHOULD BANKING SUPERVISORS AND NOTABLY THE SSM PLAY AND WHICH ADDITIONAL POLICY ACTIONS ARE NEEDED?

Money laundering has drawn considerable attention recently in the wake of a number of high-profile cases. And it is indeed an issue we urgently have to deal with for many reasons. From our point of view, money laundering damages the reputation of banks, destroys public trust in the sector and may even lead to bank runs and failures. We take this very seriously.

The SSM is responsible for prudential supervision while national anti-money laundering authorities are in charge of assessing how vulnerable banks are to financial crime and illicit money flows. Still, there is some overlap, of course, and that's why cooperation is key. We have now signed an agreement to exchange information with anti-money laundering authorities from across the euro area.

So we take money laundering and terrorist financing risks into account when controlling access to the banking sector and assessing internal governance and controls at individual banks. And next year, new legislation will come into force that strengthens the requirements for prudential supervisors to incorporate relevant concerns into the supervisory review and evaluation process.

Greater prudential focus on money laundering and terrorist financing risks as well as close cooperation between banking supervisors and anti-money laundering authorities can help to drive progress. Still, in order to properly address the issues confronting us, we need a more European approach. As money laundering is often a cross-border business, weak rules or poor enforcement in one Member State can have negative effects across the Single Market. And in my view, the latest review of the relevant European directive might not be sufficient. Also in this area, we need to move to maximum harmonisation and stronger institutional arrangements at the European level. This, however, is a task for European legislators not us banking supervisors. ●

I. EU AND EUROZONE CHALLENGES AND PRIORITIES

Issues at stake

It is the right time to define the priorities for the incoming Commission, as a new political cycle is starting for 5 years.

The EU has a long-standing growth and productivity weakness and is falling behind the US and China in the development of a number of technologies. Attracting foreign capital, increasing investments in technology and ensuring an appropriate allocation of capital across the EU are essential for tackling these weaknesses.

Achieving sustainable economic growth moreover requires structural reforms, sound fiscal policies and appropriate investment policies to be implemented throughout the EU. This would build the foundation for a more resilient and competitive EMU and contribute to strengthening the international role of the euro. Further developing and integrating financial markets with the pursuit of the Banking Union and Capital Markets Union initiatives is also essential. An adaptation of legislative processes would also help the EU to be more reactive to digital and environmental changes and to emerging risks.

Content

EMU: what next and what else?

Pierre Gramegna

Minister of Finance, Luxembourg

Focussing on the big picture: the way forward for Europe's success

The euro has come a long way since its introduction 20 years ago. Its early childhood was marked by euphoria as Europe entered a new stage of development through a higher level of integration. After a promising first decade, the euro met its teenage crisis, laying bare the underlying weaknesses in the European monetary architecture. In its wake, trust in the common project appeared to lose ground but those days are now certainly behind us.

I have myself experienced first-hand the bold steps taken to create a stronger Economic and Monetary Union (EMU). Major achievements certainly include the reforms of the fiscal framework, the creation of the European Stability Mechanism (ESM) or the Banking Union. One cannot underline enough the historic progress made in recent years.

Sometimes taking a step back also allows to better appreciate what has been achieved, to develop a better understanding of remaining issues and to get the fundamentals right before taking the next step forward. It is crucial to remember that our common currency is a true European success story and public support for the euro is at a record high.

Looking forward, it will be essential to continue our efforts to foster the combination of structural reforms, sound fiscal policies and quality investments, which build the foundation for a more resilient and competitive EMU. This is all the more important given the softening economic momentum and such a targeted focus will be more conducive to the long-term success of our economies than yet another academic discussion on the perceived institutional deficiencies of the European construction.

Given the current economic outlook, raising potential growth needs to be at the top of the agenda. Targeted structural measures will be key to ensure higher productivity and to improve the competitiveness of the European economy. It will be crucial to step up efforts by concentrating on areas with high potential such as digitalization and knowledge-intensive sectors.

As regards public finances, policies should be encouraged that leave sufficient fiscal leeway and put debt ratios on a sustained downward path so as to ensure preparedness for a possible downturn. At the same time, sufficient consideration should be paid to the growth-friendliness and inclusiveness of public finances, as well as to the impact of fiscal policy on climate change.

Promoting and sustaining quality investment in key areas, such as education, skills, infrastructure and innovation, will support the growth potential of our economies. The aim should be to encourage higher levels of private and public investment, which nurtures a sustainable economic model and long-term well-being, without compromising resources for future generations.

In this context, the new budgetary instrument recently endorsed by the Eurogroup can play a role to increase both the euro area's competitiveness and convergence. At the same time, the Eurogroup also agreed to set up the common backstop to the Single Resolution Fund at the level of the ESM and, more generally, to further strengthen the ESM and its toolkit. These ambitious initiatives will significantly upgrade the resilience of euro area to adverse economic shocks.

By finding a broad agreement on these important elements of reform, we have sent a positive signal to the world that the EU's single currency continues to move forward. This unique capability to find compromises to complex issues makes Europe stand out in the world and it is on that basis that I remain fully confident about the continued success of our Economic and Monetary Union.

Vilius Šapoka

Minister of Finance of the Republic of Lithuania

Financial fragmentation in the EMU: what has been done and what remains to be done

We live in challenging times - Brexit, trade wars, weakening global demand. Sometimes it is easy to get caught in the news of the hour, in largely exogenous issues and miss the bigger picture - that there are endogenous structural challenges that are more relevant than ever.

The global financial crisis revealed several structural weaknesses in the Economic and Monetary Union (EMU). Most of them can be boiled down to a lack of financial unity in the EMU, in other words, the financial system is too fragmented. At the time of global financial crisis the member states were often cut off from the single market and had to face challenges in the banking sector singlehandedly, which made the burden very heavy to carry. The capital market, which was supposed to "step in" and fill in the void created by the banking sector, thus alleviating the credit crunch, failed to do so as it was also fragmented and, to a large extent, confined to the single member states.

Much has been done since then. We raised the confidence in our banking system by introducing and implementing the Single Supervisory Mechanism, which reduced fragmentation in terms of rules and regulations. Then the Single Resolution Mechanism followed; a member state no longer had to carry the burden of its banking sector issues on its own, which greatly increased the banking sector stability and issue resolution predictability in the whole EMU. The fragmentation in capital markets has not been forgotten as well. A significant amount of work has been done with substantial progress that we can be proud of. The agreement has been made on legislative initiatives ranging from harmonisation of rules and supervision to offering better options for retirement savings and improving SME's access to capital. These milestones brought much needed unity in capital markets by reducing the fragmentation further and further. At the end of the day, can we say that the EMU financial system has significantly improved? Yes. However, have we done enough? No.

With the global financial crisis behind us, it is tempting to relax and gloat over the success achieved. However, as I have already mentioned, there is an ample amount of other issues, which despite their exogenous nature can be a substantial challenge to the EMU financial system and this time we need to be not mostly, but fully ready to face it. That is why I have always supported and called for a full completion of the Banking Union (BU) and Capital Markets Union (CMU).

The European Deposit Insurance Scheme (EDIS) is a still missing element of the Banking Union, which, I believe, will be setup one day. This would be a final nail in the coffin of instability and fragmentation of the banking sector. I understand political difficulties in risk sharing when the risks are not evenly distributed. However, I believe that a mutually agreeable balance could be found. On the other hand, the progress on risk reduction is evident. As a result, there is some reason to be optimistic regarding the eventual adoption and implementation of EDIS.

I firmly believe that in the long term every member of the EMU will benefit from stability, resilience and confidence a fully-fledged BU will bring. We should not forget that the EMU is not a zero-sum game. One member's gain is not offset by another's loss, despite the fact that it may sometimes seem so in the short-term - the EMU is a positive- sum game.

With regard to the CMU, the progress on remaining policies should be sped up. Nevertheless, I am glad that in addition to more traditional capital market aspects important sustainable finance issues are also being tackled. The initiatives on low carbon benchmarks and disclosure are agreed upon and only some taxonomy issues remain, which I believe will be tackled in the near future with full support from the Lithuanian side.

In addition to the aforementioned structural weaknesses of the EMU, I feel the need to touch upon one more issue which is crucial for the sustainability of the euro area - sustainability of public finances. It is vital that the Stability and Growth Pact rules are respected.

I understand the political and economic hardship this brings. However, the only way to address the sustainability of public finances is to focus on structural reforms inside the country, as, unfortunately, these reforms cannot be done from the outside. I wholeheartedly wish that these issues, wherever they may occur, are successfully resolved all across the EMU, as this will benefit us all.

Key priorities for the incoming Commission

Roberto Gualtieri

Chair, Committee on Economic and Monetary Affairs, European Parliament

A new political way towards the Economic and Monetary Union

During the last European legislature, important progress has been achieved in the area of financial services. The SSM and the SRB have become operational, the risk reduction measures have been agreed on the basis of a balanced compromise, paving the way for the agreement on the backstop to the resolution fund, nearly all the major legislative initiatives under the umbrella of the CMU have been finalized, the Juncker Plan has introduced a new tool to successfully mobilize private and public investments and to address market failures.

We have now a better capitalized and more resilient banking system, an efficient common supervision and resolution. A number of encouraging indicators are showing the increase of equity investment and non-bank financing and the good state of the new STS securitization framework. Moreover, many of the legislative innovations in the area of CMU have not yet had the time to show their benefits and will boost the capacity of our financial system to support growth and enhance stability.

However, we have to recognize that in a number of crucial areas the necessary results to achieve a true Financial Union have not been reached. We do not have yet the third pillar of the Banking Union in order to provide the same level of protection to deposits across the monetary union, and we have not been able to remove the regulatory limitations that prevent cross-border institutions from managing own funds and liquidity requirements more efficiently within the Banking Union. These two problems are strictly interconnected, and the solution of the latter is strictly connected to the capacity to give a proper answer to the former. In the CMU area, the ESAs review has been an important success but Member States have prevented the necessary progress towards a common supervision of capital markets, while in the decisive field of the harmonization of insolvency frameworks we have not moved yet at all. As a result, financial fragmentation remains significant in the EU and in the Banking Union and the development of capital markets is still insufficient.

In the current challenging economic and political global environment, deepening integration, boosting growth and strengthening financial stability are all necessary and interconnected goals, which require to completing the Banking Union and to significantly advancing in the Capital Markets Union. However, it is evident that in order to overcome the obstacles that have so far prevented the necessary progress we need to define a new political approach.

In this respect, the political guidelines for the next European Commission presented by the new President Von der Leyen are positive and innovative. The guidelines, which have been elaborated in close dialogue with political groups in the European Parliament, >>>

>>> identify the completion of the Banking Union and the Capital Markets Union, in strict connection to the deepening of the Economic and Monetary Union, as some of the key tools of a comprehensive political strategy aimed at launching a European Green Deal, based on a Sustainable Europe Investment Plan, and at strengthening the European social market economy in order to boost at the same time growth and social cohesion.

By linking more clearly financial integration to specific policy goals, instead than making of it a goal in itself, it could be a key to strengthen the political support and ownership to an ambitious agenda and to overcome some of the deadlocks that have so far prevented the necessary progress on the basis of more transparent and robust trade-offs between member states, citizens and political groups. At the same time, such an approach will require a more targeted and tailor-made identification and selection of priorities and of tangible results, in the spirit of what Francois Villeroy de Galhau have often defined a “Financing Union for Investments and Innovation”, and in the framework of the concept of environmental and social sustainability.

What have been often defined “lack of ambition” in the completion of the internal market for financial services is in reality the result of the too narrow political basis of such an agenda. Let’s hope that the pursuit of a “new political way” towards the Banking Union, the Capital Markets Union and the Economic and Monetary Union, will prove to be more effective. ●

Jean Lemierre

Chairman, BNP Paribas

The future of the European financial system: a new agenda

After ten years of unprecedented regulatory overhaul to strengthen financial stability, the European financial system faces now a different type of vulnerability, as bank profitability is under pressure, under the combined impact of higher capital requirements and accommodative monetary policy rates.

As the European Union enters in a new legislative cycle, the financial services agenda needs to be revisited to address those issues, and to define new priorities.

One of the major stated goals of the Banking Union is to enable cross-border mergers, to address over-banking and develop “private sector risk sharing”. Given higher compliance cost of doing business, coupled with fast-changing clients ‘expectations, concentration is unavoidable, but it is very slow, whether domestically or cross-border. Rigid resolution framework, and absence of true Banking Union certainly doesn’t help, but even more fundamentally, mergers can only happen if the franchise value is sustainable, and if risks are correctly priced, which is currently not the case given the current pricing of liquidity. The Eurozone needs to find other avenues to incentivize cross-border flows.

While banks are struggling on the profitability front, they also face the challenge of digitalization, which requires massive IT investments to compete with new entrants and third country competitors. Today, European banks have to fully deduct from capital any investment in software, whereas third country banks (US, CH) are treating them as tangible assets and applying a 100% RW. This means that for any 1bn€ of capital allocated to software developments, a US or Swiss bank can spend 12.5bn€ in IT developments, while EU banks can only spend 1bn€! Such a major competitive disadvantage needs to be fixed urgently, to unlock EU banks’ investment capacity to offer cutting edge customer experience, and compete with incoming big tech. European authorities should also rethink the “open banking” concept to ensure that the value chain of financial services is fair and that zero-cost banking >>>

>>> doesn't favor clandestine passenger strategies, by new entrants that would enjoy access to data and infrastructure financed by incumbents without to contribute to support market infrastructures.

Third, Europe should implement Basel IV with care and mitigate the tightening impact of ongoing regulatory pressure by setting up a truly workable securitization framework, allowing banks to shift assets into Capital Markets and providing investors with access to previously illiquid exposures such as mortgages or loans to corporates and infrastructure projects.

Securitization should be one of the key pillars of the CMU. It can also become a major driver for private sector risk sharing across the Banking Union, and, if combined with appropriate high-quality criteria, serve as quasi-safe asset.

Securitization is the main gap compared to the US financial system. Every banking regulation has a disproportionate impact on the European economy compared to the US one.

Fourth, as the European societies are embracing the fight against climate change, it should be recognized that banks are uniquely positioned to finance energy transition and ESG goals at large, from mortgages to infrastructure and savings products. Policy makers should focus on incentivizing this move, rather than on implementing additional regulatory constraints. Sustainable Finance should be seen as an opportunity, rather than a financial risk.

Finally, as the EU action plan 2019-2024 aims at designing an industrial policy fit for the future, it is time to stress upon that the financial sector is an element of European competitiveness, and that there cannot be a resilient European economy without a competitive and resilient European banking sector. ●

Bruce R. Thompson

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

Future EU financial services priorities

The new European Commission faces both challenges and opportunities, as does the financial services sector itself. Uniting all parties should be the need to maintain financial and economic stability, which will provide the best foundation for continued growth in the EU.

Among the challenges are European businesses' greater reliance on bank borrowings, rather than capital markets activity. With constraints on the banking sector since the financial crisis, increasing the availability of different sources of finance will help both businesses and consumers in the EU. Continuing work on the Capital Markets Union (CMU) is therefore critical.

However, further development of the CMU must be undertaken with an outward-looking approach. While deeper integration of capital markets should result in a stronger European economy, it is important that the CMU develops within the context of global markets, and ring-fenced capital markets are avoided. And, in the context of Brexit, policymakers should avoid erecting barriers to cross-border market activity that do not have a sound prudential basis.

Further developing the CMU will also help boost market liquidity across a range of asset classes – this will be important if the EU is to continue to attract financial services activity following Brexit. Again, an important factor in enhancing liquidity will be taking steps to avoid market fragmentation. >>>

>>> Regulatory fragmentation is also a concern for international firms. Both in the context of Brexit and beyond, therefore, we would encourage policymakers and regulators – in the EU, the UK, the US and other jurisdictions – to work together. The role of international standard-setters such as the FSB and IOSCO is critical in this regard. Regulatory harmonisation, and co-operation between supervisors, benefits financial services firms through reducing costs, savings which can then be passed on to our clients – this is the case both within the EU and at international level.

Likewise, finalising the implementation of Basel III in the EU will be a positive step in further strengthening the Banking Union, and should be done in a way that limits divergence from global standards, in order to maintain a global level playing field.

Turning to environmental sustainability, implementing the Sustainable Finance Action Plan will help the EU to meet the challenges of climate change in a way that continues to support economic growth and encourages a longer-term approach in investing and development.

There is also a pressing need for a co-ordinated global response to climate change and, should the EU take a standard-setting role, as with wider financial services regulation there is a need to avoid regulatory fragmentation. International and well-integrated capital markets will have a key role to play in supporting the transition to a more sustainable economy.

Technology already plays a vital role in our business and personal lives, and the speed of change is only likely to increase over coming years. Implementation of the FinTech Action Plan will help ensure the EU is well-placed to address the challenges and opportunities that technology brings, balancing the potential rewards of new technology with appropriate oversight of the risks. Importantly, implementation of the FinTech Action Plan should be done in a way that promotes innovation while ensuring that same services are subject to same rules.

The coming years promise to be challenging but exciting ones for financial services in the EU and internationally, as we seek to embrace new opportunities while not forgetting the lessons of the financial crisis. The EU has a critical role to play in managing the development of its financial markets in a way that provides security and opportunity for its citizens while remaining open to global developments. With our post-Brexit EU entities now fully established in Dublin and Paris, we look forward to participating in this important debate. ●

Vittorio Grilli

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

Prioritising a single market in services for the new political cycle

Forty years ago, Europe understood that in order to compete internationally, a Common Market was needed to allow for economies of scale in goods. Today, services play an increasingly vital role in the global economy yet Europe has not responded with the same vigour.

Our priority should be advancing a single market in services to remain competitive, deepening integration, boosting growth and strengthening financial stability. We must continue developing our capital markets and maintain openness, ensure our banks are stable, liquid and resolvable and consider increasingly important issues such as fintech, sustainable finance and AML. >>>

>>> Strengthening the Capital Markets Union and completing a Banking Union should be a key priority. These initiatives are essential to establishing deep and liquid capital markets, supporting an increased international role of the euro and its reserve currency potential by improving the Eurozone's long-term resiliency. Policymakers should be careful though that this does not create barriers with global capital markets.

Europe needs growth and a dynamic economy for its citizens given a scarcity of pension savings and an ageing population. Delivering efficient outcomes will be difficult if harsh restrictions are placed on the financial sector's business models. For example, in asset management, delegating portfolio management to third countries allows investors to access global centres of excellence but certain legislative proposals could lead to restrictions on well-established market practices and European funds' openness.

The EU should consider the impact of politicising equivalence decisions on market participants' location decisions and their ability to operate efficiently across borders. Equivalence decisions should be based on respective rules' merits, the outcomes achieved and made in a transparent and predictable manner.

Post-crisis reforms have fundamentally improved the financial system's strength, stability and resiliency. The Commission should faithfully implement Basel and FSB agreements to ensure the proper capitalisation of Europe's banks. Some EU banks may find regulatory capital increases challenging, but systemic stability demands that banks are properly capitalised. Banks should not retrench from, rather support, the economy in another downturn. Without better institutional cooperation and a mandate for authorities to act, EU institutions could face difficulties in making decisions on achieving financial stability and economic growth through an efficient financial sector.

> *"Our priority should be advancing a single market in services to remain competitive."*
>
> \- VITTORIO GRILLI

National regulators' focus on their own markets' financial stability makes sense from a country's perspective but can lead to inefficiencies and trap financial resources. "Home" and "host" Member States highlight the lack of integration between regulators; a system founded on flows of information, not just trust, between authorities is needed with robust processes to guide cooperation.

Supervisory convergence towards innovation should be enhanced and the EU's financial sector should better embrace new technological opportunities, for example through adopting the Commission's fintech action plan. Any new regulatory framework should be flexible, graduated and principles-based; oversight should be tied to scale and risk.

Europe is a global leader in sustainable finance. Customers need more clarity and transparency; financial firms need better and consistent disclosure at the corporate level to provide useful information for investment decisions. We would caution that EU authorities should approach climate and environmental factors for financial institutions from a risk-based perspective and appreciate that firms have varying exposure to these factors.

On AML, we support enhanced supervisory cooperation through the creation of a single supervisor and converting the Directive into a Regulation. This may be politically complicated, but greater efforts can lead to increased confidence in our financial services.

The next Commission should prioritise integrating Europe's financial sector, but further integration means breaking down barriers in the cross-border trade of services and integrating human capital through labour laws, education and pension systems and professional qualifications. The priorities should be those related to CMU, Banking Union and trends posing new risks and opportunities for the sector. ●

Harald Waiglein

Director General for Economic Policy and Financial Markets,
Federal Ministry of Finance, Austria & Member of the Board of Directors,
European Stability Mechanism (ESM)

The EU setting its priorities in financial services

The past five years have been successful for the financial services sector, as the EU has taken the opportunity afforded by the benign market climate to advance an ambitious reform agenda to strengthen the financial services sector and the EU at large, in order to make them more resilient and ready for future challenges and to support integration. Clearly, Europe's financial sector has become more stable over the past years. Nevertheless, Europe faces increasing financial, geopolitical and environmental challenges that need to be addressed at the highest political level.

As the EU is now setting its priorities for the next five years, it is necessary to focus on finalizing already tabled core European projects, as well as introducing new approaches with a clear view to the future. The different aspects that affect the EU financial services sector, such as political stress factors, fast-changing technology, low interest rates combined with low profitability and challenges to traditional business models, need to be taken into account when thinking about priorities.

> *"Participation of households, start-ups, SMEs and high growth companies in capital markets is vital."*
>
> \- HARALD WAIGLEIN

The Banking Union is still incomplete and thus the new Commission will play a fundamental role in strengthening and completing the Banking Union without delay. Strong decisions must be taken to reduce the fragmentation in the Eurozone and to create an integrated and stable market for banking. Further, the priorities must focus on stimulating the Capital Markets Union and hence market-based finance across the EU single market. The participation of households, start-ups, SMEs and high growth companies in the EU capital markets, the attraction of international investors and the removal of national barriers to the free movement of capital are vital elements in this regard. The principle of proportionality should be kept in mind, as the European financial market is characterised by a variety of business models and market actors.

The need for transitioning to a more sustainable economy cannot be ignored by the financial sector and must be followed up by the EU. The Paris Agreement on Climate Change as well as the Sustainable Development Goals are setting the way forward with ambitious targets that require significant financial contributions. The Sustainable Finance Action Plan needs to be completed and discussions should be held on investment predictability, estimation of climate risks, disclosure of information and the need for specific initiatives to be taken by the financial markets as well as by regulators.

Another topic that needs the attention of the new Commission is the accelerating pace of technological advancement and its applications in across the financial services sector that create opportunities to serve customers in new ways. Customers increasingly expect flexible and personalized services specifically tailored to their needs at

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>>> times and in places of their choice. Existing market participants need to adapt their business models to the changing environment, and new innovative businesses will be entering the market. Supervisory practices and legislation needs to address the changing environment in order to create a fair and stable market without hampering innovation and technological progress. Apart from the opportunities offered by digitalisation, market actors and regulators need to take into account cyber risks and prepare accordingly. The past few years have also shown the risks from money laundering and terrorist financing for the financial services sector. The work of the new Commission, building on previous initiatives to address this challenge, will be of great relevance.

The priorities in the financial services sector need to have a long-term perspective and steer the path to a more integrated, resilient, competitive and innovative European financial market. The new Commission needs a concrete political vision and plan for defining the role that the European financial market should play in the global economy and facilitate investments in Europe in order to ensure competitiveness and growth.

Odile Renaud-Basso

Secretary, Directorate-General of the French Treasury, Ministry of Economy and Finance, France

Financing the future of the European Union

Between 2015 and 2019, the Banking Union and Capital Markets Union (CMU) have made some progress towards a more resilient and consistent framework for financial services in Europe, covering aspects such as prudential ratios, securitization, central clearing or transparency. In doing so, these initiatives have deepened the approach initiated in the aftermath of the 2008 financial crisis, which aimed primarily at restoring buffers, increasing reporting and tightening supervision. The CMU has been conceived mostly as one of the pillars of risk-lowering and private risk-sharing in the EU alongside the Banking Union.

"Despite the high level of household savings, European financial markets remain poorly integrated."

\- ODILE RENAUD-BASSO

Despite the high level of European households' savings, European financial markets remain underdeveloped and poorly integrated. They suffer from a lack of liquidity and the financing of the economy relies mostly on the national and "traditional" banking channels. Following its agenda for investment in Europe, the Juncker Commission acknowledged the relevance of the subject and proposed an action plan bringing together a range of technical initiatives.

The essential function of a financial market is to provide them with diversified and interesting investment opportunities that will fund the growth everywhere in the EU. This is a critical task for the CMU, one that ought to transcend the different pieces of legislation that have and will continue to underpin it. This is a strong political >>>

>>> message which we should focus on during the next five years, on a pragmatic and results-oriented manner.

European savers hold the key to the future of our financial markets. European markets should first and foremost serve European consumers, savers and investors. This implies streamlining current documentation and granting seamless and accurate access to two types of information that are critical in making informed investment decisions: performance (net from fees) and risk.

EU companies are less inclined to go listed than ever before. It is of course a widespread phenomenon among developed capital markets. But the fact remains that European entrepreneurs today are skeptical that their business can be valued in Europe as much as it could be abroad. Private equity has gathered a lot of momentum but should scale in size in the field of venture capital, as we still see too few European unicorns. In that regard, the review of Solvency 2 should facilitate investments in equity, as this would offer alternatives to bank financing while benefiting to clients.

Europe was undoubtedly right when pioneering the field of sustainable finance. The drawback of this dramatic uptake is the looming risk of further market fragmentation, across too many labels and definitions. The Commission should therefore strive to harmonize the concepts of “sustainable” and “green” finance, making it a European standard that can then be a reference for the rest of the world. The taxonomy of environmentally sustainable activities will be a crucial tool in this respect.

Data sciences and technologic disruption are also a core component of financial markets. Spearheading this revolution would position Europe at the forefront of innovation in customer services, payment systems, market infrastructure and collateral management models. Two technologies in particular should focus our attention: blockchain and its applications in the realm of virtual assets, and the advent of a more pervasive use of artificial intelligence and machine learning. An SME raising funds in 2030 may resort to classic issuance, crowdfunding, token emission all at once with instant knowledge of their investor base and infinite possibilities to tailor the parameters of the instruments they offer, most likely embedded with a strong component of automation and smart execution.

As a conclusion, one should recall that the single market in the field of financial services will obviously not be achieved without the support of existing European financial players. Thus, the effect of Basel 3 on EU banks, and more specifically on corporate and investment banking business, must be carefully assessed – there is indeed a serious gap between the impact recently measured by EBA and the political guidance from ECOFIN and G20 that the reform should not lead to a “significant increase” of capital requirements. Besides, initiatives such as STS, or a supplementary facilitation of securitisation may help European banks adapt and increase their performance in the future. ●

Strengthening the role of the Euro

Vitas Vasiliauskas

Chairman of the Board, Bank of Lithuania

Stronger global role of the euro calls for the right structural conditions

While the euro's international use has been declining following the onset of the global financial crisis, the latest ECB data shows signs of a turnaround. It remains to be seen whether this recent uptick is a one-off development or a new trend. For now, it appears to be mainly driven by processes outside the euro area, including international trade tensions and unilateral sanctions.

Recent developments have reaffirmed that there is potential to increase the global role of the euro. Today, being the second most widely used currency, the euro has all the necessary attributes to become a credible alternative to the US dollar. The results of the recent consultations of the European Commission suggest that market participants share this view as well – there is broad support for an elevated standing of the euro.

Ultimately, it is market participants, both private and public, who decide to use a certain currency. As policymakers, we can do our part by putting the right structural conditions in place and establishing a similar environment where the world's No1 currency exists. This includes rendering the European economic and financial architecture more resilient, as well as providing the markets with common Pan-EU infrastructure solutions – for example, in the payments area.

"To boost the global role of the euro, we must first «do our homework» in terms of deepening the EMU."

\- VITAS VASILIAUSKAS

If we want to truly boost the global role of the euro, we must first "do our homework" in terms of deepening the Economic and Monetary Union (EMU). Without a breakthrough in this area, no other measures will be effective.

First of all, to increase confidence in our financial sector and the single currency, we have to complete the Banking Union (BU). A fully mutualised European Deposit Insurance Scheme is critical in this regard. Once in place, it could help to

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>>> mitigate the sovereign bank loop, reduce risk, facilitate the expansion of pan-EU banking and reinforce the financial stability of the euro area as a whole.

Second, a deep and liquid Capital Markets Union (CMU) is of the utmost importance in fostering the euro's global use. It would enhance private risk sharing, provide alternative financing sources for the real economy and allow the EMU to withstand shocks more easily. To develop the CMU, we must address fundamental issues, such as fragmented insolvency regimes. This underscores the importance of a cross-country and inter-institutional dialogue, as well as discourse with policymakers in domains outside the economic and financial remit. Given the complexity of the issue, leveraging local initiatives seems to be a possible way forward in advancing the Pan-EU CMU agenda. The Baltic states' capital markets harmonisation initiative stands out as an early positive example in this regard.

Going forward, we should not shy away from the debate on creating an adequate supply of safe assets on the EU level. The lack of such assets, which would in practice be comparable to the US Treasury bonds, may be considered as one of the main obstacles for deeper European capital markets and a stronger global role of the euro.

All in all, in order to increase prominence of the euro internationally, we must first make substantial progress in deepening the EMU and I hope that efforts to complete the BU and CMU will feature as a top priority on the European agenda in the new legislative term. ●

Vítor Constâncio

Former Vice President, European Central Bank (ECB)
& Professor, University of Navarra Masters School, Madrid

The internationalisation of the euro requires CMU and a European safe asset

There are five key conditions for a currency to become a significant international currency. The first is having a very large economy, which engenders network externalities and lowers transaction costs. The second, is given by deep, efficient, and open financial markets for investors to cheaply and easily getting in and out from assets denominated in that currency. Third, good political and macroeconomic governance with low stable inflation to preserve the value of a currency. Fourth, full enforcement of the rule of law is equally crucial as it ensures the protection of investors' property rights. Fifth, one should not overlook the importance of geopolitical influence and political stability.

It is therefore not easy for a currency to fill all the conditions necessary for it to have an international role. Consequently, we will not see a major change in the hegemonic role of the US dollar over the next 10-15 years – though the conclusion may well be different over a longer horizon.

A simple composite indicator of the international place of the euro in different dimensions[1] shows that after a peak in 2005, the euro´s position declined until 2016, recovering slightly after that. This clearly indicates that the world financial crisis and its specificities in the Euro Area were the decisive causes of this evolution. >>>

>>> Structurally, it is easy to see that the weakest feature for the euro to have a bigger role as an international currency, lies with low degree of integration and depth of capital markets. Consequently, transactions costs are higher, and periods of lower liquidity may occur more frequently. Both equity and bond markets are still fragmented as a result of legal and tax differences as well as the concerns regarding redenomination risk in the Euro Area.

> *"The new Commission will have to relaunch the CMU project with priority and ambition."*
>
> \- VÍTOR CONSTÂNCIO

The main initiative to foster the international role of the euro is therefore the implementation of a genuine Capital Markets Union (CMU), a project that unfortunately has not yet been taken seriously by European Governments. We should however, acknowledge that it is a difficult project because it implies deep integration, requiring a European safe asset, the harmonisation of taxes on financial products, a convergence of company law, including on bankruptcy, the creation of a single rule book of regulation for markets activity and ultimately a European Single Securities Market Supervisor. Another crucial component is the creation of a European safe asset to foster the integration of the bond market. There are proposals to do it without implying mutualisation of national debt. Unfortunately, until now, most of the initiatives related to CMU were directed more to the general development of capital markets than to integrate and unify financial markets in Europe. The new Commission will have to relaunch the CMU project with priority and ambition. ●

1. See Chart 1 in the ECB Report on "The international role of the euro" at https://www.ecb.europa.eu/pub/pdf/ire/ecb.ire201906~f0da2b823e.en.pdf?5e2f2979de08d8c0e2d05b230dad4f11

Gilles Moëc

Chief Economist, AXA Group

The Euro's international role: policy independence first!

Even if some progress was made last year, the Euro has not yet been able to decisively challenge the dollar's role as the world's dominant reserve currency. Some of the reasons are contingent. A negative interest rate since 2014 may be hard to swallow even for non-profit seeking reserve managers. Others – such as the lack of progress on banking, capital market and fiscal union, and the absence of a joint risk-free asset – are more structural. But a question is seldom asked: why would it be in the Euro area's interest to turn its currency into a "proper" reserve currency?

Reserve currency status comes with some potentially problematic conditions. One is that its issuer must provide the rest of the world with a decent quantity of assets to invest in. This normally entails running a current account deficit. The Euro area since the Great Recession has on the contrary been generating a current >>>

>>> account surplus. In those conditions, a permanent rise in the international demand for euros would take interest rates further into negative territory and trigger a significant appreciation in the euro's exchange rate. This would manage to both further irk savers in core countries such as Germany and price-sensitive exporters in France and Italy.

At the same time, a reserve currency provides its issuer with a crucial advantage: the ability to frame its policy stance fully independently. The Fed ultimately sets the tone for interest rates worldwide. It is not on the receiving end of financial spill-overs. The US fiscal policy is less concerned with counterproductive "crowding out" when supporting domestic demand given the structural overseas demand for US bonds. Moreover, given the number of currencies which are implicitly or explicitly pegged to the dollar, the US can largely ignore the impact of its policy decisions on its external financial conditions.

"A stronger reserve role for the euro would protect from uncooperative US approach."

- GILLES MOËC

We would make the point though that lately the Euro area has been able to "decouple" quite easily from the US, bringing market interest rates to extremely low levels irrespective of the Fed's stance. The existence of a massive current account surplus means that risks of crowding out if fiscal policy turns expansionary are close to nil. In short, not being the issuer of the world's top reserve currency has not been much of a hindrance for the Euro area.

Still, a lot of this decoupling owes to the ECB's unconventional policy at a time when monetary easing in one region was seen as a net positive for everyone. The Fed was supportive of the ECB's action even though they were not going in the same direction. Unfortunately, the US administration now sees any monetary accommodation elsewhere as "currency manipulation", with the possibility of retaliation via trade. A stronger reserve role for the euro would protect from uncooperative US approach.

We would insist though on the need to make this part of a holistic strategy. Finally setting up a common risk-free asset and some joint fiscal capability would make the euro more attractive as a reserve currency by helping to put the usual "existential concerns over the monetary union, while helping the Euro area to move away from high current account surpluses towards a more balanced model, more reliant on domestic demand, to make it less dependent on the gyrations in the global cycle. ●

Improving capital allocation across the EU

Benjamin Angel

Director, Treasury and Financial Operations,
DG Economic and Financial Affairs, European Commission

Improving capital allocation and promoting investment across the EU

Long-term, flexible and efficient investment is essential for the economic growth of the EU, the well-being of its people and facilitating upward convergence. Lessons from the crisis have shown that not all investments (e.g non-tradable investment in peripheral Europe, excessive residential investment) lead to lasting growth. An appropriate allocation of capital is essential to ensure that investment support productivity and growth through attracting exports, FDI and technology for Europe's future.

An appropriate regional allocation helps to transform savings into investment and growth across the entire EU, avoiding financial fragmentation. Data on cross-border capital flows shows, however, that despite recent improvements, financial integration in the EU remains below pre-crisis levels. Retail credit markets are fragmented, cross-border private risk sharing is subdued and a persistent home bias remains in portfolio allocations. Instruments at the European level, such as the Macroeconomic Imbalances Procedure, help to identify emerging weaknesses in the economy which e.g widening current account deficits may suggest. However, without appropriate private risk sharing, country-specific shocks will continue to cause persistent dispersion in economic outcomes across countries of the EU. Accelerating the integration of European capital markets and the completion of banking union are important policy priorities in this respect.

"Transform savings into investment and growth across the entire EU."

\- BENJAMIN ANGEL

An appropriate sectoral allocation ensures that private sector funds are attracted to (also riskier) sectors which can deliver returns and that idle capital is unlocked. This entails removing obstacles to investments and venture capital. The Investment Plan for Europe focuses on identifying and removing obstacles to investment, providing visibility and technical assistance to investment projects, and making smarter use of financial resources, including through supporting the development of venture capital funds of an appropriate size. All this aims to allow follow-on investments, to >>>

>>> consolidate market practices, support pan European activities, develop regional markets and reduce administrative barriers. Deeper equity markets would bring economies closer to the technological frontier, supporting growth and encouraging 'greener' innovations.

Most capital is, and will continue to be, allocated through the private sector. But where the private sector is not willing or able to take partly or fully the risk of undertaking a specific category of investment, the public sector has a role to play, at both national and EU levels. For example, the new InvestEU Programme will allow implementing partners (including national promotional institutions) to finance projects that would not be financed without a budgetary guarantee, working in tandem with private sector financial intermediaries targeting specific EU policy priorities.

It's also important to keep the long-term perspective in mind. The next decade may well see a revolution in manufacturing service provision, through shared platforms built on control over data flows. Countries are increasingly engaging in active competition to secure leadership in many of these sectors. But none of the world's 15 largest digital firms are currently European. A strategic focus on growing future innovation leaders is important here, as is attracting and retaining skilled labour in Europe. A possible investment arm of a European industrial strategy should keep in mind the objective of developing innovation in key industries of the future, fixing financial market inefficiencies and fostering technological adoption and diffusion. It could, for example, focus on strategic long-term investments, tailor-made to support European champions of the future. ●

Roger Havenith

Deputy Chief Executive,
European Investment Fund (EIF)

Boosting European risk capital markets: an EIF perspective

The financing gaps in European risk capital markets are driving both early-stage and growth-stage companies to turn to non-European - for example US and Chinese - investors to meet their financing needs. Skype, Minecraft and Beddit are cases in point: all great ideas born in Europe, and all of them bought up by the likes of Apple and Microsoft when the time came to move to the next stage in their development.

These gaps in the financing market have three main causes. First, a lack of funding. Second, regulatory fragmentation across the EU, which hampers cross-border investments. Third, the risk-averse nature of the European investor. There is no quick-fix to improve innovation financing and give bright European minds the opportunities they deserve right here in Europe, but there is a lot that can be done and the public sector has a pivotal role to play.

Sustainably improving innovation financing across the EU comes down to strengthening the financial ecosystems that drive European economic growth. EU public sector support has proven key to fostering these ecosystems. In 2017, the average European fund size grew to a record EUR 98m, and in 2018, the number of 1350 ventures financed constitutes a new record high – both in part thanks to EU support. As we move into the new EU budgetary period, continuing to step up public support for innovative European ventures should remain at the heart of Europe's strategy to improve our competitiveness in the global arena. >>>

>>> In order to compete with large, uniform economies like the US (where average fund size is significantly larger, exceeding EUR 170m), or economies where the state plays a strong role, the EU must focus its efforts and boost its firepower. We need to design market-oriented financial instruments that target gaps in terms of sectors, geographies and SME segments that stand to benefit most, so that we can ensure long-run growth benefiting future generations. But we also need to offer continuity in our offer of support, throughout a company's lifetime, focussing as much on early-stage innovative ventures as on companies in the growth and expansion stages.

"We can no longer afford to be the incubator for other industrialised countries."

\- ROGER HAVENITH

We need to offer the kind of support that will allow the next global industrial champions to not only be born in Europe, but grow and flourish in Europe, without having to relocate to access the finance they need. Today, of the world's 15 largest digital firms, not one is European. We can no longer afford to be the incubator for other industrialised countries. We must support disruptive and critical technologies that are key in maintaining Europe's leading role in innovation and global competition.

At the EU-level, we have already been making considerable progress in this direction. The EIF alone has been committing around EUR 3.5bn annually to equity investments over the past few years, making financing available and building up know-how in the venture capital ecosystems. And we have diversified our offer of financing solutions to include securitisation, loan funds, social impact funds and business angels. But we need shift gears and significantly increase volumes. One way to do that is by facilitating the pooling of resources from European, national, regional, and private sources. Needless to say, simplifying the regulatory regime and reducing the administrative burden will help crowd-in more private capital. Ultimately, however, this will entail a political decision to channel more resources in this direction.

With some of the best universities and research institutions in the world, the potential to nurture the next great idea is there. But to turn that idea into a viable business proposition, Europe has to do more. The public sector, and in particular the EU, need to reinforce financial instruments so that they are able to offer effective, field-proven, market-based solutions that can attract private capital and boost the European innovation ecosystem. ●

Pervenche Berès

Former MEP

A challenge for the next Commission: implement a EU sustainable long-term investment strategy

Invest in the future for the EU economy means in priority, besides technology or innovation in digital, ecological transition, education and ageing.

The European innovation scoreboard 2019 is quite positive since it figures out that the EU's average innovation performance has increased by 8,8 % between 2011 and 2018, one point above the US. This might be true but what ever the level of comparison may be, the EU is facing a long-lasting structural issue regarding the level of incentive for public and private investment. This has already been acknowledged by the outgoing Commission when the Investment Plan, the so-called Junker plan, was launched followed by the capital market union. Nevertheless, the bottle is still to be filled in and all the lessons to draw from the recognition of a specific lack of investment in the EU have still not been draw.

In addition, the interest rate environment should stimulate the decision process at a time where the ECB has clearly made public it's intention; this >>>

>>> should not be a loose opportunity like the one we had with the "jackpot".

A debate among economist, led by Olivier Blanchard from the Peterson Institute, invites public authorities by take the lead. The Junker plan has renewed the role of the public sector as leverage for private investment in a depressed environment. The debate is obviously still up to date.

"The EU is facing a long-lasting structural issue regarding the level of incentive for public and private investment."

- PERVENCHE BERÈS

Having all this in mind, the new Commission should implement a horizontal consistent strategy to favor investment with a comprehensive understanding of the future challenges:

- make full use of InvestEU, the follower of the Junker plan that allows to build bridges with the use of structural funds;
- insure a strong implementation of Horizon Europe for which the European Parliament has request from the next multi-annual financial framework a budget of 120 billions euros over the 2021/2027 period;
- review the Stability Pact to include a capacity to drive investment and define for the euro zone the proper aggregate fiscal stance. Euro area member states should much better use the privileged of stability given by common currency to support long-term investments;
- when re-launching the capital market union, draw all the lessons from the success of national promotional banks in insuring a certain threshold of investment and make sure not to build incentive for speculation but for long term investment towards ecological transition and education with a digital priority;
- have fresh look at the taxation biases favoring debts towards equity;
- rethink the competition policy and the way it should support an EU industrial policy. Up to now this policy was first targeted to oppose monopoly but in a more complex world trade environment the debate has finally emerge on how should the EU competition policy favor EU stakeholder vis-à-vis their global competitors. In this spirit, it will be very interesting to follow the next step after the adoption of the copy right directive with which the EU could be taking the lead to boost it's cultural and creative industry;
- make sure that this new strategy allows to correct existing imbalance inside the EU and especially within the euro area between the North and South;
- and finally, the question of a carbon tax is unavoidable if you want to have the right incentive for market investment. It requires that a courageous answer will be given to counter balance the unfair social impact of it. ●

Edite Ligere

Barrister, Advisor, Galileo Global Advisors

The future is promising, even if artificial

The European Union (EU) is in transition. Fragmentation instead of an ever closer union looms. Productivity is slowing, inequality rising and climate change continues to require urgent concerted effort. The race to avoid similarities with the extinction of the Venetian Republic described by William Wordsworth: "... And what if she had seen these glories fade; Those titles vanish, and that strength decay; Yet shall some tribute of regret be paid when her long life hath reached its final day; Men are we, and must grieve when even the shade of that which once was great, is passed away" is on.

"A clearer focus on responsible investment in AI and a sufficiently flexible regulatory framework are needed to improve sustainable capital allocation across the EU."

- EDITE LIGERE

While there are many dimensions to capital flows in the EU, the development of machine learning and artificial intelligence (AI) are revolutionising many, if not all, sectors of the EU's and global economies. These developments have great potential to enhance productivity yet the economic impact remains hard to define. Greater clarity about the regulatory framework for AI within the EU is likely to contribute to attracting investment from outside the EU. The Recommendation on Principles for the Responsible Stewardship of Trustworthy AI published by the Council of the Organization for Economic Cooperation and Development which includes all EU Member States in May 2019 and adopted by the Group of Twenty in June 2019 is a convenient starting point for providing a degree of consensus which is likely to encourage investment in digitalisation from outside the EU.

Approximately one third of the EU's AI activities currently take place in London. In 2019, the United Kingdom's investment in AI start-ups was almost equal to that of the rest of the EU's Member States combined. While investment in AI involves several risks, including commercial and technological risks, strategic deployment of public and private investment in the context of skills training, infrastructure investment, research and development and digital eco-system innovation is needed to explore AI opportunities and encourage confidence in AI development in the EU.

At present, the EU is home to 7% of the world's leading technology >>>

>>> companies. In 2016, European private investments in AI amounted to approximately EUR 3.2 billion, compared to almost EUR 10 billion in Asia and EUR 18 billion in the US. In 2018, China attracted almost half of global investment in AI start-ups. There is considerable divergence of investment in AI across the EU with Northern European countries eclipsing Southern and Eastern European countries.

Attracting global investment in AI is fundamental to ensuring the EU's continued success, particularly in the context of the challenges and opportunities posed by Brexit. Doing so in a less fragmented way seems to be the only way forward. A clear focus on responsible investment in AI in the EU and a sufficiently flexible regulatory framework are needed to improve the mobility of capital within the euro area, attract investment from outside the EU, embrace the many opportunities presented by AI for economic growth and encourage sustainable capital allocation across the EU.

Hiroshi Nagamine

Managing Executive Officer, Head of Europe, Middle East and Africa, Mizuho Financial Group, Inc. / Mizuho Bank, Ltd.

Attracting investment into the EU through regulatory harmonisation

Japanese financial institutions have historically played an important role in providing liquidity to the EU economy. However, for a sustainable contribution, we should progress beyond conventional boundaries of solely providing financial services and provide complementary non-financial services to add value to our clients, compete effectively with nascent players in the market and attract non-EU investors. A core part of this strategy is digitalisation, which creates more choice, more competition, more transparency and ultimately more efficiency for clients. Building a market where non-EU financial institutions may seamlessly provide funds and services to non-EU investors willing to contribute to digitalisation initiatives in the EU is fundamental.

We welcome the EU's ambition to accomplish the Capital Markets Union and to unlock the full potential of the single market. The EU is effectively 28 markets with 500 million people, as opposed to the US: a single market with 320 million people. The EU market is fragmented for cultural, political, linguistic and, crucially, regulatory reasons. Therefore, it cannot be as agile and decisive as a single national government. The EU may benefit from breaking down these barriers in order to attract greater investment, including from third country investors, reducing regulatory fragmentation. The creation of a single EU securities exchange as part of the Capital Markets Union would also increase harmonisation and align with the US approach.

For global financial institutions to operate in the EU, they generally have two options: establishing a subsidiary or operating out of a third country branch. The former may allow the institution to operate in the EU on a passport whereas the latter requires compliance with the applicable national regulatory regimes. Regulatory fragmentation concerns relate not only to discrepancies between the laws of member states but also worldwide. Contrast, for example, Japan's precise implementation of the Basel reforms within the requisite timeframe with the approach of other jurisdictions. Although marginally differing regulatory regimes may be necessary to respect sovereignty, onerous requirements such as those relating to capital or liquidity may trigger third country banks to consider the extent of their presence and business model in Europe. The reduction of market fragmentation was highlighted as a key priority at the June G20 summit in Japan. We hope there will be a move towards greater globally harmonised financial regulation through increased home state recognition of regulatory and supervisory frameworks.

We conclude with the elephant in the room. The EU financial markets will inevitably be harmed by Brexit. The UK is a top performer and contributor to the European financial industry. We would welcome the EU maintaining close cooperation and dialogue with the UK post Brexit, to preserve, as far as possible, a consistent regulatory and supervisory framework so as to encourage investment into the region as a whole.

Jean-Jacques Bonnaud

EUROFI

Europe needs a strong industrial policy

The lagging situation of investments in Europe compared to the levels in other regions in the world is a major concern for the future of an economic independence of Europe, in as much as it concerns new and intensely technological activities that are keys to future competitiveness, and not only to the social equilibrium of the region.

It is true that in certain sectors such as defense, security, space and energy, some important and ancient common initiatives have been taken by the European institutions and countries to challenge the rising costs of research and industrialization. No country relies only on the pure virtue of the market to facilitate the transformation of startups into large and multinational firms. The American experience itself, alongside a wide financial market, dedicated funds and numerous individuals lightly taxed has largely taken the opportunities of spillovers from dual innovations generated by huge military financial programs under the leadership of public institutions like the >>>

>>> D.A.R.P.A. We should learn from this experience to wrap our initiatives and any new ones into a common strategic analysis of our future position in the world to come.

But an industrial policy is of course not only the matter of public interventions in costly strategic new sectors, as has just demonstrated the new European program on batteries for the motorcar industry and as expressed in the common German - French manifesto of February 2019 it should include two other components: The first would be of course the success of the Banking and Capital Markets market Unions; rapid outcomes in those fields are clearly necessary to overcome the existing fragmentation of the financial system, provoking a lack of trust among the European savers. The problem is not a question of volumes of savings but of channellisation. A second component would be to use common means to help promote where they do not exist sound and effective clusters, or ecosystems, which have proved their effectiveness in the emergence of startups in some European countries -UK, Netherlands, France Germany-as well as in US in California or other places. The trust lies not only in big policies but also in visible and local successes.

However the main political problem raised by the emergence of a more common industrial policy lies in the lack of trust of some parts of public opinion in the capacity of the union to reach sizable results, and the lack of belief and conscience of the very rapid challenges facing our continent in a fast changing balance of influence and powers. This is a very crucial point for the future role of Europe as a partner respected and able to demand reciprocity in a world dominated not only by the US-with a regrettable misuse of their extraterritorial pressures- and the new emerging challengers.

Here is probably the main priority of the new European legislature. ●

Adapting EU legislative processes

Sylvie Goulard

Second Deputy Governor,
Banque de France

The EU legislative process under the test of financial innovation

The development of innovations in the financial area is at the top of the agenda of European institutions. While fintechs and others new entrants are challenging the efficiency and the strengthening of financial integration in the EU, the EU strategy is meant to prevent a fragmented environment and stimulate business expansion across borders.

The EU legislative functions are exercised jointly by the European Parliament and the Council, which represent EU citizens and Member States respectively. The duration of the legislative process ranges from 16 to 37 months, with an average of 22 months. The entry into force of a newly adopted legislative act depends on the chosen legal instrument: a directive will have to be transposed into national legislation within an average period of 2 years, whereas a regulation may enter into force on the 20th day following that of its publication.

EU institutions should therefore make regulations their first choice, while ensuring that this is consistent with the principle of proportionality enshrined in the EU Treaty. This would facilitate the development of innovations throughout EU Member States in an orderly manner and reduce national discrepancies.

"The Union is prepared to promote its own strategy for a genuine financial single market."

\- SYLVIE GOULARD

EU regulations have proved to be adequate legal instruments once adopted: they are drawn up in 24 official languages and the single set of rules they introduce in the legal system is legally binding in all Member States. Though the common interest is to be found in a multicultural surrounding, regulations have often proved to be cost effective and time saving. National law making can also be long for a narrower scope.
It should also be noted that urgent proposals (such as macro-financial assistance to third countries) may be adopted within 4 months. Urgency can hardly be

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>>> invoked to enact legislation in the area of financial innovation, but could still be used if needed. To the contrary, its impact should be largely assessed before triggering the legislative process. Market participants can also be involved at a very early stage through public consultations organised by the European Commission or any European Supervisory Authority (EBA, EIOPA and ESMA).

Moreover, the Commission has the power to adopt delegated acts as well as regulatory technical standards in the financial area developed by the supervising authorities. This scheme makes it possible to adapt the existing framework to ongoing innovations. Furthermore, the ESAs monitor the developments in line with the pace of dissemination of new technologies in financial services.

A Committee on financial innovation has been established within EBA so as to coordinate the regulatory and supervisory treatment of new or innovative financial activities and provide advice to EU institutions. It has for instance assessed the applicability and suitability of EU law to crypto-assets in January 2019.

Financial innovation is also dealt with at the international level (FSB, Basel Committee, G7, G20). In that respect, the EU strategy should include an international component that would enable the EU to play as such a full part in the definition of global standards. The EU FinTech action plan has to be completed in this regard.

All in all, we can draw from all these instruments and procedures the conclusion that the European Union should not be considered to be in a particularly awkward situation when addressing the challenges of financial innovation. In addition, a given group of Member States may decide to take common initiatives to move forward as a first step. The Union is prepared to promote its own strategy for a genuine financial single market that would facilitate cross-border investment and retail financial services and that would help diversifying sources of corporate financing. Meanwhile, the EU should strengthen its role within international fora so as to better protect the interests of European market players and consumers.

Anneli Tuominen

Director General,
Finnish Financial Supervisory Authority (FIN-FSA)

A way forward for more sound and prudent legislation in the financial markets

What makes good legislation? I would say it takes at least three elements: comprehensibility, predictability and stability. Legislation is made in a process where different opinions, values and conflicts of interests are brought together, and the result is always a compromise. This applies to both national and EU level legislation. In the EU, however, the level of difficulty of the legislative process is even higher, because different national interests are put on the same table. In cases where stricter national legislation is already in force, interests in changing the status quo might be limited. Therefore, in a rapidly growing innovative market place there is a pronounced risk of fragmentation if the EU legislative process does not follow market development closely enough. It should be noted, however, that there is not always need for EU-level solutions and sometimes we should not try to fix things that are not broken.

Technical innovations have developed in a variety of ways in recent years. During the Finnish EU Presidency, negotiations on the crowdfunding legislative file, >>>

>>> for example, will continue. As in many other cases, crowdfunding markets and legislation have already been developed in many Member States. To minimise fragmentation ESMA gave its opinion to the Commission back in 2014. National legislation does not, however, confer a right to a passport to provide services, consequently the markets potential for growth is limited. In order to be able to passport, we need EU level solutions.

On the other hand, we have examples such as cryptocurrencies and the technological solutions linked to them. These global phenomena cannot be solved entirely at the EU level and we need common understanding and willingness to face new types of businesses in a global forum. Some of this work is done at the OECD, which takes additional time and effort. There is a need, however, for prompt reaction by the authorities, as national practices have already started to differ.

Negotiation of compromises takes time and sometimes the process is too slow. Sometimes it is easier to find a solution on principles rather than in details. The Lamfalussy process makes it easier for the co-legislators of the EU to move difficult details of legislation to the financial supervisory authorities for decision.

"National legislation does not, however, confer a right to a passport to provide services, consequently the markets potential for growth is limited. In order to be able to passport, we need EU level solutions."

\- ANNELI TUOMINEN

There are examples where the legislative process has been swift within the EU. The Directive on Bank Recovery and Resolution was negotiated promptly and nationally implemented within a very limited period of time. This was partly possible because of high political pressure and the common interests of the Member States. Unfortunately, banks in various Member States were not predisposed to such fundamental change due to their legacy assets combined with sizeable retail investor bases.

Businesses need time to adapt their products and processes to new requirements. In addition, supervisors should have enough time and resources to prepare legislation. It would, in many cases, be in the interest of the industry to have a single EU-level supervisor with fully harmonised legislation and a wide Level 2 mandate. I am, however, hesitant to recommend such a structure for supervision in consumer protection related issues because they are often very country specific.

In the United States, the SEC can issue so-called no-action letters to an individual or entity. These letters are based on the specific facts of an individual case. This limits their use in the United States to a larger extent. As part of an open dialogue and supervision, these could be also used in the EU to some extent. No-action letters regarding certain types of phenomena could also be considered.

It is obvious that legislation lags behind market innovations and there is no single solution to this. As a supervisor, we are on the pulse of market development and would naturally prefer new urgent problems to be solved instantly.

What we should do is inform co-legislators more actively of the phenomena we have seen. One way of doing this is to use solutions such as the European Forum for Innovation Facilitators, set up by the Commission. It is also important to commit political-level decision-makers to these discussions at an early stage. Ultimately, we need to remember that even though we need to focus on optimising the legislative process, this should not be done at expense of quality. ●

Robert Ophèle

Chairman,
Autorité des Marchés Financiers (AMF)

A more agile and common legislation for a dynamic and competitive financial market

The European regulatory process is not appropriate to develop competitive and efficient capital markets in the Union. It is too slow and delivers complex and, sometimes, contradictory frameworks.

First, we should favor regulations, with very few national options, over directives (especially directives with minimum harmonization, examples of which still exist in the financial sector, such as AML-TF or UCITS). Moreover, we should minimize European legislative voids (for example bilateral relations with third countries when there is no EU equivalence regime). One cannot achieve supervisory convergence and the completion of the CMU with so many national stances.

Second, we should adopt more robust regulatory processes. As established by the Lamfalussy report, the distinction between legislative and delegated acts, as well as between directives and regulations, should be strictly respected. Level 1 legislation should be restricted to setting out framework principles, leaving technical details to Level 2 or 3. Moreover, EU co-legislators must set realistic implementation dates for all stakeholders, including regulators and regulated entities. And a rational sequence between various levels of texts: Level 1 provisions should only come into force after the necessary key Level 2 measures have been published.

> *"First, we should favor regulations, with very few national options, over directives."*
>
> - ROBERT OPHÈLE

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

The French Legal High Committee for Financial Markets (HCJP) has made a proposal to introduce in EU law a new tool to suspend temporarily the application of provisions of a delegated act, in exceptional circumstances where necessary. A recent practical illustration where such a tool would have been useful is the regulatory difference between the EU and the US on the exchange of bilateral margin for physically-settled FX forwards. Other past examples are the application of EMIR variation margin requirements to non-centrally cleared derivatives; PRIIPs inadequate calculation methodologies for performance scenarios and cost indicators in the KID; or MiFID II tick size regime for third country instruments traded in Europe. EU resistance to providing its institutions with a power of regulatory forbearance is a cause for concern.

>>>

>>> Finally, we should also work better together to ensure convergence when implementing and enforcing regulation across the EU. Through a more collegial approach between supervisors of entities located in several countries. By better articulating supervisory responsibilities between home and host Member State authorities; and combatting jurisdiction shopping by preventing market players from choosing as home a country in which they have no substantial activity. By harmonizing practices in sanctions, for instance through dedicated independent peer reviews.

This does not mean to suppress all national regulatory initiatives. In areas not yet covered by European regulation, national frameworks may be a first step, allowing for the development of innovative initiatives. The strength of national experience can then facilitate the emergence of the necessary European dimension. It has been the case for crowdfunding, crypto assets or climate disclosure... However, these national regulations should be viewed as an intermediary stance towards a European approach. The latter should come about sufficiently rapidly in order to avoid fragmentation along national lines, difficult to overcome. ●

Jacek Jastrzębski

Chair of the Board,
Polish Financial Supervision Authority

Adequate regulatory framework still required

When the financial crisis broke out, weaknesses of the financial supervision in the EU were exposed. As a result, new laws and reforms had been introduced to rebuild financial stability and preserve public confidence. The reforms covered inter alia rules to strengthen financial supervision based on, among other principles, full harmonization. Single market has been one of the greatest achievements of the European integration and full harmonization has brought many advantages, like unification of the deposit guarantee schemes. 10 years on, one needs to reconsider whether the full harmonization in some areas is really desirable and whether this approach may expose the EU financial regulation to the risk of stagnation and limit the NCAs' ability to respond to new challenges.

We observe that the EU has already undertaken initiatives aimed at reducing the excessive regulation and strengthening the enforcement of the proportionality principle. A good example is the CRR/CRDIV, which covers credit institutions and investment firms even though these are in fact two different types of entities with different business models. Unlike credit institutions, investment firms neither accept deposits nor grant loans and therefore are exposed to other risks. The prudential framework introduced by CRR/CRDIV focuses on credit institutions and their risks rather than on investment firms and services provided by the latter. As a result, according to the EBA report on investment firms, one year after introducing CRR/CRDIV, 85% of the EEA investment firms decided to limit the scope of their activities.

Therefore, the recently adopted IFR/IFD will apply new rules to the investment firms and adequately address the proportionality problem. IFR/IFD will simplify inter alia own funds, capital requirements, liquidity and supervision reporting procedures. We have gladly noted the proposal of a proportionate regulation of the investment firms, adequate to their risk profile, proposed by the Commission. On the other hand the problem of harmonization gap has been particularly acute for the host markets due to insufficient supervisory tools enabling to react to inappropriate practices of the entities operating under the FOS. This problem has been stressed by the ESAs recent report on cross-border supervision of retail financial services. The report encourages the EU co-legislators to consider reinforcing the harmonization on conduct of business >>>

>>> rules and consumer protection in the banking sector and to clearly set out responsibilities between home and host Member States. Such an observation is correct, however our experience proved that this problem concerns also other markets.

Most of the EU laws regulating financial markets were drafted for the traditional financial institutions providing traditional services. Nowadays Fintech solutions very often do not fit into these mechanisms. Nevertheless, we take note of some steps taken in the right direction. One of them is the revised PSD2 directive. One should seriously consider developing a separate community regime for Fintech entities, such as dedicated licenses for digital virtual banks or common EU framework for tools like a regulatory sandbox. It would be essential however, to provide a leeway also for national mechanisms of Fintech support, like no-action letters issued on a country-level by competent authorities.

To this end, the KNF began offering support to innovative businesses by issuing such no-action letters. This tool proves to be beneficial for both the supervisor and market participants, fostering innovation. Thanks to this approach the Fintechs' perception of regulatory uncertainty is reduced while the supervisor keeps pace with new tech.

Large diversity and level of development of financial markets in the individual EU Member States proved that one size doesn`t fit all and that a minimum harmonization principle may be, together with broader use of the proportionality, more effective for the EU in some areas. One must strike the right balance between safeguarding the financial stability and consumer protection on one hand and providing for an adequate regulatory framework with a possibility of different applications at the national level on the other, so that an optimal environment supporting the innovation is achieved. The question remains whether the EU is ready for a substantial change in its current regulatory approach if such a move supported the development of innovation?

Jacques Beyssade

Secretary General, Groupe BPCE

We need EU legislations to be more oriented towards financing the economy

As the EU is developing its strategy for 2019-2024, it is now time to consider the main constraints we are facing today and think about the principles that could guide the action of European legislators and regulators for the coming years. In this context, the structure of our decision-making process can sometimes appear at odds with the pace at which the world is moving and the need for consensual yet practical solutions.

The EU is able to support and encourage a competitive global economic environment, the growth of disruptive technologies and new business models, as well as the drive to transition to a low-carbon economy – however, this ability is subject to limitations. We can broadly divide the main constraints into three categories:

1. The political will to further integrate our banking sector is limited despite a general acceptance that the number of banks in Europe is too high and their profitability too low, and that new challenges arise from digitalisation and cybersecurity or the United Kingdom's envisaged exit from the EU;
2. The EU decision making process itself is not always straightforward, and can be affected by competing objectives of and even rivalries between the Commission, the co-legislators, the ESAs and supervisory authorities;
3. An abundance of technical regulatory detail, which, instead of protecting against divergent interpretations and circumvention, can have the opposite effect and create costly complexity for all stakeholders.

In the light of these constraints how can Europe maximize its potential? Part of the answer is that financial sector legislation needs to be directed towards a clear target which is to improve financing of the economy. This sense of purpose would help our decision-makers to take a holistic and result-oriented approach and avoid as much as possible >>>

>>> to propose legislations in "silos" within our sector. Second our decision-makers should associate more closely technologies, new modes of consumption and financial innovation.

"Our decision-makers should take a holistic approach and avoid to propose legislations in «silos»."

- JACQUES BEYSSADE

Improved methods of preparing legislation could support this approach by increasing the use of multidisciplinary expert groups.

Another tool, the concept of sandboxes can promote the exchange of ideas between actors and authorities in the interest of adapting future EU regulation as best as possible to FinTech innovation. Certain conditions are essential for the proper functioning of such a tool: equal access between all actors and convergence of practices in each jurisdiction to avoid regulatory arbitrage.

These new approaches and methods would then allow progress on topics such as:

- Assessing barriers to the adoption of Cloud Computing, addressing considerations on ethics and trust in Artificial Intelligence and working towards a common definition of digital assets (e.g. crypto-assets) (cf. Loi PACTE in France);
- Establishing a comprehensive EU retail investment strategy that might explore the concept of an EU Investment Savings Account, including a "green" one;
- Tackling the EU and the Rest-of the world issues with equivalence regimes as some equivalence regimes have different purposes and can therefore demand different solutions;
- Concerning the abundance and sometimes costly complexity of technical regulatory detail, introducing a forbearance mechanism (i.e. no action letters). ●

Dr. Kay Swinburne

Vice Chair of Financial Services,
KPMG in the UK

Back to first principles: restoring discipline in the EU legislative process

The adoption over 18 years ago of the Lamfalussy process for EU legislation, with its four distinct levels, is the cornerstone that is meant to underpin the EU's approach to legislating a rapidly-evolving financial services marketplace. In practice, however, the application of the process has fallen short of its original clarity. A lack of understanding and trust between the EU institutions, coupled with party political and national differences, has led to the inclusion of technical provisions in Level 1 legislation and a tendency to address issues of national divergence via more and more detailed regulations rather than Level 4 powers (supervisory convergence).

Lamfalussy set out a clear distinction between Level 1 legislation and Level 2 delegated acts and implementing measures, which remains the ideal model for financial services regulation.

At Level 1, the co-legislators should set out the core principles, allowing the ESAs to develop at Level2 the detailed rules, based on the realities of the market and empirical data. Importantly, by keeping such detail at Level 2, it also allows the regulatory bodies to respond more quickly to emerging market trends and risks, and to innovation and technological advance.

Unfortunately, this clear separation has rarely been maintained. Instead, the detail of Level 1 legislation has been fought over in the early hours of the morning, with a series of compromises that include increasingly granular requirements that bear little or no relation to hard evidence.

Legislation is poorly thought through and increasingly proscriptive, and the process has become progressively less suited to a fast-moving marketplace, just as the pace of change has accelerated.

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

"It is time for a more disciplined and fact-based legislative approach – a return to Lamfalussy."

- DR. KAY SWINBURNE

Re-establishing the clear distinction between Level 1 and Level 2 will also allow innovation to flourish. With so much detail now enshrined in Level 1, adapting rules as new technology emerges has become a slow and painful exercise, disadvantaging consumers and businesses. All requirements should be technology-neutral.

Political and national concerns about delegating too much to the ESAs are largely unfounded, in my view. The ESAs' role in developing Level 2 delegated acts is to advise the Commission on what is required, not to act independently. And scrutiny by the co-legislators is built in.

Get this right and there is a real opportunity to develop legislation in a way that suits the nature of European financial services today and incentivises innovation, stimulates competition and improves customer choice, with no sacrifice of regulation and protection.

A process developed almost 20 years ago remains fit for purpose, but only if we are disciplined in how we apply it. ●

Othmar Karas

Vice-President, European Parliament

Boosting the European Union as engine of global innovation

Research and innovation are at the core of a secure, competitive and sustainable financial sector, which promotes jobs and growth in our Single Market. To strive they need suitable regulatory frameworks which are supportive, risk sensitive, unbureaucratic and at the forefront of technological developments.

As response to the global financial crisis, the EU has proven to jointly find solutions to complex and mutual challenges over a relatively short period of time. Although the EMU is not yet complete, many of the jointly adopted regulatory acts represent milestones, such as the common rules for all financial market participants or the supervisory and resolution frameworks applicable in all Member States.

However, at a time of major technological transitions in the financial sector -such as the continuous shift to digital, the rise of fin-tech, blockchain technology, machine learning, the implications of a low carbon economy or cyber-risks- there is criticism that the European legislative process needs to become even more responsive.

The trade-offs are clear: On the one hand, there must always be a fully democratically legitimised, open and transparent legislative process, which allows the voices of all effected citizens, institutions and stakeholders to be heard. On the other hand, financial sector innovations in today's digitised world are moving at such an unprecedented pace that legislative processes must allow for even swifter regulatory action.

One of the key priorities in this regard must be the shift from unanimity to majority decision-making. Especially in taxation, the veto possibility in the Council has so far hindered the adoption of many pressing initiatives such as the fair taxation of the digital sector. Unanimity leads to blockages and policy failure. If we want a more effective and innovative Union, we must change its decision-making. Our aim must be that all decisions are taken by majority and jointly by the Member States and the European Parliament as voice of the European citizens.

At the same time, an innovation friendly regulatory framework which successfully overcomes national barriers and enhances capital flow needs to have the bigger picture in mind. The different legislative acts and projects -the Banking and Capital Market's Union- must harmonise well together on the global, European and national levels. They need to consider the whole lifecycle of an innovation and provide for regulatory certainty.

"Unanimity leads to policy failure. An effective and innovative union needs majority decision-making."

- OTHMAR KARAS

Last but not least, the diversity in our financial sector is a source of strength which contributes to more innovation, less vulnerability to crisis, greater choice and more elaborate financing opportunities. This diversity as well as the structural specificities of our financial sector–such as a bank funded real economy which relies much less on capital markets than in the U.S.–must be taken fully into account when implementing global standards into EU law.

At the start of the new parliamentary term there are many challenges to be addressed: our answer to uncertainty, populism or nationalism must not be to escape into protectionism or isolation. Regardless of political dynamics, the EU must continue to thoroughly draw the lessons from the past and become more independent, determined and effective in the global arena. ●

Rimantas Šadžius

Member, European Court of Auditors

European auditors go for more than financial corrections or management practices

We are currently at the tail end of intensive regulatory and institutional reforms which started as a response to the 2009 crisis. Common rules for the EU financial sector are meant to ensure a more effective level playing field in the Single Market and prevent negative cross-border spillovers. However, so far, these reforms have not solved fragmentation of the national rules applying to financial markets. This continues generating regulatory arbitrage and thus fosters unfair competition and/or cross-border issues affecting the financial stability across EU.

The administrative structure of the financial supervision is certainly an area, where we need reforms. The current ESAs are set up primarily to provide co-ordination between national competent authorities and develop level 3 rules (i.e. non-binding guidelines). To this >>>

>>> end, their mandate, governing structure and work programmes can broadly deliver. However, the current setup is not suitable for stronger supra-national rulings in case of serious divergences, as it does not allow them to control, intervene, and make final decisions in emerging cross-border issues. In its audits, ECA identified a number of such serious, systemic gaps in the supervision of the EU's financial sector and called EU legislators to adjust accordingly the respective regulations and frameworks. We recommended, among other measures, to rethink the governance and powers of the ESA's.

"To keep EU competitive, we need courage to address systemic issues by single-market-fit approach."

- RIMANTAS ŠADŽIUS

As a practical example, in our very recent report on the stress tests carried out by the European Banking Authority, we found out that this exercise - being key for financial stability - marginalised the EU-wide perspective. The underlying reason was the dominant role of the national authorities in the design of the test scenarios. More specifically, their role was not conducive to ensuring that the scenarios were comparable and unbiased for all Member States. Consequently, we requested the Commission to address the appropriateness of EBA's governance structure in the context of the next three-year review of the EBA Regulation.

ECA's report on EIOPA published last year identified a systemic issue in the supervision of cross-border business. We concluded that it results in the wrong incentives for both supervisors and insurers, which take advantage of a lower level of supervision in other Member States. Hence, we called upon the co-legislators to close the underlying regulatory gaps in insurance supervision.

The recent ESAs reform was a lost opportunity to address multiple weaknesses in the EU's supervisory structure. This depicts familiar weakness of the European legislative process: high outset ambitions, then thorough preparation and hard work, and eventually - a piecemeal solution addressing only some most pressing problems. For success of a big reform agenda, we should tackle systemic Europe-wide issues with courage by genuine pan-European single-market-fit approach. ●

Joanna Cound

Managing Director, Global Public Policy, BlackRock

Future proofing the legislative process to deliver CMU

Europe needs a strong policy vison and coherent narrative to develop our capital markets and deliver long-term economic benefit for Europe's citizen-savers. Indeed, the ambitious goals of the Sustainable Action Plan can only be met if savers are willing and able to invest in markets. Europe needs: a policy framework that balances investor protection with investor inclusion, empowering European savers to engage with markets; an investor-friendly capital markets architecture that lets European investors benefit from the combined scale of European and global markets; and a clearer focus on the funding needs of companies.

We cannot deliver on this vision without a much more holistic legislative strategy. Today end-investors' needs are lost between myriad siloed product and service initiatives, which too often result in inconsistencies, contradictions and gaps. For example, the same investment fund is required to show different transaction costs in different countries depending on how it is bought – which means end-investors lack a single point of authoritative information upon which to base their decisions.

The ambition must be that EU legislation is coherent for the end-investor across securities and prudential regulation, tax and accounting and the provision of investment products and services. In addition, policy aims must be coherent: applying macro-prudential polices to investment funds would not compatible with Capital Markets Union (CMU) objectives, for example. And specific policy choices should be underpinned by detailed economic analysis from a bottom-up end investor as well as a top down macro-economic perspective.

Next we need to revisit the balance between Levels 1, 2, 3 and 4 to provide for robust long term strategic principles at level 1 with the mass of technical detail filled in at a lower level to allow the EU respond more flexibly to market innovations and global developments UCITS is rightly recognised globally as the gold standard for investment funds – this is because the Level 1 text delivers a clear framework and parameters but with flexibility that allows different business models to compete and respond to evolving client needs.

"The ambition must be that EU legislation is coherent for the end-investor."

- JOANNA COUND

The certainty and confidence provided to market participants by common rule books must, however, go hand in hand with greater convergence of supervisory cultures. We recommend that the new supervisory coordination networks led by the ESAs work on the development of common templates for authorisation and supervision to be applied by national supervisors on a consistent basis. This has significant potential to accelerate supervisory convergence in Europe. We strongly support the development of a common reporting platform for ESMA to allow it to assess better market trends and any potential build-up of systemic risk.

Finally, a stronger and holistic articulation of the political goals of the CMU might encourage Member States to take complementary action in areas where the right of initiative and competence resides with them (e.g. financial education, pensions, taxation). Only then can we consider that we have something close to the appropriate legislative strategy to deliver CMU. ●

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II. GLOBAL COOPERATION AND BREXIT IMPLICATIONS

Issues at stake

The financial system is global in many areas and international 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 trade tensions are increasing. Fragmentation in the global financial sector may grow as a result.

Brexit is creating further challenges. At this point in time it is likely that third-country regimes, when they exist, will be the basis of future EU-UK relationships in the financial sector. Stock-taking exercises conducted at the European and international levels should help to identify the improvements needed to ensure that equivalence regimes are adapted to the flow of business that exists between the UK and EU. Assessing the nature of EU-UK relations in the financial sector going forward, how the structure of the European financial market is likely to evolve and the potential impacts of these changes on the financing of the EU is also necessary.

Content

Global cooperation in financial regulation

Hester Peirce

Commissioner,
U.S. Securities and Exchange Commission (SEC)

Shared, shunned, shattered: fragmentation in the global derivatives market

The human desire to transact with other people all over the world is nothing new. Today's technology makes it easier than ever to engage in global interactions. Tomorrow's technology will further facilitate people's ability to collaborate across borders. Financial markets, including derivatives markets, play a central role in uniting the global marketplace.

Although we often think about our national financial markets as distinct and each certainly has its own characteristics, we share an integrated, international financial market. This market, when working properly, sends capital to its most efficient use and shifts risks to those most able to bear them, regardless of location. We must work together to be good stewards of our shared resource.

"We must work together to be good stewards of our shared resource."

- HESTER PEIRCE

There are a number of things regulatory caretakers of the global derivatives markets can do. First, we should recognize their appropriate jurisdictional limitations. We all make choices about how to protect investors and other market participants in transactions that occur within our borders. At the same time, we must also be sensitive to the potential distortions that we can introduce into the market when these transactions technically occur within our borders but involve two counterparties outside those borders. Second, regulators should make accommodations to allow foreign firms to compete in their markets. Third, we should eliminate immaterial but market-fragmenting differences in our rules. Fourth, mutual recognition is valuable. Our rules need not be identical to achieve nearly identical objectives.

In fact, a diversity of approaches can be healthy; if one regulator's approach engenders problems, the consequences will be less severe than they would have been if all regulators had adopted the same regulatory approach.

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>>> Regulators around the world have implemented reforms in response to a shared post-crisis commitment to financial stability, but these reforms have sometimes produced results that are inconsistent with the equally important shared commitment to a unified, well-functioning financial system. Sometimes regulatory obligations are so onerous that firms take steps to avoid being subject to them. For example, in an appendix to a recent IOSCO report on market fragmentation, the Commodity Futures Trading Commission described how policy choices led to fragmentation "into separate trading and liquidity pools: those in which U.S. persons participate and those in which U.S. persons are shunned." Similarly, in a recent white paper, ISDA pointed to different data and reporting requirements as a source of fragmentation.

The SEC is finalizing its framework for security-based swaps, and we are inviting our counterparts to talk with us about substituted compliance. I know that we will learn much from each other in the process and expect that the end result will be a system in which we all work together—each within our own jurisdiction—to achieve the goal of a shared financial market that is robust and focused on serving, not undermining, the broader economy. Substituted compliance determinations will not be based on rule-by-rule assessments of foreign regulatory regimes, but on a broader look at whether the alternate regime achieves the same objectives as ours, even if it does so differently. Being able to defer to other regulators in the U.S. and abroad is a strength of our regulatory approach to security-based swaps. Shared concern for global derivatives markets serves not only to help those markets function well, but to deepen cross-border relationships.

These comments reflect my own views and not necessarily those of the U.S. Securities and Exchange Commission or my fellow Commissioners. ●

Brian D. Quintenz

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

Unfracturing the global swaps market

The global financial regulatory system today bears little resemblance to its state ten years ago, when G-20 members first discussed meaningful reforms in response to the financial crisis.

The world's largest swap markets have made substantial progress toward implementing the G-20 commitments, including trade reporting, clearing, margin for uncleared swaps, and capital requirements for uncleared derivatives. Given this significant progress, one of the new challenges that regulators face is regulatory-driven market fragmentation. Liquidity pools have fractured in response to regulatory disputes over the extraterritorial application of jurisdictions' rules, with counterparties from one jurisdiction unwilling to transact with counterparties from another jurisdiction if conflicting or overly punitive sets of regulations apply.

I am pleased that international standard-setting bodies, like the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board (FSB), have recently examined the fragmentation of derivatives markets along jurisdictional lines, including considering what actions regulators can take to foster global markets[1]. Both reports suggest that deference between regulators is crucial to mitigating or avoiding the adverse effects of fragmentation. I believe a cross-border regulatory approach grounded in deference offers the greatest potential to reduce market fragmentation. The full promise of the G-20 reforms cannot be realized by a single nation acting >>>

>>> alone, but progress can be actively defeated if each jurisdiction expects all others to adopt the breadth, depth, and detail of their rulesets.

For its part, the CFTC as it exists today – under the prior guidance of Chris Giancarlo and under the current leadership of Chairman Heath Tarbert – strives to work with its global counterparts to ensure that economic activity and risk management can occur across jurisdictions without concerns of market fragmentation caused by conflicting regulatory requirements. Most recently, the agency has approved comparability determinations for uncleared swap margin requirements for Japan and Australia and also exempted foreign trading venues in Singapore and Japan from registering with the CFTC due to comparable oversight by local regulators.

These actions adopted an outcomes-based approach toward evaluating the comparability of another jurisdiction's regulatory regime, rather than requiring line-by-line comparisons of rules or statutes. This holistic approach toward finding comparability appropriately respects the sovereignty of foreign jurisdictions to implement the G-20 reforms as they see fit, facilitates U.S. firms' ability to compete in foreign markets, and allows those foreign jurisdictions' counterparties to gain access to U.S. firms' services. In my opinion, the key to fostering a global, vibrant swaps market lies in each jurisdiction's recognition of, and deference to, the sovereignty of other jurisdictions, as well as other regulators' supervisory interests in regulating their own local markets. ●

1. Market Fragmentation and Cross-border Regulation, IOSCO (June 2019), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD629.pdf; FSB Report on Market Fragmentation (June 4, 2019), https://www.fsb.org/wp-content/uploads/P040619-2.pdf.

Burkhard Balz

Member of the Executive Board,
Deutsche Bundesbank

Financial fragmentation: regulatory reforms in central clearing

Over recent decades, economic globalisation and the liberalisation of national financial markets have led to ever more integrated economies and markets around the world. As a result, economic prosperity has grown. However, the safety of the international financial system was grossly neglected. The global financial crisis brutally exposed the system's flaws. In response, the G20 adopted a reform agenda that strengthened the global financial system and committed to implementing global standards so as to avoid regulatory-driven market fragmentation.

In particular, the G20 promoted the use of central clearing to limit systemic risk in the financial system. As things stand today, all major jurisdictions have implemented regulatory reforms that mandate the use of central clearing and govern the requirements for central counterparties (CCPs) – and thereby safeguard the financial stability of their respective jurisdiction. However, these regulatory reforms did not lead to major cross-border market fragmentation in central clearing, for two reasons. First, national reforms followed international principles and standards. Second, national regulation allowed for deference as long as financial stability was ensured. This means that Europe-based financial institutions are allowed to use CCPs in a recognised foreign jurisdiction and vice versa.

Three years ago, the United Kingdom voted to leave the European Union (EU) and with it its highly integrated financial markets. As a consequence, Brexit makes it likely that we >>>

>>> will see greater fragmentation of financial markets in the future. This scenario is in particular important for central clearing and the derivatives markets. While the derivatives markets are global markets where financial and non-financial institutions hedge their risks, the competence for the regulatory framework for central clearing still rests with the respective jurisdictions. Against this background, the EU identified substantial risks for its own financial stability when significant parts of EU-trades are cleared through a third-country CCP and is adjusting its regulatory framework accordingly.

The soon-to-be adopted revision of the European Market Infrastructure Regulation (EMIR) contains new requirements for third-country CCPs that are systemically important for the financial stability of the EU. Third-country CCPs deemed systemically important by the European Securities and Markets Authority (ESMA) must fulfil the requirements not only in their own jurisdiction but under EU regulation as well. Only then will they be allowed to offer their services to EU market participants. Furthermore, EMIR will include the possibility of not recognising third-country CCPs if they pose a continuous threat to the financial stability of the EU. Such CCPs would need to either relocate to the EU or stop offering services to EU customers, probably increasing financial market fragmentation.

To be clear, the new EU regulatory framework is intended neither to increase market fragmentation in central clearing nor to raise hurdles for EU market participants to use third-country CCPs, but to strengthen the stability of the EU's financial system and to insulate it from systemic risk. Thus, any possible degree of market fragmentation clearly is an inevitable by-product of the reform. It should also be noted that such fragmentation might have consequences in terms of reduced market liquidity. However, I am confident that the net benefit to financial stability will be positive.

Moreover, our common goal should be to avoid – or at least to minimise – the potential for market fragmentation in central clearing. Much has already been done in the past, such as the establishment of deference frameworks and close supervisory cooperation between jurisdictions. Therefore, it is commendable that the USA has opted for further regulatory deference. The EU is also committed to continuing its equivalence framework for a wide range of non-systemically important third-country CCPs. However, for systemically important third-country CCPs, both the USA and the EU reserve the right to impose stricter regulatory standards, which might lead to fragmented markets. Here, the key will be close supervisory cooperation across jurisdictions. Only then will we be able to mitigate the potential adverse effects on the financial markets and uphold high financial stability standards. ●

Shannon Lilly

Deputy Chief Executive Officer,
BofA Securities Europe SA

Fragmentation: re-joining the pieces

Let me start with the punchline: a financial system that is both global and stable is a universal public good and needs genuine cross-border regulatory cooperation and trust in order to thrive. Leading up to the crisis, the system was very global, but unstable. Now, after 10 years of reform, the system is very stable, but less global. This journey has been marked by changing attitudes and behaviours towards cooperation in global finance.

Early on, policy-makers recognised that the global crisis required a global solution. This leads to an extraordinary level of cooperation between central banks and regulators, which ultimately helped stabilise the global financial system. However, as the scars of the crisis began to heal, the political commitment to cooperation >>>

>>> started to fade. The outcome was a move towards protectionism and the ring-fencing of national banking systems. Global banks were seen as transmitters of crises resulting in some regulations, for example the GSIB surcharge, being designed to penalise the largest global banks for, well, being global.

Despite this, the global business model remains critical for economic growth and stability. Global banks create global economic benefits in two key ways. First, we serve multinational clients and facilitate cross-border trade, reducing costs for our clients, which in turn benefits consumers and the economy. Second, we are an important channel for directing excess savings from one country to another with investment needs. In doing so, we broaden the funding choices available to these markets, thereby reducing costs of borrowing and promoting growth.

A stable global business model needs effective global regulatory cooperation. Unfortunately, we're currently hearing "fragmentation" more than we're hearing "cooperation". Fragmentation undermines the global model as it increases the cost and risk of sustaining a global footprint through inefficiencies: from differences in prudential rules to duplicative processes to unnecessary trapping of capital and liquidity in subsidiaries.

The commercial reality is that banks will inevitably have to curtail their global footprint if costs consistently exceed the benefits. Financial stability suffers as a consequence: the system is less diversified; market liquidity contracts; capacity to monetise assets in a stressed environment is reduced; and banking activities are pushed outside of the regulated banking sector.

"A stable global business model needs effective global regulatory cooperation."

\- SHANNON LILLY

So what does effective cross-border regulatory cooperation look like? Our shared strategic vision should be to minimise regulatory complexity and frictions for global banks by enhancing regulatory consistency across national regimes. In other words, regulators could improve the ease of doing business, whilst at the same time improve stability, through:

- Harmonized implementation of internationally-agreed standards to ensure a global level-playing-field. For example, the final Basel 3 package should be implemented in all jurisdictions without national deviations.
- Consistency of regulatory judgement, application and outcomes to ensure comparability of global banks. For example, application of Pillar 2 should be more consistent to allow comparability of risk profiles.
- Alignment of and collaboration on supervisory processes to avoid duplication and trapped resources. For example, processes such as stress testing and recovery and resolution planning should be more centralized.

Finally, how do we get from fragmentation to cooperation? As much as I'd like to take politics out of finance, national regulators work to accomplish objectives set by their governments - these objectives should be reviewed with a global lens. Perhaps in the longer term they might consider the operating model of the Banking Union in Europe as something to aspire to globally, at least for the oversight of GSIBs. In the meantime, the efforts at the G20 and FSB in prioritising fragmentation as a financial stability concern is a welcomed step in the right direction.

These efforts will be successful if they help lead to a cultural shift in the way national policy-makers and regulators think about global banks, particularly as they review the impact of post-crisis regulatory reforms (over-calibrated?). In doing so, it should be recognised that the sector is now structurally healthier, less inter-dependent, less complex, and culturally much more responsible. ●

George Stansfield

Deputy Chief Executive Officer and Group General Secretary,
AXA Group

Global cooperation in insurance: progresses, challenges and perspectives

Global actors such as worldwide insurers are by essence used to complying with different regulatory approaches across jurisdictions and to adapting rapidly to evolving requirements. Global cooperation efforts are welcomed in that they facilitate global business through simplification and transparency and allow for comparability. Global cooperation improved since 2008, but divergences in regulatory approaches remained visible even in efforts to develop global supervision initiatives (e.g. global systemic frameworks), or regional requirements with extra-territorial scope (e.g. data protection regulation). This has created for global insurers a higher degree of complexity that risks affecting their capacity to rapidly adapt to changing customer needs, remain competitive or benefit from group synergies.

International cooperation efforts in prudential policies have intensified since the 2008 financial crisis. The entry into force of the International Systemic Risk Framework in 2016 brought positive perspectives in terms of better assessing and mitigating systemic risks in the insurance sector globally. But differences in approaches on the specifics of the framework led, among other reasons, the Financial Stability Board (FSB) to announce in November 2018 the suspension of the identification exercise of Global Systemically Important Insurers (G-SIIs), and refer to the progress made by the International Association of Insurance Supervisors (IAIS) on the Holistic Framework for Systemic Risk which should serve as an alternative.

The development, also by the IAIS, of an International Capital Standard for insurers (ICS) raises a number of questions. While applying a common rule-based capital standard is conceptually interesting, the feasibility of it will depend on whether the key jurisdictions involved can see how their key concerns on this topic are taken into account. A progressive evolution towards such a capital standard would be preferable rather than a rapid move that would fail to address these questions.

The implementation of General Data Protection Regulation's (GDPR) in Europe has initially been perceived mostly as a challenge by European companies. Because they had to invest heavily in personal data protection, they perceived it as possibly affecting their competitiveness compared to companies operating mostly in areas where data protection rules are less stringent. This has however brought significant improvements: on public awareness on data protection rights, on the increased attention and understanding of this topic by public and private actors, and on the level of ambition manifested by the extraterritorial scope of this regulation. To the point that similar initiatives are gaining ground in other jurisdictions outside Europe, possibly reflecting a global shift towards greater data privacy protection. The evolution of this trend will depend on whether diverging strategies on artificial intelligence, for instance, will impact it.

Looking forward, further cooperation and coordinated supervision will likely be essential in areas where the insurance industry is rapidly transforming. The industry is indeed becoming modular, the insurance value chain is getting increasingly fragmented compared to a few years ago with an increasing number of unregulated actors providing technological services in the insurance value chain's multiple areas. The Supervisory & Regulation model will need to be revised as the industry evolves. There is a clear interest in taking a rather global approach to these changes for they would enable groups to fully benefit from synergies. Overall, global cooperation in insurance will be successful if it can bring simplicity, transparency and consistency in the principles that will guide action globally. Should the lack of consensus on the specifics of their implementation persist, then global cooperation will be more efficient if it focuses on defining the overarching principles. ●

Latest Brexit developments and future of EU-UK relations

Katharine Braddick

Director General,
Financial Services, HM Treasury

The changing climate of UK-EU relations

It is a hazardous business predicting the future and relying on such predictions perhaps even more so. One of Shakespeare's characters in Macbeth asks the three witches at the beginning of the play "if you can look into the seeds of time and say which will grow and which will not, speak, then, to me". Rather inevitably, from the audience perspective at least, the future for poor old Banquo is short-lived and doesn't turn out quite the way he might have hoped, and that was with the benefit of accurate predictions.

Nevertheless, we have an innate desire to understand what the future might be like, and for governments and businesses it's essential to prepare for tomorrow and the day after. For the financial services sector in Europe, Brexit looms large in any such considerations and in recent years – government, firms and regulators - we have all been focusing intensively on preparations. These are, rightly, the preoccupations of today. But they will not be the preoccupations of tomorrow.

Instead, I can see the importance of financing and supporting the transition to a zero-carbon economy occupying a greater and greater significance in our work. In five years, green finance will be a central issue at events such as Eurofi, and globally. Climate change is shaping up to dominate the future of the financial services sector just as it is becoming a predominant theme for society, governments and other sectors of the economy.

> *"In five years, green finance will be a central issue at events such as Eurofi, and globally."*
>
> \- KATHARINE BRADDICK

The scale of the climate challenge is well understood but the changes that will be required in the financial services sector, less so. Taking an example, 70% of banks in the UK now consider climate change as a financial risk, good progress, but only 10% of UK banks are taking a long-term strategic approach to managing the financial risks from climate change. In the coming years it is essential that governments and the sector move beyond thinking only about green finance as how to finance green initiatives – though that must continue of course. Attention must also be turned to how >>>

>>> we will transition to a green financial system, and that will mean making fundamental changes to the way that decisions are made.

This change is starting to happen. One of the most influential initiatives to emerge is the Financial Stability Board's private sector Task Force on Climate-related Financial Disclosures (TCFD), supported by Mark Carney and chaired by Michael Bloomberg. This has been endorsed by institutions representing $118 trillion of assets globally. An increasingly large proportion of the private sector is now beginning to implement the TCFD recommendations and in September 2017, the UK became one of the first countries to formally endorse them.

In the UK, we have also launched the Green Finance Institute, with a mission to accelerate the domestic and global transition to a clean, resilient and environmentally sustainable economy. As the principal forum for public and private collaboration the GFI will foster greater alignment of public and private sector initiatives, create commercial opportunities for finance providers and drive the global green finance agenda through international dialogue, partnerships and trade.

As a global financial centre and the first major economy in the world to set a target of net zero greenhouse gas emissions by 2050 the UK will continue to demonstrate leadership in this field, in both thought and action. It is in that context that we published a Green Finance Strategy earlier this summer (https://www.gov.uk/government/publications/green-finance-strategy).

I may not be able to look into the seeds of time, but I can confidently predict that green finance will grow to dominate discussion in the financial services sector. ●

Denis Beau

First Deputy Governor,
Banque de France

Keeping the momentum for both preparing and strengthening the financial European system

It is the responsibility of the financial industry itself to prepare for the consequences of Brexit, starting with the loss of the benefits of the European financial passport for UK institutions. In this regard, regulatory and supervisory bodies have stated from a very early stage the principles that should be followed by supervised entities (in particular the prohibition of empty shells). Furthermore to cope with the consequences of the British withdrawal in the absence of a deal, supervisors have (i) engaged institutions, (ii) monitored actively the design of detailed and prudent plans and (iii) followed their implementation. Most major players have already taken the necessary design steps and started implementing their initial plan for «Day 1», but some concerns linger regarding the preparedness level of smaller players, particularly electronic money and payment institutions.

The relevant measures have been taken by public authorities at both European and national levels to deal with the specific risks of a no-deal Brexit that could threaten financial stability or consumer protection. At the European level, these measures include the temporary and conditional recognition of British CCPs, or temporary waivers on mandatory clearing and bilateral margin exchange for a limited >>>

>>> category of products. Member States have also adapted their domestic regulations. In France, legislation has been enacted to ensure continuity of financial contracts (e.g. OTC derivatives or insurance contracts), introduce some ISDA master agreements under French law and maintain an extended access to UK settlement systems by French entities.

The decision of the European Council to extend the Article 50 TFEU period allows for a few more months to prepare for a possible hard Brexit, but has translated in a loss of momentum in the preparation process. Therefore, the message must be restated with emphasis on the need for all to continue preparing actively for a no-deal. For banks, efforts should be maintained or stepped up in order to fully implement target operating models.

The momentum should also be kept in further strengthening European financial services as a reshaping of the landscape is inevitable. The most plausible scenario is that of an integrated polycentric network of financial centers.

Among the challenges to be met to that end is the design of post-Brexit equivalence regimes. In this regard the developments introduced by EMIR2 regarding both the power – via ESMA – to directly supervise third-country CCPs which have a systemic footprint vis-à-vis the EU and the reinforcement of the equivalence regime are most welcome. They remain to be implemented. The monitoring and control of equivalence decisions could also be improved by granting more power to the ESAs, and by providing the European Commission with more gradual options through flexible tools in the case of regulatory divergence: for example, temporary, partial or conditional lifting of equivalences.

But most importantly, we should pursue the efforts towards building an integrated and efficient European financial system. The way forward is what François Villeroy de Galhau and Jens Weidmann termed the "Financing Union for Investment and Innovation". It should notably be built on (i) a consolidated banking system with more pan-European financial institutions able to operate seamlessly at least within the single jurisdiction which the euro-area should be reaping the full benefits of the Banking Union (ii) reclaimed sovereignty in retail payments through genuine pan-European payment solutions (iii) resolute progress on the Capital Markets Union on topics such as the harmonization of insolvency regime. ●

Nobuyuki Kawabata

Managing Executive Officer, International Business Unit, Sumitomo Mitsui Financial Group, Inc.

SMBC – preparations for Brexit

In preparation for the original Brexit deadline of 31 March 2019, SMBC implemented a major project to plan and execute our Brexit strategy as regards both our banking and securities businesses. We built a new bank and a new investment firm in Frankfurt and transferred the majority of the branches of our UK bank to the new bank there and were ready for business before the deadline.

Like all market participants we now face the uncertainty of the next few weeks and the real possibility of a no-deal Brexit on 31 October. However, in order to ensure that we would be able to maintain service to our clients without disruption through Brexit and beyond, our basic planning assumption from the start was that there would be a no-deal Brexit. This has enabled us to be as well prepared as we can be for Brexit, although we recognise that there is still work to do. >>>

>>> SMBC has carried out an intense programme of customer communications and our major corporate and financial institution customers appear to be well prepared for Brexit. However, it is vital that all of our customers are aware of the implications of Brexit and we have found that some smaller corporates have needed guidance. It is quite possible that further customer communication will be required as 31 October approaches.

A key issue for SMBC has been to assist customers to transition where appropriate from our UK entities to our new German entities. Good progress was made on this, but as 31 March approached the uncertainty relating to Brexit meant that the pace of transitions slowed and of course after Brexit was delayed customers understandably considered that transition had become less urgent. We continue to work on ensuring a smooth transition for customers and this will continue for some time after 31 October.

SMBC must build up the revenues of its new entities in Germany – original assumptions have been revised due to the slower pace of customer transitions. A recent market survey in the City indicates that SMBC is not alone in finding that the delay to Brexit has resulted in a higher expense ratio in its new entities than originally planned. This will need to be carefully managed.

SMBC was able to hire all the staff it needed in Frankfurt in order to be ready to start operations on 31 March and had limited need to move staff from London or elsewhere. However, the uncertainty associated with the delay in Brexit has meant that staff moves are perhaps more challenging than before.

> *"Our basic planning assumption from the start was that there would be a no-deal Brexit."*
>
> - NOBUYUKI KAWABATA

In order to support the operations of its new entities in Germany, SMBC will use its significant middle and back offices in the UK. This will ensure efficiencies of scale and lower potential operational risk. In order to achieve this, a significant overhaul of group service level agreements, policies and procedures has been undertaken. While efforts will be made to reduce the complexity of these arrangements, this greater focus on outsourcing will require maintenance and ongoing work and we will continue to build the necessary governance structures for this.

As regards cross-border business from the UK into the EU 27 certain national regimes have been introduced in the EU 27 and generally they are helpful. However, they are country-specific and relate mainly to investment business.

As regards cross-border lending business, marketing from the UK into the EU 27 will become much more difficult - cross-border service provision by third country banks may be tolerated in certain countries for certain products, but it is very difficult to develop a coherent marketing strategy on such a patchwork of regimes. This is of course an area of interest for many firms - we will continue to monitor developments carefully and SMBC's staff in the UK will need to support its new entities in Germany, particularly in structured product areas.

We expect the EU 27 and the UK to remain strategically aligned in respect of major regulatory initiatives, but the UK will not become a passive "taker" of EU regulation given the leading role its authorities have taken in developing new regulations and the importance of financial services to its economy. There is now generally an acceptance that UK regulation will start to diverge from EU regulation, even though lawmakers may seek to achieve the same regulatory outcomes. This will present challenges that firms operating cross-border into the EU 27 will have to manage with care. ●

Enhancing financial policies dealing with third-countries

John Berrigan

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

Equivalence in financial services

Recently, equivalence is being frequently mentioned in the context of the UK's withdrawal from the EU and the way how UK firms may continue providing services in the EU. The EU equivalence system is much more than that. It has become a significant tool in fostering integration of safe and efficient global financial markets and cooperation with third countries in about 40 areas of financial services. It supports and enhances regulatory and supervisory cooperation, while at the same time, it maintains open and globally integrated EU financial markets. It is an important policy component in placing the EU in international financial markets.

End July 2019, the European Commission published a communication that outlines the EU equivalence policy in the area of financial services. With over 280 equivalence decisions benefitting over 30 countries, and with recent legislative improvements, the Commission expects its equivalence approach continue to play an important role in strengthening cooperation and narrowing cross-border duplications and possible inconsistencies and thus market fragmentation.

> *"The Commission expects its equivalence approach continue to play an important role in strengthening cooperation and narrowing cross-border duplications and possible inconsistencies and thus market fragmentation."*
>
> \- JOHN BERRIGAN

The communication sets out the EU's approach to assessing non-EU countries' regulatory frameworks and monitoring the performance of the equivalence decisions. The Commission also takes stock of recent reforms of equivalence rules, both in terms of legislative and practical improvements, included for instance in the reviews of the European market infrastructure regulation[1] and the European supervisory authorities[2] or the investment firm review[3]. These reforms ensure that the supervision and rules of third country providers is commensurate with the nature of services and the risks they may raise. They also enhance the powers of the relevant ESAs, ESMA in particular, and the general transparency of the process. At the same time, these reforms send a clear signal that the EU's equivalence >>>

>>> framework remains in place and that the EU is committed to international standards that aim to facilitate safe and efficient global markets.

It is important to stress that the equivalence process needs to preserve the regulatory and decision-making autonomy of the EU, both for the adoption of an equivalence decision and any subsequent amendment or repeal. Third countries may express an interest in being assessed for EU equivalence in a specific area and the Commission will consider it, but there is no right to receive an equivalence decision.

The EU assesses the overall policy context and to what extent the regulatory regime of a given third country achieves equivalent outcomes as the EU rules. In doing so, the Commission applies proportionality in the assessment criteria and follows a risk-sensitive approach. This means it can sometimes be more demanding with countries whose markets have a bigger impact. The recent communication confirms this approach. Recently, some have implied that the Commission would tend to misuse equivalence for political motives, outside the field of financial regulation and that also in relation to UK's exit from the EU. The validity of this criticism must be challenged. First, the Commission still hopes (and has not spared any efforts in this sense) for a deal and for a future cooperative relationship with the UK. Second, the recent changes in regulatory framework and communication are not a reaction to specific actions by any given country. They do reflect a changing landscape of European finance. More broadly, equivalence, as a tool for more efficient, sound and secure global markets, inherently takes into account several dimensions, including prudential and macro dimensions. EU decision makers and supervisors need to act with confidence when they accept to expose EU investors and interests to foreign jurisdictions.

Lastly, as also showed by our recent communication, the Commission understands the need for and shares the objective of a more transparent, robust and effective equivalence system. Beyond the regular engagement and dialogue with the European Parliament and the Member States, the Commission also establishes technical dialogues with the third country authorities to ensure the accuracy of our underlying assessments. ●

1. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/post-trade-services/derivatives-emir_en
2. https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-supervision-and-risk-management/european-system-financial-supervision_en
3. https://ec.europa.eu/info/publications/171220-investment-firms-review_en

Steven Maijoor

Chair, European Securities
and Markets Authority (ESMA)

It is a right time to revise the EU equivalence regime

The G-20 Leaders, during the St Petersburg Summit in 2013, agreed that "jurisdictions and regulators should be able to defer to each other when it is justified by the quality of their respective regulatory and enforcement regimes, based on similar outcomes, in a non-discriminatory way, paying due respect to home country regulation regimes".

In this context, the European Union (EU) translated this overarching "deference" principle into a comprehensive market access model based on equivalence and recognition. This model, available for a significant number of financial markets >>>

>>> activities, aims at keeping EU markets open. At the same time, equivalence achieves the objective of avoiding unnecessary market fragmentation while supporting financial stability and a level-playing field on a global level.

In its recent report on "Market fragmentation and cross-border regulation" IOSCO recognised that the use of "deference"-related regulatory and supervisory tools has increased since 2015, when IOSCO issued an earlier report on this subject matter. In particular, as stated in the 2019 IOSCO report, this increase has been achieved particularly through the very extensive use of equivalence in the EU.

Looking ahead, the EU approach towards cross-border regulation and supervision needs to change. The fact that, as a result of Brexit, Europe's largest capital market will leave the EU has accelerated a reconsideration of our third-country arrangements. As the UK will continue to be an important capital market for the EU post-Brexit, it is also vital that an appropriate EU framework for third-country regulation and supervision is in place.

To take one example, a well-known area where the EU equivalence approach is applied concerns CCP supervision. Access to the EU market for central clearing is allowed after a positive assessment of the third-country's regulatory framework by the European Commission, and subsequent recognition of individual Third-Country CCPs (TC-CCPs) by ESMA. Since the application of EMIR, the European Commission has adopted 16 equivalence decisions. In addition, a total of 34 TC-EU CCPs from 16 jurisdictions have been recognised by ESMA.

> *"EMIR 2.2 will introduce an enhanced recognition regime for systemically important TC-CCPs."*
>
> \- STEVEN MAIJOOR

This model, while providing the possibility of full access by global market infrastructures to the EU clearing market, entails certain concerns from an EU financial stability perspective. The EU approach entails full reliance on third country rules and supervisory arrangements, while giving ESMA very limited powers to intervene should a risk emerge from a TC-CCP affecting EU stability.

With the recently agreed amendments under EMIR 2.2, the EU will address the key limitations of the current system and introduce a more proportionate framework. In particular, EMIR 2.2 will introduce an enhanced recognition regime for systemically important TC-CCPs, whereby such CCPs will have to comply with EMIR requirements and be subject to certain supervisory powers from ESMA. At the same time, with regards to 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 non-EU market players, assessed from an EU risk perspective, and combined with direct supervisory powers at European level, should become a guiding principle of an improved equivalence model. Looking beyond CCPs, similar changes have been politically agreed regarding non-EU Investment Firms (under the Investment Firms Review legislation).

In that context, I am looking forward to the European Commission's assessment of the need for strengthening the third country arrangements regarding non-EU Trading Venues and non-EU CSDs, in line with the political agreement achieved in the ESAs review.

Finally, in view of the extensive use of the equivalence model, including its expected application to post-Brexit UK financial markets, there is an increasing need for closer and ongoing equivalence monitoring of relevant developments in third-countries. To this end, I welcome the new competences and resources in this regard under the ESAs review package. ●

Takanori Sazaki

Regional Executive for EMEA,
Mitsubishi UFJ Financial Group

Enhancing comparability of regulatory regimes to help close the fragmentation gap

In the current climate of rising trade tensions and slow economic growth, the regulatory community is faced with an ongoing challenge of seeking the right balance between ensuring resilience of the financial system and promoting economic growth. While the goal of ensuring resilient financial institutions has been addressed through a globally agreed regulatory framework, there are also concerns that certain markets are at risk of becoming fragmented along jurisdictional lines.

MUFG welcomes Japan's leading role in the debate on market fragmentation by putting it on this year's G20 agenda. It is also encouraging to see that the Financial Stability Board (FSB) has recognised the need to address the risk of market fragmentation and its potential impact. According to the FSB, market fragmentation arises for various reasons, most notably due to differences in national regulations and supervisory practices, governing financial activities that are international in their nature.

One of the potential paths to close the gap, particularly in the interest of reducing regulatory and supervisory overlaps between jurisdictions, could be to further enhance processes of mutual recognition – also known as equivalence in the EU. The aim of these processes is to avoid that two (or more) regulatory regimes are being applied to the same market or activity. For a diversified globally operating financial services group such as MUFG, mutual recognition of regulatory regimes is an important element for continuing our cross-border activities in the jurisdictions where we operate. It also provides our home regulator with a sense of comfort about the foreign regulator's supervisory oversight.

It has been recognised that the EU process for granting equivalence needs to be further improved and streamlined for cross border activities. Supervisory and regulatory cooperation is key in this process.

The G20 and FSB can play an important role in specifically targeting fragmentation by defining a consensus approach and overall framework for these various types of cross-border regulatory cooperation and coordination. The assessment process could focus on more of an outcome-based approach that avoids line-by-line compliance and facilitates comparability. The most recent report published by IOSCO provides a number of practical examples where early cooperation between regulators on recognition assessments, methodology and criteria has resulted in some practical solutions for the ongoing work in this area. The use of memoranda of understanding (MoUs) and potentially creating a repository of these agreements, could be part of the solution to enhance regulators' access to the information required to make equivalence decisions in a more effective manner.

Further work to enhance comparability of regulatory regimes is not only important for the globally standards agreed today, it will become even more important when formulating the regulatory framework for risks that face the financial system tomorrow. Continuous dialogue, not only between regulators, but also taking into consideration the timely input from foreign entities whose cross-border activities are being impacted at an early stage of implementation, is crucial when focusing on prevention of future proliferation of inconsistencies.

We hope to see constructive mutual recognition discussions between EU and UK post Brexit, but given that fragmentation is happening on a global basis, we need a framework to address the global level fragmentation as well as regional (i.e. EU/UK) framework, that allows proper functioning of capital markets and lending activities. ●

Markus Ronner

Group Chief Compliance and Governance Officer, UBS Group AG

An outcomes-focused equivalence framework is key to delivering the EU's Capital Markets Union

There is broad agreement among regulators, policymakers and market participants on the risks that market fragmentation present to financial resilience. The G20, the FSB and IOSCO have all recognised recently that a coordinated policy response is needed to address these risks. IOSCO has acknowledged a role for deference in the regulation of capital markets, complemented by other measures to strengthen regulatory and supervisory collaboration. Despite this recognition, divergent implementation and reluctance among regulators to recognise each other's rules remain prominent.

In the EU, the Capital Markets Union (CMU), which aims to broaden the funding base for European corporates and households, is expected to remain a key project as the new European Commission and Parliament take shape. Global firms like UBS would like to contribute to making the CMU a success by continuing to facilitate capital, liquidity and investment flows into Europe. The CMU is fundamentally about breaking down barriers to these flows in Europe's capital markets and >>>

>>> as such is an important channel through which market fragmentation issues can be addressed. However, achievement of this goal risks being undermined by the lack of clear political willingness and insufficient cross-jurisdictional cooperation arrangements between home and host regulators, both within and beyond Europe.

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

In addition to enacting global reforms, Switzerland, for example, has substantially reformed its regulatory framework in recent years to align with MiFID II standards. Yet the recent expiry of EU equivalence for Swiss trading venues illustrates the lack of legal certainty third-country partners face with the current system, given that Switzerland meets all technical requirements for unrestricted equivalence. The absence of a reliable equivalence mechanism will lead to more fragmented markets, to the detriment of businesses and investors both in the EU and Switzerland. And should this approach proliferate, financial integration will erode, to the detriment of financial stability, savers and investors in the EU.

To achieve the full benefits of an efficient and safe EU-wide and globally integrated capital market, any temptation to establish new barriers that could ultimately inhibit the CMU's ability to deliver increased competition, choice and innovation should be resisted.

"A CMU that integrates an outcomes-focused and consistent equivalence framework must be a priority."

\- MARKUS RONNER

Building the CMU in a way that integrates an outcomes-focused, transparent and consistent equivalence framework must be a priority. It will lead to more legal certainty, lower costs and higher productivity for all market participants and customers. ●

Sébastien Raspiller

Assistant Secretary, French Treasury, Ministry of Economy and Finance, France

Strengthening the European equivalence framework

The European equivalence framework has come under increased scrutiny in recent times. This is not unexpected, since in the context of the UK withdrawal, the EU has insisted that the equivalence framework is the only possible future framework that preserves both the EU and the UK capacity to adopt their own rules, to ensure a level playing field, and to act in the interests of their financial stability. Why is it so?

Equivalence refers to a process by which the European Union assesses and deems a third country's regulatory and supervisory framework equivalent, which allows it to defer to the third country's regulatory and supervisory framework to grant its entities access to the EU financial services market. Two key elements need to be highlighted. First, the objective of the equivalence framework is not liberalization per se, even though the European Union is a proponent of market openness. It is first to reduce overlaps and facilitate the compliance with regulatory requirements by EU firms that might have exposures to third countries. Second, the equivalence framework applies to all third countries and is not meant to be tailored to a jurisdiction's specific preferences. Consequently, changes to any piece of the equivalence framework might have far-reaching consequences and particular care must be taken when modifying them to avoid unintended consequences.

The EU may review and, when needed, enhance its equivalence rules to ensure they are fit for purpose in the evolving landscape of cross-border services provision of which the EU is part with its trading partners. For instance, certainty is needed that the equivalence criteria are robust enough, and that provisions are in place to ensure that EU authorities have adequate oversight over third country risks.

Within such a review some key characteristics of equivalence regimes should be stressed. Firstly, the definition and implementation of equivalence regimes is a unilateral competence of the European Union. The autonomy of the EU to ultimately grant or withdraw equivalence decisions is not negotiable.

Secondly, reviewing and improving the framework essentially means that the existing equivalence regimes should be reinforced across several dimensions, especially the clarity of their requirements and the monitoring of equivalence decisions.

On the clarity of requirements, the equivalence process should be made even more transparent and predictable. "Equivalence" does not mean "line-by-line alignment". But the EU should be prepared to ensure that outcomes are only deemed equivalent in a very robust and significant sense. Moreover, strengthening the equivalence framework does not entail creating new equivalence regimes.

On the monitoring function, the EU needs to be able to react with regard to possible evolutions in third-country regulation and supervision. Likewise, the EU should not grant equivalence without an end-limit or a realistic withdrawal framework. This would be contrary to the need for the EU to be able, at any time, to safeguard and protect its financial stability.

Finally, the EU has constantly been willing to engage in close regulatory cooperation. As a matter of fact, the Commission has extensive experience in such regulatory dialogues with third countries. Nevertheless, regulatory cooperation should not hamper the autonomy of rulemaking of the EU. ●

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III. PRIORITIES FOR THE EU FINANCIAL SECTOR

Issues at stake

The EU banking sector remains fragmented and oversized. The "sovereign-bank loop" has not disappeared and in certain countries has increased. Euro area banks' return on equity (ROE) at around 6% remains below that of some of their international peers at a time when technological innovation requires significant investment. In such a context making the Banking Union effective and improving the competitiveness of EU banks are key priorities. In addition, EU legislators should make sure that the implementation of Basel III does not affect the financing capacity of EU banks.

Furthermore, the Capital Markets Union action plan has so far not allowed a strong development of capital markets in the EU. Brexit makes the implementation of CMU even more important for Europe and calls for a thorough reflection on how to promote an efficient and competitive financial system in the EU.

Content

Policy priorities for the banking sector

Felix Hufeld

President, Federal Financial Supervisory Authority, Germany (BaFin)

European financial markets have become more stable

The sociologist Max Weber likened politics to the arduous task of boring through hard boards of wood – an activity that requires both passion and perspective. In my view, this description can also be applied to financial regulation. At present, the community of European financial regulators has some rather tough materials to work through – and against the backdrop of somewhat unfavourable conditions. With that I am referring, among other things, to interest rates, which have been historically low for some time now. The persistently high levels of non-performing loans in some EU member states is another relevant topic.

"the past few years have seen the launch of some innovative projects that have succeeded in increasing financial stability in Europe."

- FELIX HUFELD

In spite of this, the past few years have seen the launch of some innovative projects that have succeeded in increasing financial stability in Europe. The European Banking Union comes to mind – with two out of three pillars in place, we have already crossed two key milestones in this regard. In November, we will be able to celebrate the fifth anniversary of the first Pillar, the Single Supervisory Mechanism (SSM) under the umbrella of the European Central Bank (ECB). As a member in the Supervisory Board of the SSM, I have seen first-hand how processes have become increasingly established and cooperation between the ECB and national supervisory authorities has become routine practice. The high degree of professionalism that has come to characterise the SSM is not just visible in the day-to-day supervision of institutions, but also in the implementation of strategically important projects.

Our success can also be seen in the second pillar of the banking union, the Single Resolution Mechanism (SRM), with the central resolution authority, the Single Resolution Board (SRB). The SRM aims to ensure the orderly resolution of systemically important banks with minimum impact on the real economy, the financial system, and public finances. That is of value in itself. But when we look beyond the big picture at the hard work on the ground, the positive development in the SRM >>>

>>> becomes clear, for example in coordinated resolution planning for significant institutions operating on a cross-border basis, and in the formulation of complex capital requirements, such as for own funds and eligible liabilities (MREL).

The situation is a little more complicated when it comes to the third pillar of the banking union, the possible introduction of a common European Deposit Insurance Scheme (EDIS). I expressly share the opinion of the German Federal Government that the introduction of an EDIS must be tied to certain conditions. These conditions have not yet been met. Before we launch a common deposit guarantee scheme, we must first sufficiently reduce the various existing risks in the financial sectors of the member states.

One consideration that is becoming increasingly important at the European level is consumer protection. The cornerstones of Europe-wide regulation are the Markets in Financial Instruments Directive (MiFID II), the Insurance Distribution Directive (IDD) and the Regulation on key information documents for packaged retail and insurance-based investment products (PRIIPS Regulation). Supervisory convergence is now also gaining in importance; this describes efforts to create a common supervisory culture, ensure coherence in supervisory practices and guarantee the use of consistent procedures.

The three European Supervisory Authorities (ESAs), which have recently been bolstered by the compromise reached as part of the ESA review, particularly with regard to consumer protection, have an important role to play here. International cooperation between national supervisory authorities will also gain in importance – a trend which is amongst others fostered by digitalisation. Cybercriminals as well as money laundering activities will not be stopped by national boundaries, which is why supervisors and regulators need to find the ways and means to work together more closely and more effectively across national borders.

Another key European project is the creation of a Capital Markets Union (CMU), or the further integration of financial markets within the European Union. If the right conditions are created, the CMU will contribute to making the European capital market and banking market more efficient, competitive and diverse, and to broadening the possibilities on offer for both private and corporate customers. ●

Xavier Musca

Deputy Chief Executive Officer, Crédit Agricole S.A.

Basel IV: the one reform too many for European banks competitiveness

The new European legislature will be tasked with the transposition of the Basel Committee December 2017 recommendations into EU law. As a reminder, only those Basel recommendations that are transposed into national or European law have legal force. It is therefore up to the legislators to take their responsibilities.

We call that reform "Basel IV" because it implies a radical shift away from the 2005 Basel doctrine which Basel III then confirmed: a move from a risk-based capital requirements approach to a flat-rate approach that does not suit low risk balance sheets. This would particularly penalise large EU banks whose balance sheets' risk density is lower than US banks'. The Basel Committee estimated in March 2019 that capital requirements would decrease in Asia, increase in the US by 1.5% but >>>

>>> increase in the EU by more than 20%. This would create a competitive disadvantage for EU banks, particularly vis-à-vis US corporate and investment banks that already enjoy a 50% EU market share.

This would also penalise the financing of the European economy and its competitiveness as the capital requirements increase would be particularly high for the financing of unrated corporates, real estate or specialised lending (infrastructures, aviation, rail etc.) for which the increase could be well over 100%.

Within a rationale of standardisation, comparability of models and strengthening of solvency, the Basel recommendations have thus considerably deviated from the 2016 G20 statement, the 2016 ECOFIN conclusions and the 2017 European Parliament resolution. There should be no significant increase in the overall capital requirements for the banking sector and no significant differences across regions of the world. We are very far from these objectives.

Last July EBA aggravated impact estimates for EU banks, with an average increase in capital requirements of 24.4% for all EU banks and of 28.6% for GSIBs, which is more than significant. Besides, EBA recommends tightening certain aspects of the Basel approach, for instance applying the output floor at entity level. Furthermore, EBA has not assessed the impact of Basel IV on capital requirements under the MREL. Worse still, EBA downplays the impacts of that reform on banks by assuming on the one hand that banks' capital surpluses beyond the regulatory minimum will allow partially addressing the impact and, on the other hand, that banks' retained earnings will absorb the rest.

> *"The Basel recommendations have thus considerably deviated from the 2016 G20 statement."*
>
> - XAVIER MUSCA

For investors, however, what matters is not the absolute level of banks' own funds but the excess of own funds compared to the regulatory requirements. Dedicating the accumulation of future earnings to these new regulatory requirements would lower profitability, which is an important soundness indicator for debt and equity investors. Furthermore, this would reduce the capacity to fund the European economy at a time when important investments in technology and ecological transition are called for.

Let us recall that in response to the 2008 financial crisis, regulators already greatly increased own funds requirements. For the past ten years, the level of capitalisation of European banks has more than doubled: it now reaches 14.4% of CET1 on average and thus includes a substantial amount of capital reserves.

Last, constant regulatory instability has become a source of concern rather than comfort: despite the Banking Union and all the prudential measures already adopted, equity investors have been shifting away from the European banking sector.

Let us make no mistake. We are not questioning what has been implemented to strengthen the safety of the financial system. This is by no means to argue for any deregulation. A sound banking system is not a system investors would turn away from.

Let us be cautious not to create Malthusian banks unable to finance economic development, by looking at financial stability only through the lens of capital level.

The European Union has set the political conditions that must govern the conclusions of a Basel agreement. That political will must not abdicate. ●

Carlos San Basilio

Secretary General of the Treasury and International Financing, Ministry of Economy and Business, Spain

Addressing the challenge of bank profitability

The Banking Union can support bank profitability by both reducing and sharing risks as well as by fostering cross-border flows, broadening the customer base and incentivising cross-border mergers.

Although with certain ups and downs, return on equity in the EU has been on a general upward trend over the last years, increasing according to the EBA from 4.8% in 4Q2013 to 6.8% in 1Q2019. Nevertheless, these figures are well below the situation before the recent crisis.

Behind this drag on profitability there are both temporary and permanent factors. From a conjunctural perspective, low interest rates can stimulate the flow of credit but at the same make it difficult for banks to get financial revenue, with latest signals from both the ECB and the Fed hinting at the possibility that low policy rates are here to stay for the foreseeable future. Additionally, the currently decelerating macro environment is also worsening the prospects of banks making revenue. From a structural perspective, banks have been facing a wave of new regulatory requirements, while at the same time being faced with mounting competition from new FinTech providers.

In this context, what can we do as policymakers to help the banking system keep its capacity to fund the real economy? First, we must incentivise banks to do away with the legacies from the crisis, by adequately valuing and provisioning assets and selling those that are distressed. The reforms of the Spanish banking system is a case in point, encompassing a domestic asset quality review and stress test, ambitious provisioning requirements and stricter criteria on forbearance. From a European perspective, ongoing work by the European Commission, the EBA and the ECB to catalise the set-up of a market for NPLs in the EU could greatly contribute to cleansing bank balance sheets. Second, we must make sure there are no regulatory obstacles to bank restructuring, namely by streamlining insolvency procedures.

Efforts by the European Commission to harmonise insolvency procedures in the EU are very positive in this regard, contributing also to cross-border restructuring. Third, we must guarantee a level playing field between banks and new FinTech providers under the principle that a given activity must always be subject to the same regulatory requirements, regardless of the nature of the provider. All that being said, it is key to bear in mind that policymakers should only complement and never substitute for private market adjustment.

Within an increasing interconnected world, the cross-border perspective is also relevant to bank profitability. In this regard, the Banking Union can support bank profitability by both reducing and sharing risks as well as by fostering cross-border flows, broadening the customer base and incentivising cross-border mergers. While it is true that cross-border banking mergers and acquisitions are still rare even after the inception of the SSM and the SRB, it is to be expected that the ongoing efforts to finalise the Banking Union, most prominently through the set-up of an EDIS, will give depositors, investors, managers and shareholders across the euro area certainty that the guarantees are exactly the same regardless the location of the bank they put their money into.

Finally, there is also a positive note on this profitability challenge, which will make banks adapt their business models to become more efficient. Profitability challenges are an issue that should be dealt with by banks themselves, with financial authorities playing a role to facilitate the adjustment and making sure investors' and financial consumers' rights are adequately catered for along the process. ●

Challenges and priorities for EU capital markets

Adena Friedman

President and Chief Executive Officer, Nasdaq

Modernizing capital markets to fuel economic prosperity

Efficient capital formation is the bedrock to job creation, economic growth and prosperity. The evolution of our global capital markets is essential to continued economic opportunity. Adopting new technologies and taking measures to ensure that the markets are fair for all participants will only drive our global markets forward.

Exchanges are the beating heart of capital markets. Companies of all sizes utilize exchanges to gain much-needed access to investors who in turn fund their ideas and raise capital. Exchanges also play a crucial role in fostering stability in the financial markets, facilitating transparent pricing and providing all investors, professional and non-professional, with the opportunity to achieve their desired asset allocation and enjoy in the benefits of growth.

> *"As more investors, companies and exchanges embrace new technologies, modernizing the global capital markets to keep pace with advancements in technology becomes an urgent priority."*
>
> \- ADENA FRIEDMAN

With the rapid rise of new technologies, however, the capital markets ecosystem is shifting dramatically. The cloud, machine intelligence, cryptocurrency and the like are giving investors new and unprecedented opportunities in the capital markets. From establishing digital currencies to storing immense data sets to machines that can send pricing information in fractions of a second to distinguishing malicious trading behaviors, we know technology can transform capital markets for the better.

As more investors, companies and exchanges embrace new technologies, modernizing the global capital markets to keep pace with advancements in technology becomes an urgent priority. At Nasdaq, we believe the following practices will fuel the future of modern global markets:

Implement orderly market structure

Equity markets exist to serve public investors, especially retail investors, and it is imperative that all participants are treated fairly with equal access. Beyond

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>>> investors, the market structure should support companies of all sizes, recognizing the different liquidity characteristics of small- and large-company stocks.

Embrace innovative technology
New technologies have fundamentally changed the way customers interact with market infrastructure providers. Developments in data analytics, field-programmable gate array (FPGA), mobile technology, cloud computing, machine learning, artificial intelligence and blockchain hold the promise of allowing capital markets to operate more efficiently while simultaneously providing greater transparency and security to investors.

Sustain healthy IPO market
An active IPO market invigorates securities markets, as research has found that a vast majority of new jobs in young firms come after they go public. Recently, Nasdaq Nordic, particularly Stockholm, has been a leading IPO venue for small- and medium-sized enterprises. Bringing those companies to the public markets is a critical step in unlocking the potential of job creation for the broader European market.

Prioritize sustainability
While Environmental, Social and Governance (ESG) has been a prevalent part of investment strategies in the European markets for many years, we're finally seeing ESG become a top priority in the U.S. The growth in ESG comes amid a growing body of research and fund reports that suggest ESG-themed investments can outperform during calm markets and withstand market volatility and downturns. Since 2017, we've been a leading force in bringing about standardized, voluntary ESG guidance and now offer an ESG data portal solution that allows investors and listed companies to reach their sustainability goals.

At Nasdaq, we've seen how these factors stimulate capital markets and the greater global economy, and we have a responsibility to leverage our capabilities to make the capital markets better for tomorrow. Tomorrow's markets, if governed with properly-calibrated regulation, should embrace rapid technological advancement for the betterment of all market participants, and continue to unleash the dynamic, entrepreneurial spirit that drives economies forward. ●

Patrick Thomson

Chief Executive Officer, EMEA,
J.P. Morgan Asset Management

Empowering Europe in the funds space

Europe is in a position of strength when it comes to asset management - boasting a vibrant funds infrastructure and strong investor protections. However, the industry is facing significant challenges.

Two of the biggest challenges are 1) under-investment in Europe and 2) global market fragmentation. The good news is that there are opportunities for both industry and policymakers to address these problems.

J.P. Morgan Asset Management recently conducted a survey. 49% of investors in Austria, Belgium, Spain, UK, Germany and Italy say they are concerned about poor returns but are too afraid or insufficiently informed to take action. Investors know their bank deposits aren't generating the returns they need but they don't know >>>

>>> how to invest most effectively. 76% of 6000 people we surveyed do not own a single investment product. Simple lack of knowledge about markets and investment seems to be leaving Europeans in the dark. So how do we remedy this?

Financial literacy is key. We need an EU policy agenda that is more focused on investor education. I'm delighted that our new European Commission President Ursula von der Leyen is keen to empower Europeans through education and skills – investor education needs to be a key component of this. Retirement planning should be central to this agenda given the current generational shift.

Technology will also play an important role. An individual on average takes in 34GB of data a day and listens to an average of 105K words. The average parent only has 17 minutes per day to themselves. Modern society is really busy – we don't have time to digest information the way we used to. Fortunately, technological advancements make it easier to provide accurate, clear and relevant information efficiently to make it a lot faster and easier for people to invest. We are partnering with FinTechs designing platforms that make it easier for people to save for retirement and for companies to offer pension plans. But policymakers can play a role too in ensuring that regulation is balanced appropriately, to harness this kind of positive innovation. Regulations like MiFID and PRIIPs, while well-intended, can hinder digital delivery of information to investors. We need to open up new channels for sharing information especially to appeal to younger investors in Europe.

> *"Promoting Europe's global attractiveness, and empowering investors will help Europe thrive."*
>
> \- PATRICK THOMSON

We also need to promote Europe's attractiveness on the global stage. Both geographically and geopolitically, we are at the centre of many of the world's key investment themes here in Europe. In the asset management industry more than anywhere, we have embraced this opportunity. UCITS remain the top shelf mutual fund in many jurisdictions across the world. But we cannot take this for granted. Market fragmentation is a real threat to UCITS' success across the globe. We still hear murmurings about the need to tamper with third country delegation rules that are so critical to the success of UCITS. The ability for European firms to delegate portfolio management across the globe provides European investors with access to expertise across the world. Reducing access and promoting a "local markets for local people" mentality in Europe would be a major setback.

We see opportunity in promoting our markets and our products across the globe. Latin American countries have taken advantage of UCITs as a gold standard. Local rules in some Latin American and Asian jurisdictions create challenges to client-onboarding and to fund distribution. We should help where we can.

In short, when we think about cross-border fund management, we need to shift out of the intra-EU mindset and take a global outlook. Selling Europe-domiciled UCITS and opening up global markets is a huge opportunity. But if we aim to open up global markets, we also need to lead by example and embrace an open and attractive market here at home.

In conclusion, as we move into the next EU mandate and as we think about investment management policy, we would encourage lawmakers to focus on two central themes 1) making investment simpler and easier and 2) promoting Europe's attractiveness on the global stage. Europe has shown leadership in the asset management space over past decades – the creation and nurturing of UCITS has been critical. If we focus on promoting Europe's global attractiveness, and empowering investors through financial literacy and technology, we will create the right mix to thrive for decades to come. ●

EUROFI MEMBERS

Impacts of Basel III

Joachim Wuermeling

Member of the Executive Board, Deutsche Bundesbank

A milestone in stabilising the global financial system

The finalisation of Basel III represents an important milestone for the G20 post-crisis reform agenda and a clear commitment to internationally agreed global standards. As such, Basel III will help stabilise the global financial system and ensure an international level playing field for banks.

The framework must now be transposed into the national legislation of the jurisdictions represented in the Basel Committee on Banking Supervision – fully, consistently and in a timely manner.

In Europe, the first step was for the European Commission to analyse the impact of the remaining elements of Basel III before it comes up with a legislative proposal – presumably in 2020. The results of the impact assessment carried out by the European Banking Authority will form the basis for the implementation of Basel III in European law.

The assessment shows that banks in the EU can cope with the remaining elements of Basel III: while minimum capital requirements will significantly rise for some larger, internationally active banks, the additional demands on smaller banks are on a smaller scale. And even though we recognise the challenges for some bigger banks, the increase is manageable.

The expectation articulated by the Group of Central Bank Governors and Heads of Supervision (GHOS) that finalising Basel III should not, on average, significantly increase overall capital requirements posed a particular challenge while wrapping up the Basel III package. Differences in financial systems across stakeholder countries made it difficult to strike a universally acceptable balance.

A focal point in the discussions of the Basel Committee was the calibration of the output floor. However, in the end, the objective to not significantly increase minimum capital requirements on average was reached at the global level. The latest Basel III monitoring results show a moderate increase in minimum capital requirements worldwide of 5.3% for large institutions and 9.0% for other institutions.

Of course, there is heterogeneity across regions. Large European banks, for instance, face an increase of more than 20%, whereas the increase of 1.5% for large American banks is considerably smaller. But these numbers reflect averages and do not represent the impact on each institution in the sample. On an individual basis, the impact varies significantly depending on each institution's specific business model.

Furthermore, the estimated figures for European banks are far below the numbers from the initial Basel III reform package, which was assessed for the first time in 2012. Back then, respective shortfalls were eliminated within four years. This gives me

>>>

>>> confidence that the European banking sector can cope with the additional capital demand this time as well.

It is important to emphasise that changes in individual capital requirements are not unintended side effects. The major goal of the Basel III reform package is to make the requirements more risk-appropriate, restore the credibility in the calculation of risk-weighted assets (RWAs) and improve the comparability of banks' capital ratios. Bank-specific changes in minimum capital requirements reflect these goals.

This is why calls for divergent, more lenient implementation of Basel III are unwarranted. For example, there have been demands to allow for a parallel use of external ratings and own assessments of a borrower's credit quality under the Standardised approach. Others are pushing to maintain the option to apply the advanced IRB approach for exposures to large corporates and banks. These proposals are neither in line with Basel III nor justified from a risk perspective.

It will take some time until the new rules become fully effective. As soon as this is the case, it will be important to monitor whether the objectives of Basel III have been achieved. To that end, the Basel Committee has already approved a comprehensive evaluation work programme.

Before this can happen, full and timely implementation is needed. Laying the foundation for an evolving global economy and a healthy, strong and stable financial sector is essential and has to be underpinned by effective regulation. In order to secure the financial system, collaboration and transparency in international rule-setting are crucial. Achieving effective international regulatory cooperation is of utmost importance. ●

Casper von Koskull

President and Group Chief Executive Officer, Nordea Bank Abp

Basel III: a special consideration for the Nordic economies

The Nordic economies are open, competitive and rank high on economic welfare indicators. They have high employment rates, high incomes, strong social safety nets and solid government finances. In addition, the distinct Nordic legal tradition combines an effective and modern legal infrastructure with a high degree of creditor protection. This combination not only ensures a strong macroeconomic shock absorption capacity, but also financial and economic stability.

It is worrying to now see the potential effects from Basel III on these economies. Assessments from the European Banking Authority (EBA) suggests an average increase of 24.4% in the minimum capital requirement for EU banks, with an even higher increase expected for low-risk markets such as the Nordics. Even more concerning is that fact that regulatory capital requirements will be the result of a regulatory design that does not match the risks banks actually face – thereby distorting the incentives for banks when it comes to business selection and pricing. This can ultimately create a negative impact for the financing of Nordic corporates and households, and ultimately make the Nordic financial system less robust.

With this outset, I would like to suggest the following to European policy makers:

1. **Don't penalise low risk portfolios.** Low risk assets will be particularly impacted by the combined effect of standardised approaches and an output floor. If part of the >>>

>>> intention of Basel III was to further disincentivise the holding of high-risk assets then this will do the opposite, creating a penalising effect for holding assets like low risk household mortgages and loans to high (credit) quality Nordic corporates. One way to mitigate the impact of the output floor is to use minimum Basel capital requirements for the output floor measure – i.e. not impose buffer requirements based on this measure as well. Further, to apply Basel III in a way that accommodates the specific ways in which EU corporates and household are financed.

2. **Ensure we have the same rules for the same risk.** While the regulation of banks has been strengthened considerably with Basel III, the same is not true for other parts of the financial system. As a result, some activities that are key service areas for banks are being taken over by other financial service providers – not all of which are regulated to ensure financial stability. Key examples are market making activities and mortgages. The broader risk is one of regulatory arbitrage. A regulatory system that overcharges for risks for one type of market participant (and not others) will likely see those risks move to where the cost of holding the assets more closely reflect the risk or even undercharges for the risk.
3. **Ensure a better coordinated use of the multitude of capital tools.** The regulatory reforms have resulted in regulators – national as well as European - having a wide range of tools at their disposal. As a result, it has become more complex to decide which tools should be used to address which risks. It has also become more complex to ensure a clear allocation of responsibilities between national regulators and the central union supervisors. This can lead to multiple tools being used to cover a single risk issue and that certain "popular" risks become over-capitalised. I attribute part of this issue to the way in which supervisory responsibilities have been compartmentalised. The addition of Basel III could exacerbate this issue and I therefore recommend the use of existing tools and division of supervisory responsibilities be assessed as part of the implementation.

To conclude: If regulatory implementation is based on an EU average, there is a clear risk that the impact will be unreasonable for the Nordic financial system and the Nordic economies. This can have a direct impact on Nordic corporates and households and even financial stability. Ultimately the result will be a loss of trust in and hence credibility of the EU regulatory system – not just in the Nordics. I therefore urge EU policy makers to deliver a capital framework that (reasonably well) reflects the real risks and which is relevant to the diversity of the financial ecosystems in Europe. ●

Philippe Bordenave

Chief Operating Officer,
BNP Paribas

Let's be serious with CMU

It is ironic that wise ECB efforts to encourage growth are countered by banking supervisors. Indeed, on one hand, the ECB incentivizes banks to grow eurozone lending by the TLTRO subsidized funding. On the other hand, most banking supervisors in the Eurozone worry about excessive credit growth and incentivize banks to reduce lending by setting contra-cyclical buffers. Moreover, the Basel Committee and its EU members announce a further tightening of capital rules, so called Basel IV, with a 24% average impact on EU banks, triggering an anticipation of credit slowdown.

Those contradictory injunctions disrupt the financing of the European economy, which, as we all know, is 70% based on bank finance. European banks suffer from low revenues linked to accommodative monetary policy, increased funding costs due to longer maturities and higher subordination, and excess capital and liquidity sterilized for regulatory purposes instead of being put at work for growth and job creation. Hence, their profitability is insufficient. It is therefore difficult for them to attract fresh capital. In order to reach the Basel IV related additional capital requirements, they will have to severely restrict their provision of credit.

EU Member States, well aware of this dilemma, had set a clear guidance to the EU members of the Basel Committee: Basel IV «would not be expected to result in a significant increase in the overall capital requirements for the banking sector, therefore not resulting in significant differences for specific >>>

>>> regions of the world» [Ecofin, 12th july 2016].

The balance of powers at the Basel table led to ignoring this mandate. Can we still today unlock this situation and relaunch growth while maintaining the high degree of financial stability now reached in Europe?

The only way forward is to accelerate the development of European capital markets, to mitigate the negative consequences of Basel IV on bank lending. It is thanks to highly developed capital markets that the US finance 75% of their economy. In the EU, this requires a decisive action and a major shift from recent trends:

a. Truly encourage securitization. The recent legislation is mostly driven by a desire to reduce risks in securitization transactions. This protective framework should be implemented in a flexible way to allow market development. Moreover, a framework to securitize home loans should be designed, with the sponsorship of a public institution with required expertise (the EIB?) to be the trusted third party that would give confidence to investors. Super-senior tranches of such high-quality home loans securitizations could play a role as « safe assets » in the EU.

"The only way forward is to accelerate the development of European capital markets."

\- PHILIPPE BORDENAVE

b. Stop the ongoing weakening of large European banks active in capital markets. The number of such banks has already decreased a lot, and the trend is to retrench from those activities. This trend should be seen as worrying by European authorities, in a context where Capital Markets are necessary to relaunch the economy, finance low risk assets and energy transition infrastructures. In particular, the "FRTB", which requires a complete overhaul of the surveillance tools to manage market risks, combined with a doubling of the capital charges, should not be made binding in Europe as long as it is not in the US. Otherwise, the US banks, which already have a 50% market share in the EU in these businesses, will soon possess all the keys to provide or deny access to markets to European corporates, financial institutions, and sovereigns.

As the new European agenda for 2019-2024 is to "increase its capacity to act autonomously to safeguard its interests", large international banks should be clearly identified as one of Europe's strategic sectors and a core element of European economic sovereignty. ●

Adam Farkas

Executive Director,
European Banking Authority (EBA)

Basel III output floor and EU IRB repair

After the great financial crisis, a general mistrust in the outcome of banks' own models ensued, as internal models were seen as sources of risk underestimation at the root of the financial turmoil. Institutions were believed to use IRB models to "optimise" their risk-weighted assets to achieve capital savings. In analysing the results of the first EU-wide stress test, the EBA flagged the wide dispersion in models' outcomes already in 2011 and launched various efforts to understand the drivers of RWA variability. The objective to "repair" IRB models a joint effort of the EBA and competent authorities to rebuild trust in internal models has been pursued via regulatory and supervisory initiatives.

The results of these initiatives are already evident, as rules on IRB models and their governance have been clarified by the EBA, and the benchmarking exercise helped competent authorities identify any material differences in RWA outcomes. Moreover, model improvements have been required in the euro area to address the deficiencies identified during TRIM reviews.

At the global level around the Basel Committee table, it is well known that regulators held different views on how to restore the credibility and robustness of RWA calculations while maintaining sufficient level of risk sensitivity in the capital requirement framework. The compromise was the introduction and calibration of an output floor – a limit to the outcome of internal models based on the standardised approach – that acknowledges the progress with the "bottom-up" repair of IRB, but also puts a backstop to the outcome of banks' internal models.

So far, shortcomings in internal models or in input data have been partly addressed via Pillar 2, for the part covering model risk, and deploying macroprudential measures, for instance for real estate exposures. Since the introduction of the output floor implies that some of these issues will be addressed under Pillar 1 requirements, the EBA decided to recommend that competent/designated authorities reconsider the calibration of Pillar 2 requirements and macroprudential buffers to prevent any double counting of requirements.

"Basel III implementation to contribute to restoring credibility of banks' internal models."

\- ADAM FARKAS

The output floor was not the European regulators preferred measure, but it is the result of a negotiation and its final calibration reflects EU concerns. It has been also instrumental to preserve global regulatory alignment and the possibility to use internal models. Its full implementation is now necessary to ensure the credibility of the EU >>>

>>> banking sector and a level playing field at international level.

The EBA has conducted an assessment of the impact of Basel III rules on the EU banking sector. The results were published in July. The analysis shows that, using conservative assumptions, the minimum capital required in the sample of banks participating in the exercise will increase and the output floor is responsible for a part of this increase.

The impact however is mostly driven by large and systemically important institutions, while it is limited for medium and small sized banks, as originally intended by the reform. The possible recalibration of Pillar 2 and macroprudential requirements, which would be decided case by case by the competent authorities, would partially mitigate the impact.

Overall, Basel III is a framework that aims to ensure stability of and global level-playing field in the financial system in the longer term. For this purpose, the EU should strive to adopt these rules in full without deviations. ●

Martin Merlin

Director, Bank and Insurance, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Balancing the objectives of Basel III

The overall aim of the final set of prudential reforms agreed upon at international level in response to the global financial crisis – referred to as the "finalisation of Basel III" – is to restore confidence in the calculation of risk-based capital requirements. Empirical studies have demonstrated excessive variability in risk-weighted assets which have given rise to doubts about the reliability and comparability of banks' internal models used to calculate capital requirements. At the same time, existing standardised approaches for calculating capital requirements have been found to lack sufficient risk sensitivity to provide a robust alternative to internal models.

The reform was to be carried out in a manner that would meet this aim without significantly increasing the overall capital requirements. And when the Basel Committee assessed the impact of the reform the results did indeed show that, from a global perspective, the average increase in capital requirements was not significant. However, as is always the case with averages, they do not tell the full story. A closer look at the impact per jurisdiction shows that for some jurisdictions the reforms would actually lead to a reduction in capital requirements, while in others, among which the EU, they would lead to important increases in capital requirements.

"It is essential that we faithfully implement the solutions agreed at international level."

- MARTIN MERLIN

The difference in the impact can to some extent be explained by the fact that the current prudential requirements in those jurisdictions that would see a decrease are stricter than those contained in the reforms. So, the actual difference in the impact will in part depend on the extent to which those jurisdictions will decide to adjust their current prudential approaches towards the new minimum required by the strengthened Basel III framework. From an EU perspective, the actual difference will also depend on the extent to which the outcomes of the ongoing work to strengthen internal models of EU banks, driven by the EBA and the ECB, are taken into account in the analysis. Since that work is expected to lead to a reduction in the excessive variability of capital ratios, it should inevitably reduce the overall impact of the Basel III reforms.

But, in the end, what will be the actual impact of the Basel reforms on EU banks? The Commission asked the EBA to answer this question. The EBA's preliminary analysis shows that, under very conservative assumptions, some EU banks would see large increases in their capital requirements. An important aspect of the work in the coming months will be to identify the drivers behind these increases, to determine whether those increase are justified in view of the actual risks faced by those banks, and to assess whether those increases will have disproportionate negative consequences for the EU economy.

If the analysis shows that certain specificities need to be accommodated, there is some room to do so. But this room is limited if one wants to preserve the integrity of the overall framework. As we in the EU want to maintain a multilateral approach to solving important global issues, it is essential that we faithfully implement the solutions agreed at international level. Only then can we expect that our international partners will do the same. ●

Karin Dohm

Global Head of Government & Regulatory Affairs and Group Structuring, Deutsche Bank AG

Consistency and flexibility – calibrating Basel III in Europe

The implementation of the G20's Pittsburgh agenda over the last ten years has enhanced the consistency of the international regulatory framework and has made t3he financial system more resilient and transparent.

Greater consistency does not mean though that rules are or should be completely identical across >>>

>>> every jurisdiction. Different markets, banking systems, legal and economic situations mean that greater alignment of regulatory outcomes has to be achieved with some flexibility to suit the local context.

This is especially true for Europe, where banks have historically made greater use of internal models. We in Europe believe that this leads to better risk management and better allocation of risk weights to exposures.

"Protecting Europe's funding model needs to be reflected in the transposition of the final Basel III package."

\- KARIN DOHM

This reliance on internal models means that European banks are more severely impacted by the Basel III reforms, which are designed to limit the use of internal models, through the introduction of an output floor and additional standardisation. The scale of this impact can be seen from a number of impact assessments: BCBS (plus 25%), EBA (plus 28%) and Bundesbank (plus 28%) - all confirm that European banks would be significantly impacted if they had to apply the proposed standardised approaches as input to an output floor calculation.

In Europe banks play a more vital role in financing the economy than compared to other jurisdictions. The EU banking sector provides 75% of corporate and 90% of household financing – more than twice the ratio in the US. Any significant change in capital calculations for credit risk are therefore expected to have a more direct impact on the European economic activity than for instance on the US economy.

For these reasons the implementation of Basel III changes to the credit risk frameworks must be calibrated very carefully in Europe, in order to avoid 'significant increases' in risk weights that could have damaging and unintended implications for the EU economy.

Protecting Europe's funding model needs to be reflected in the transposition of the final Basel III package. In order to do that policy makers should focus on calibration in the following areas:

- **Corporate credit exposures** - most EU corporates don't have an external rating, which penalises them when banks have to apply the standardised approach for the output floor. Risk weights could double or triple. This could be resolved by tailoring the framework for unrated corporate exposures and allow the use of the lower risk weight of 65% which is used in other jurisdictions for unrated corporates.
- **Corporate hedging** - activities are impacted by application of the standardised approach to calculate exposures to derivatives (SACCR). This standard is already overly conservative, but with the output floor capital requirements for Interest Rate, FX or Commodity derivatives could increase by 2.5 to 5 times. The BCBS should review the standard and as this will take time, Europe should set the multiplier, the so-called alpha factor at 1 to avoid unnecessary consequences, until the BCBS has updated the calibration.
- **Real estate** - the Basel framework assigns risk weights to real estate exposures (both residential and commercial) according to Loan-To-Value (LTV) bucketing, with progressively higher RWs. These LTVs are not representative of the LTVs applied in Europe. The LTV buckets are not aligned to European common LTV ranges and the RW assigned per LTV are excessively high and not justified by the good historic loss performance.

Targeted tailoring of these inputs into the calculation of the output floor is key, necessary to ensure funding for European corporates and helps to avoid disproportionate impacts on the risk weights of EU banks and the European economy. ●

Making the Banking Union effective

Robert Holzmann

Governor, Oesterreichische Nationalbank

Banking Union: how to overcome the existing fragmentation of the EU banking sector

The great financial crisis from 2008 onwards was not only a financial and a sovereign debt crisis, but in particular a banking crisis. One element to weaken the link between banks and their national sovereign in the Euro area, was the political agreement of 2013 to create a Banking Union. While its first two pillars, the SSM and the SRM have been established, the third pillar of the Banking Union, a common system for depositor protection – the European Deposit Insurance Scheme (EDIS) – still waits for a consensus on design and implementation.

A staggered approach seems to be the most pertinent to bridge the current impasse that prevails in the EDIS debate.

Both the non-implementation of EDIS, as well as a premature and ill designed implementation imply costs. Without EDIS, fragmentation of financial markets is likely to persist, resulting in higher costs of financial intermediation for households and companies alike. However, a poorly implemented EDIS with wrong incentives could easily increase moral hazard and thereby lead to unfair risk sharing with the danger of unwarranted cross-subsidization across countries and hence political tensions across the entire Banking Union.

Undeniably, substantial progress has been achieved on the risk reduction side over the last years including an ongoing shift to new business models with more sustainable lending practices. Risk reduction has also happened against the backdrop of a benign macro environment and discussions on the need to address structural elements (especially related to national insolvency regimes and the treatment of sovereign exposures) persist.

Liquidity provision is crucial for the trust in deposit guarantee systems. The currently proposed, yet controversial next step is the introduction of the first phase of EDIS, whereby national deposit guarantee schemes would have to deplete their own funds first, before they can receive liquidity through a loan from EDIS that has to be repaid afterwards. An alternative approach would be to directly introduce the fully-fledged European system of deposit guarantees, an insurance scheme funded with risk-based contributions at bank level without a layer of national pulling.

When it comes to a fully-fledged EDIS, harmonization of national insolvency regimes and the regulatory treatment of sovereign exposures to account for the home bias of Euro area banks are highly important issues.

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>>> Another often cited element when discussing the effectiveness of the Banking Union are regulatory barriers across countries. While the Banking Union has made significant progress in the harmonization of national options and discretions since its inception, achieving the right home-host balance remains a contentious issue. In fact, the home-host debate is closely related to the EDIS discussion - the protection of national depositors has been a strong argument for ring-fencing measures in the past. The latter bias would disappear under a genuine European deposit insurance scheme.

Allowing for the free flow of capital and liquidity within cross border banking groups would make the Banking Union more effective. However, it has to be ensured that these banks are not only multi-national alive, but also in death. While the SRM has achieved significant progress in this regard, the functioning of the current resolution regime for large cross border banking groups begs a number of questions which have not been fully addressed at this juncture – think of the SPE-implementation across borders in a time when MREL is just building up gradually. The issue of liquidity in resolution would be another case in point. Here too, a staggered approach focusing on a fully functioning resolution regime including the implementation of the Single Resolution Fund (SRF) backstop could lay the basis for future advances in the field of home host cooperation and thus render the Banking Union more effective.

The European banking sector is at the crossroads. Protracted profitability below the cost of equity, the challenge of technological change and digitalization, issues of overcapacity in a number of markets and a more challenging macro environment looking ahead make it all the more important that the regulatory framework operates smoothly in a non-distortionary way – progress in completing the Banking Union is therefore needed. This progress should however be stepwise avoiding misguided incentives. ●

Madis Müller

Governor, National Bank of Estonia (Eesti Pank)

Overcoming the fragmentation of the EU banking sector

In the year that we celebrated the 20th anniversary of the euro, we have to admit that the progress in financial integration, one of the criteria for joining the euro area and one of its goals, has not been as fast as we might have hoped. If anything, the banking sector has become even more fragmented in the years since the financial crisis. This leaves EU lenders unable to compete with bigger and more efficient global peers, which makes it worrying that the political momentum behind completing the banking union seems to be fading and that a considerable number of national rules hinder cross-border consolidation.

One of the stumbling blocks to completing the banking union is the weakness in the banking sector, which is demonstrated by the relatively low returns on capital and the length of time it has taken for banks to clean their balance sheets after the last crisis. In more recent years, the banks in most EU countries have managed to reduce considerably the share of non-performing loans (NPL) among their total stock. However, this progress has been held back by the chronically low profitability of the majority of EU banks and the still substantial stock of NPLs, which in turn reduces profitability. The revenue earned by banks has been too small to cover the losses incurred in the past 10 years. This gap is especially stark in the euro area, where, mainly because of overcapacity in the banking system, net interest income is smaller and the cost-to-income ratio is higher than for the banks in non-euro area countries. This suggests that the banks' resilience to >>>

>>> a macroeconomic downturn in the future may be limited, even if their capital ratios have improved in recent years. The key question here concerns not deficiencies in regulation but the sustainability of the business models of EU banks in an environment of overcapacity.

We have been building the banking union for five years and we still haven't agreed on the blueprint for its third pillar, common deposit insurance. Without this however, the incentive will be greater to use resolution tools for failing banks rather than to close them down. We have built up sizeable funds in the SRF for resolution, but at the same time many national deposit insurance schemes remain underfunded. There is an obvious need for a European deposit insurance system with ex-ante funding and decision-making at the EU level, as we have already agreed upon European-level supervision and resolution mechanisms. But it is also understandable that reaching an agreement on this requires all the member states to be comfortable that the relative risks in their banking systems have been brought to a comparable level. We need to work hard to get there as soon as possible.

Macroprudential supervision meanwhile should remain at the national level as a policy tool for mitigating country-specific risks. It is unfortunate then that the creation of a proper macroprudential toolbox in host countries is hampered by the fears of home countries about ring-fencing. Measures taken by macroprudential authorities are applied equally for local banks and for foreign subsidiaries. Several macroprudential policy instruments are in place but using them can sometimes be complicated. There are also several gaps in the toolbox, as more targeted measures would for example be warranted for addressing the cyclical risks of individual exposure categories like mortgage loans. Moreover, the current framework also lacks the tools it needs to mitigate the risks related to the expanding activities of non-bank financial intermediaries.

The Nordic banks have not only been more profitable but have also been regionally more integrated than the EU average. Some Nordic-Baltic banking groups have efficient cross-border branches in the region instead of subsidiaries. Having cross-border branches eliminates many of the home-host problems that are being debated among EU regulators. The preference for establishing subsidiaries may be a missed opportunity in financial market integration. Some of the energy we spend on arguing about whether regulation should apply at the solo or group level could be better spent on thinking about why banks are using subsidiaries instead of branches. ●

José Manuel González-Páramo

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

The Banking Union, as it stands, remains unfinished. What next?

Much work has been done in the European institutions over the last few years to create a single and centralized banking regulation, supervision and resolution framework to develop a credible Banking Union. The last milestone achieved at the beginning of the summer was the finalization of the risk reduction banking package (the so called CRD V) which marked an important step in lowering the risk of bank failures and ensuring public money will not be used to fund bailouts.

Despite these achievements, the Banking Union is far from complete and work remains to be done. An evidence of this is that the European banking market continues to be largely fragmented across national borders and that the Banking Union is failing to deliver the degree of financial integration expected in its early stages. Distrust among Member States lies at the root of this, resulting in barriers to the free flow of capital and liquidity across the EU, preventing the diversification of risk and the risk sharing and therefore introducing systemic weaknesses.

The 2019 elections of the European Parliament indicated a renewed interest in Europe among citizens, with the highest turnout in 20 years. The coming institutional cycle in the European Commission is expected to take >>>

>>> an ambitious pro-European approach. Thus, the new leaders of the European Union should be able to provide a fresh impetus to the Banking Union project, as the President of the European Commission said, this is "A Union that strives for more".

"Achievements in the Banking Union mark a significant milestone for Europe."

\- JOSÉ MANUEL GONZÁLEZ-PÁRAMO

To achieve these goals, it is important that legislators move to further economic and monetary union integration addressing reforms in three main fields. First, the development of a backstop for the Single Resolution Fund (SRF), the creation of a European Deposit Insurance Scheme (EDIS), a true Capital Markets Union with harmonized insolvency and tax regimes and a European safe asset would pave a fully operative Banking Union. Second, a single harmonized insolvency regime for banks managed by a single authority (SRB) and with a single creditor hierarchy would help to harmonize the European resolution framework. In addition, it is crucial to establish a funding in resolution mechanism with a robust and credible public backstop. The last regulatory field for reforms would be the reduction of regulatory fragmentation, so that EU banks' competitiveness is preserved, especially in view of the close finalization of Basel III.

Achievements in the Banking Union mark a significant milestone for Europe. Now it is high time that regulators finalize it in order to further underpin the credibility of the project. Besides, this it is only one step in a longer journey towards the future of Europe where fiscal, economic and institutional discussions are yet to come. The broader political and economic challenge for the EU is to reconcile its vision of economic integration with a sustainable framework to define and defend the European public interest through adequate rules and institutions. ●

Diederik van Wassenaer

Global Head Regulatory and International Affairs, ING

Cross-border banking and national impediments to free flow of funds

Economic prosperity grows when there is optimal allocation of funds. In the Eurozone the integration is under much pressure Member States use the flexibility in the regulatory framework to restrict intragroup cross-border free flow of funds. This reference to national discretion impacting free flow of funds covers aspects of liquidity, capital and the large exposure regime.

Proponents of a true banking union, amongst which ING, believe that the development of the SSM, SRM, SRB and EU recovery and resolution framework have made national arguments for ring-fencing capital and liquidity less appropriate than they were before and during the crisis. The EC also promoted this view as was reflected in the first CRR2 draft from 2016 which offered amendments that could ease cross-border flow of funds.

"To achieve a truly integrated Banking Union national discretions should be removed."

\- DIEDERIK VAN WASSENAER

But many host countries still see the need to protect shareholders, creditors and taxpayers in their countries by ring-fencing capital and liquidity using measures that exceed the prudential standards that were agreed upon at the global level. Their key argument so for is that the Banking Union is not yet complete because it lacks a fully integrated safety net including a single deposit guarantee scheme.

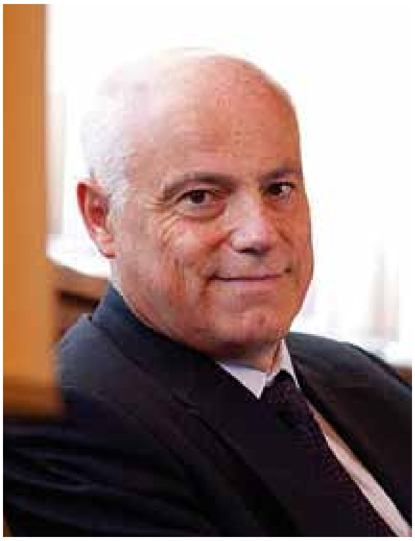
As a result, the post-crisis European banking landscape remains fragmented across national borders. While integration has recovered from the trough in 2011-12, most indicators of financial integration (including quantity-based ones, such as the share of cross-border loans, and price-based ones, such as the dispersion of rates between countries) have not recovered to pre-2008 levels.

For example, 83.6% of loans by Eurozone banks to households and businesses is lent in the home country. Only 6.1% is lent to households and businesses on a cross-border basis elsewhere in the Eurozone. Lending across borders within the Eurozone did increase from 2.3% in 1997 to 5.2% in mid- 2008, but progress has come to a virtual standstill since then. In the deposit taking market, a retrenchment to home markets can be observed since 2008. In mid-2008, 47.1% of bank deposits were collected domestically, and another 21.1% from elsewhere in the Eurozone. Today, 54.1% is collected domestically, while the share from elsewhere in the Eurozone has declined to 19.2%.

One could argue that before 2008, there was too much "wrong" financial integration within the Eurozone: the system seemed stable but wasn't. But we can be pretty sure that today, we have too little of the "right", stability-increasing, financial integration. Cross-border banking groups are not able to efficiently allocate internal capital and liquidity as they face limitations that block resources from flowing to where they are most in demand from businesses and households. This leaves them unable to compete with bigger and more efficient global peers. It could also explain the absence of major European bank mergers in the last decade, as well as the increasingly excessive exposure of European banks to home countries (approx. 60%).

Therefore, to achieve a truly integrated Banking Union, in parallel to building EDIS, national discretions should be removed to the extent that they impede the efficient allocation of fund. ●

Improving the global competitiveness of the EU financial sector



José Manuel Campa Fernández

Chairperson, European Banking Authority (EBA)

Shakeout: a way out of the profitability trap?

EU banks' profitability has lagged behind that of US banks for years. Whereas the return on equity (RoE) stood at 6.5% for EU banks in 2018, it was 11.9% for their US peers (EBA Risk Dashboard, US Fed). This difference cannot be attributed to a single reason. It is striking that in the US the consolidation of the banking sector has moved much faster than in the EU. Also, the number of exiting institutions has been bigger in the US compared to the EU. This higher rate of restructuring occurs both between large and small institutions. As a result, in the US the number of credit institutions has fallen by 30% since 2008, while the decrease in the EU was just 20% (ECB, US Fed).

Furthermore, comparing EU banks with their US peers, the cost to income ratio (CIR) for the former is on average 66.3% versus 62.8% for the latter. These similar ratios underscore however different underlying trends. US banks have decreased their CIR from 71.8% in 2014 whereas it has increased for EU banks since then from 62.9% (EBA Risk Dashboard, US Fed). The poor peformance of the CIR is mostly explained by the difficulty of banks to adjust operating expenses in line with the negative evolution of their income in a challenging environment.

> *"Shakeout through consolidation, exit and orderly restructuring might improve banks' profitability."*
>
> \- JOSÉ MANUEL CAMPA FERNÁNDEZ

The EBA's risk assessment questionnaire (RAQ) shows that banks are aware of this challenge. Many of the respondents pointed out that they plan to reduce overhead and staff costs and to invest in automatisation and digitisation. Differences in profitability and cost structures between EU and US banks are similarly reflected in investor perceptions of them. More than 80% of US banks were trading at a price to book multiple (PtB) above 1 in July this year, compared to less than 30% of EU/EEA banks. At the beginning of 2008, the PtB was above 1 for around 90% of the banks in both jurisdictions.

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>>> One should not conclude that consolidation is a goal in itself nor that consolidation as such drives profitability up. However, through creative destruction, an active process by which more efficient institutions continue to gain market share, while weaker, less efficient institutions exit the market will be one contribution to improve profitability. At the same time such consolidation could potentially benefit from operating synergies allowing the remaining firms to provide better services while enhancing their profitability.

Consolidation along national borders appears more appealing than cross-border consolidation within the EU. Overlaps in staff and branch networks of banks operating in different countries are more limited and so would be the reduction of operating expenses from cross-border vs. domestic mergers. Differences in tax and insolvency regimes also make cross-border transactions more complex. Additionally, different supervisory practices and national application of macroprudential measures as well as the ring-fencing of capital and liquidity of subsidiaries are perceived as an obstacle to cross-border M&As, according to a stocktake run by the EBA.

Regulation should not pose additional undue obstacles but should ensure that the basis for healthy competition exists. This should include adequate exits from weak banks with unsustainable business models, effective competition, and the ability for incumbents and newcomers to adopt new technologies that provide better services while ensuring financial stability.

The EU regulatory framework can help in this area by finalizing the effective implementation of the resolution framework to ensure orderly exits from banks happen. Effective supervision and harmonisation around the setting of capital buffers, like the systemic risk buffer and the buffer for other systemically important institutions, need to assure that no unnecessary burdens exist. The setting up of a fully-fledged European Deposit Insurance Scheme in the Banking Union would also reduce the reluctance of regulators to exercise national waivers on liquidity and capital. Finally, regulation needs to be put in place to allow for the introduction of new technologies and new players in the industry that foster competition while preserving financial stability. ●

Elke König

Chair, Single Resolution Board (SRB)

European banking – there is strength in diversity

If the European Union's motto is 'United in Diversity', then perhaps the Banking Union's motto should be something along the lines of 'Strength in Diversity'.

The Banking Union is a diverse mosaic of small and complex financial institutions. In some states, the banking market is dominated by foreign operators. In others it is small banks that have the lion's share of the market. And in others still, the market is largely made up of just a few large banks. The structure of individual markets within the Banking Union varies hugely reflecting not least different traditional development. This diversity in structures is not necessarily a bad thing. For example, a large bank poses a serious risk to financial stability if it cannot be made resolvable; smaller banks may not have the economies of scale to be viable in the long-term. There are pros and cons to each model – the important thing from a financial stability point of view is that small banks and big banks have sustainable business models. Regulation and supervision have to cope with the variety of business models. Just to name two points: Regulation has to be proportionate, there is no "one size fits all" and in a single market the diversity in national rules has to be overcome to facilitate mergers and acquisitions.

A good regulatory framework can facilitate this, but of course, the role of the regulator is not to ensure every bank can make a profit. Every bank, big and small, must be in >>>

>>> a position to comply with regulatory standards and bear the cost that is inherent in the safety net that regulation provides to society. That said, the regulatory landscape should facilitate as much as possible the natural behavior of a free market in the European banking sector. The challenge for regulation has always been to recognize that one size does not fit all, while also balancing the need for a level-playing field.

However, it is not just about regulation for the financial industry. A fully functioning Capital Markets Union, which allowed for investment to flow easily across the euro area, is much needed and would do much to ensure that banks have an enlarged "home market for capitalization and investment". A proper, fully functioning capital markets union in Europe would allow for greater integration of investment, allowing for the possibility of more consolidation, creating banks ready to operate right across the 19 Eurozone countries. This would introduce competition for the consumer, but it would also diversify the banking market within many member states, which would be a good thing. Unlike the Banking Union however, the Capital Markets Union is more of a concept, and idea or a notion, rather than a concrete legislative framework.

"Diversity in structures is not necessarily a bad thing."

- ELKE KÖNIG

There is also work to be done in harmonising insolvency procedures. In the Banking Union itself we have 19 different insolvency procedures, so banks and their investors will have to contend with and learn about many different legal systems just to invest in a market that is outside their home member state. The single market has still a way to go.

It is also true that completing the Banking Union and having all European deposits protected at EU level, in a harmonized way, would promote stability and confidence if and when the next crisis strikes.

There probably is a need for consolidation in the European banking market in order to remove overcapacity and ensure greater profitability overall. Some banks will simply have to exit the market; mergers and acquisitions can play a significant role in consolidation. In any case, a completed Banking Union and a full Capital Markets Union would be a solid framework so that the markets can be left to play their part, strengthening the sector going forward and thus helping to promote financial stability. ●

Michael West

Managing Director, Global Ratings & Research, Moody's Investors Service

EU financial sector held back by low growth, interest rates and fragmented markets

The scale and profitability of many EU financial institutions falls short of that of US counterparts. Lower interest rates and slower economic growth in the EU contribute to this shortfall. Between 2010 and 2018, US GDP growth exceeded EU growth by 0.7% annually, on average. In the EU, interest rates remain close to zero, while in the US they hover between 2.25% and 2.5%. Lower growth and interest rates, along with the bloc's fragmented markets, will hold back profitability and scale for banks and asset managers.

There is no true single market for the EU: instead, it is segmented along national lines and cost inefficiencies plague some domestic banking systems. On the positive side, banks' stocks of non-performing loans are falling, longer term assets are building, and capital buffers are wider. Still, weaker growth and low interest rates will constrain bank profitability and improving cost efficiency remains a key challenge. Large EU banks still lack the necessary scale to compete with global banks, and they will soon face significant challenges from big tech and fintech firms. While bank digital strategies provide revenue and pricing >>>

>>> opportunities, benefits have yet to fully materialize.

EU asset managers similarly lack scale compared with their US counterparts. The 10 largest US asset management firms manage €22.1 trillion or 30% of global assets under management (AUM), while their 10-largest EU peers manage only €7.9 trillion or around 10% of global AUM. Smaller EU firms are struggling to sustain high margins amid long-term trends towards lower fees and higher costs.

The fragmented EU fund market – which will be exacerbated by Brexit – also hampers competitiveness against US peers, which benefit from the large single market in the US. US asset managers are leveraging their global positions and scale (notably those in the "trillion-dollar club") to compete in the European markets. Consolidation is under way in the EU, and EU-wide rules allow funds to conduct business across EU borders. Nevertheless, legal and political obstacles to a single EU market have yet to be fully addressed.

"Large EU banks still lack the necessary scale to compete with global banks."

\- MICHAEL WEST

National boundaries that divide the EU market are less of an issue for insurers. The entire insurance industry is fragmented globally. EU firms are largely focused on the EU despite the EU having a few global players in reinsurance, and in commercial, property and casualty. Prudential rules are also fragmented; Solvency II rules apply only in the EU. Profitability levels have been similar for European and US property and casualty insurers for the last 10 years, although the EU's much lower interest rates have curtailed the profits of EU life insurers.

A true single market for the EU across product lines – from retail banking and asset management, to debt and equity issuance and advisory services – is key to addressing many industry headwinds and crucial in our view to improving credit quality. ●

Philippe Heim

Deputy Chief Executive Officer,
Société Générale

A wake-up call for improving EU Banks' competitiveness

Banks are undoubtedly better equipped to face adverse shocks today than they were at the eve of the last financial crisis. Euro area banks kept providing credit to the real economy while implementing a broad set of new regulatory requirements. They have accumulated €175.6bn of CET1 capital since Q4.2014 and accelerated the clean-up of their balance sheets through a significant NPL decrease. Yet, Euro area banks' profitability remains persistently low, especially when compared to their US counterparts. Euro area banks' return on equity stood at 8.7% in 2018, lower than the level observed in 2007, while US banks reached 11.2% in 2018, recovering their 2007 level.

Since the crisis, the euro area took almost a full decade to return to its pre-crisis GDP per capita, while the US recovered in near half that time. The US economy's competitiveness was further boosted by the 2017 tax reform. Aging demographic trends are also a driver of lower European growth, and negative central bank deposit rates combined with high excess reserves cost euro area banks around €7.5bn per year.

"Europe needs competition between a smaller number of strong banks, not a larger number of weak banks."

\- PHILIPPE HEIM

In this context, it is challenging for Euro area banks to absorb the high costs stemming from digital transformation and regulatory compliance burdens. The diverging regulatory approach between the EU and the US - in particular MiFID and GDPR - and the difficult ramp-up of the Banking Union, represent key differentiating factors which favour US banks.

In reaction, several challenges must be considered to strengthen EU banks' competitiveness:

- European policy-makers should recognize the key role of banks in financing growth and prosperity but also in supporting energy transition investments. Banks are instrumental in the fight against financial crime and money laundering. The resilience and profitability of EU banks are both prerequisite to allow them to properly accomplish their missions.
- A fair and pragmatic transposition of the Basel III agreement is key to ensure EU banks' competitiveness. Otherwise, it could jeopardize EU banks' business models, notably by widening the EU/US gap over market activities. This is at odds with calls made for speeding up the CMU.
- Finalizing the EU's Capital Markets, Banking and Monetary Union is vital, especially in the context of Brexit. A more concentrated EU banking system would ease cross borders operations. Strengthening the Euro as an international currency would also ensure a greater financing autonomy by making EU banks less vulnerable to external shocks.
- It is now time to reap the benefits from the Banking Union. Completing its third pillar, an EU-wide deposit insurance system, would be decisive. But it makes no sense to have a EDIS if liquidity and capital persistently remain fragmented along domestic lines. Hence, we should first finalize its two first pillars.

Once all these issues are addressed, pan-European groups can emerge, thus reaching the necessary critical mass to improve European banks' position in the international competition.

Europe needs competition between a smaller number of strong banks, not a larger number of weak banks. ●

Luigi Federico Signorini

Deputy Governor, Banca d'Italia

Weak bank profitability in Europe: one problem, but no single solution

European banks are still recovering from the consequences of the global financial crisis and the sovereign debt crisis. Legacy problems are less of a concern today, as banks in countries that were hit harder by the crisis have come a long way in cleaning their balance sheets. But bank profitability is still far from pre-crisis levels: in 2018 the average return on equity (ROE) of EU banks was 6 per cent, well below the level of 2007 (10 per cent), and will likely remain so for some time.

Although the low interest rate environment is commonly blamed as the main factor preventing banks from returning to a double-digit ROE, there is no convincing evidence that low interest rates per se are the culprit of weak profitability. The significant heterogeneity in performance observed across EU countries and banks suggests that there is no single explanation.

"Understanding heterogeneities of weak profitability is key for devising improvement strategies."

- LUIGI FEDERICO SIGNORINI

Cyclical conditions within Europe are not uniform and banks, with few exceptions, concentrate most of their business in one or few economies; some of the heterogeneity is therefore the result of different national output dynamics, real estate and financial cycles. For Italian banks we estimate that in 2018 roughly one third of the gap between realized ROE and a 10 per cent target – a level that analysts and banks themselves deem necessary to cover the cost of equity – depended on the weak macroeconomic environment.

Second, European banks' business models differ in their sensitiveness to macroeconomic conditions, and face somewhat different structural challenges. For example, banks engaging primarily in lending are more sensitive to the domestic business cycle than those that are more involved in investment banking and trading activities. With respect to vulnerability to structural changes, institutions that focus on serving retail clients and on traditional credit intermediation face challenges due to the developments in technology that threaten their comparative advantage in exploiting soft information and physical proximity to clients. Complex universal banks are instead struggling mainly because of the fundamental changes in capital and liquidity requirements and in the global financial industry (e.g. margins squeeze on exchange traded products previously traded OTC).

Specific external conditions also influence the pace at which banks are adjusting their business models to the new competitive landscape. Many banks have downsized their physical networks and increased cost efficiency, but opportunities for fully exploiting technology are constrained by the unequal diffusion across countries of digital services among consumers and firms. In some countries legacy problems have absorbed resources at the expense of business innovation.

Consolidation can be a path to achieve greater overall efficiency but retail markets in Europe are not integrated yet, thus most benefits would be generated by the absorption of excess capacity at the domestic level rather than by the exploitation of returns from scaling up to a larger market. Achieving sustainable profitability requires not only cost cutting but adopting innovative business strategies, and further adjustments in the way banks perform their intermediation functions, leveraging on their ability to bundle credit provision with other products and services. ●

LATEST REGULATORY UPDATE

Background notes on recent regulatory developments
and macroeconomic trends impacting the EU financial sector
written by the Eurofi Secretariat

New trends in the Nordic - Baltic region

Sirpa Pietikäinen

MEP, Committee on Economic and Monetary Affairs, European Parliament

Opportunities and challenges in the financial services agenda - Nordic perspective

Entering a new five-year term is a right moment to look at where the previous reforms landed. Most regulatory priorities for the Nordic region are best solved at EU level. Key trends such as digitalisation and sustainable transformation represent areas where the Nordic-Baltic region can lead the way.

European capital markets continue to have a national bias. While there are more funds in the EU, the size of the market remains smaller than in the US. One of the first actions should be to launch a CMU 2.0 to continue measures to deepen European capital markets.

A typical element of European, and Nordic, financial markets continues to be a reliance on bank funding. Despite efforts taken in the past legislature, Europe lacks integrated cross-border venture capital funds and business angles to ensure innovative European start-ups and non-listed companies access much-needed risk financing to grow endogenously.

> *"The Nordic-Baltic region has the potential to lead in digital and sustainable transformation."*
>
> \- SIRPA PIETIKÄINEN

In global competition, efforts are needed to remove remaining obstacles to cross-border investment funds. Diversification of financing and access to different investment products will grow of importance as European citizens look for ways to invest and save for old age. This will be particularly urgent in Nordic-Baltic societies preparing for a demographic change in the near future.

A high priority should be taking forward the reforms to deepen the Economic and Monetary Union and to complete the Banking Union. The marching order should be risk reduction before risk sharing. The doom loop between bank risk and sovereign risk that still exists in some Member States, such as Italy, needs to be solved first. FinTech, artificial intelligence and distributed ledger technology are bringing households and businesses with new choice of payment and investment tools. While emergence of innovation, such as crowdfunding, virtual currencies and new

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>>> payment systems needs to be supported, the ultimate regulatory approach should be one of technology-neutrality. A similar activity, service or a product warrants to be regulated to the same extent regardless of the platform or technology through which it is being offered. Same applies to customer protection.

Digital innovation, such as open banking and real-time payments, is making accessing and using financial services easier and speedier. At the same time, it also leaves us vulnerable to new, hybrid risks. While digitalisation facilitates collection and processing of data and creates opportunities for more standardized Know Your Customer (KYC), Anti-Money-Laundering (AML) and Terrorist Financing (TF) measures, it raises questions regarding cyber security, systemic risk and customer protection. The Nordic region has been in the forefront of a dialogue on cyber resilience in terms of cooperation between financial institutions and supervisors.

Sustainable finance is entering into the mainstream of the financial system. By changing the incentives of market actors, it is bringing about a transformative reform into the real economy and underlying business models. At the core of the change can only be full transparency of risks, environmental impact, and opportunities that allows markets themselves bring forward the transition to a low-carbon, circular economy. In the next five-year mandate, sustainability indicators will be a systematic part of future revision of financial regulation across sectors.

Measures targeted to financial intermediaries, such as disclosure and due diligence rules, consultation of end-investor preferences, or transparency of benchmark methodologies, will not suffice alone. They need to be combined with modernisation of corporate reporting rules to ensure standardised and meaningful data based on audited, integrated annual management reports. In the coming years, key regulatory questions will surround on the issue of access and openness of sustainability data, supervision of standards, and liability of reporting.

Common approach to innovation and risks, sharing of best practise and effective cross-border supervision are the basis for a level playing field and integrated markets to bring the European financial market to its full potential. ●

Liga Kļaviņa

Deputy State Secretary on Financial Policy, Ministry of Finance of the Republic of Latvia

Nordic-Baltic financial sector linkages and challenges

The combined Nordic-Baltic financial sector is the fifth largest in Europe. Historically the Nordic financial groups played an important role in the process of Baltic region financial sector integration. Large Nordic financial groups in the Baltic region created financial institutions that became of systemic importance in different countries and sectors. Today the key word of the Nordic Baltic region is integration – since the region is characterized by tight trade and financial ties within itself. The Nordic banking groups have extended the concept of the home market well beyond their country`s borders. Nordic parent banks continued to provide liquidity to their Baltic affiliates during the deepest crises in the Baltic economies.

"Today the key word of the Nordic Baltic region is integration."

- LIGA KĻAVIŅA

Today the Baltic financial sector shares the common priorities and challenges within the region:

- **Digital transformation.** The Nordic-Baltic financial sector is fully committed to continue its digital transformation. The sectors strong traditions for collaboration, combined with consumer confidence and integration with the public sector`s data and registries, have been key for the digital transformation of the Nordic Baltic countries. >>>

- **Sustainable finance.** The Nordic - Baltic governments and societies have high commitment to the objective of more sustainable economy. The financial sector of the region is actively engaged in the process of transition to a green and sustainable economy in Europe, to ensure that the sector is an integral contributor and participant in this transition, actively discussing challenges and using opportunities created by the transition. For several years we have seen growth in investment products that recognize and promote environmental and social aspects.
- **Fight against money laundering and terrorism financing.** A high level of confidence in the financial system is vital to the financial sector. Regrettably, the recent serious incidents in several European banks underline the magnitude of the problem of serious financial crime for the public and private sectors. The Nordic - Baltic region has shown leadership at the European and international level to promote reforms aimed at preventing the use of financial institutions for money laundering and terrorism financing and implementing needed reforms in their financial sector.
- **Building an effective Capital Markets Union.** The Nordic-Baltic countries support the continued development of the EU capital markets as a key element in strengthening the Single Market, diversifying financing means and investment opportunities. It also helps to make the EU more resilient to shocks reducing the dependency of bank intermediation. The Baltic States have committed to create a pan-Baltic capital market with harmonization of capital market regulations and dismantling of investment barriers. The initiative will overcome constrains the Baltic States often face due to their limited individual size. ●

Erik Ekman

Head of Commercial & Business Banking, Acting Head of Group Business Risk Management, Nordea Bank Abp

Opportunities and challenges in the Nordic financial services sector

The Nordic region has a longstanding high level of integration. The level of intra-Nordic trade is significant and large banks have activities across the Nordic-Baltic region. Within the countries there is a long history of cooperation across banks to make use of economies of scale and positive network externalities.

Now cooperation is moving to the Nordic level. Six Nordic banks are working on P27, the worlds' first cross-border payment infrastructure for multiple currencies. P27 will simplify for corporates and households in the Nordic region to make payments across the region and increase competition in trade and the banking sector. Moreover, Nordic banks have created a joint venture, KYC (Know Your Customer) utility to facilitate compliance with anti-money laundering and counter-terrorist financing regulation.

"Regulatory harmonisation would support integration and help addressing challenges for our societies."

\- ERIK EKMAN

Digitalisation is present in all activities in the Nordic societies. The quick reduction in demand for cash services is driven by demands by customers for easy, accessible financial services available anywhere, anytime. Digital financial services encompass most financial services from payments and loan applications to financial advice. Visits to bank branches are replaced with online meetings and the use of AI for customers interactions and financial advice. Many Nordic customers prefer to use the mobile bank app and demand for real-time payments has led to a quick adoption of mobile payments.

Further harmonisation of regulation would enable more integration, but also help addressing challenges for our societies. The risks associated with financial crime were in the past underestimated by the financial sector. Significant amounts of efforts and resources have been spent to enhance banks' capabilities to detect financial crime. Reports of suspicious transactions to the Financial Intelligence Units have increased significantly, but the level of convictions and assets claimed has not increased to the same extent. From a societal perspective there is a need to further strengthen collaboration between authorities and banks in order to ensure a more efficient use of both private and public resources. Financial crime often takes place across national borders, therefore cooperation between authorities in different jurisdictions should be strengthened.

Nordic banks have supported the efforts to strengthen the resilience of the banking sector by requiring better quality and higher levels of capital. Capital requirements should continue to be risk-sensitive in order to set correct incentives for the financial industry and to ensure that well-managed corporates are not punished. This is particularly important for Nordic banks which have a relatively large share of low-risk assets on their balance sheets. Moreover, a more similar interpretation and implementation by regulators would lead to competition on more equal terms between banks.

Another challenge is the increasing presence of non-banks in the Nordic financial services sector. The following questions need to be answered:

- Is this development driven by efficiency gains or by cost advantage of lighter regulation?
- Will this lead to a more diverse and competitive financial system, or to new forms of concentration, market power and systemic importance? ●

Lauri Rosendahl

President, Nasdaq Nordics
and Nasdaq Stockholm

Cross-ecosystem dialogue is key to growth in the Nordics and Baltics

As a hub of the Nordic and Baltic financial market ecosystem, Nasdaq is committed to maintaining a central role in the ever-ongoing dialogue for development of the financial market ecosystems in the region. We continue to do this by building on local market strengths and shared best practices towards gradual integration and expansion.

The unique characteristics of the financial markets in Northern Europe are founded on a mix of cross-border integration and local ecosystems that have been allowed to develop according to local conditions and requirements. Such a diverse landscape of relatively small, successful and unique economies do need some common ground to thrive, something which Nasdaq is able to provide and develop.

Nasdaq enables market participants to access seven national equity and fixed income markets, all using the same technology, combined with our derivatives clearing house that serves the whole region. Another example of integration is the launch of the pan-Baltic market, including the combination of the three Baltic CSDs into one.

Over the last five years, Nasdaq Nordics has seen an average of about 100 new listings yearly, of which ca 80% are small caps. With its deep liquidity pool and great mix of different types of investors, the Swedish market has become the leading example of how to support companies in earlier stages of growth. Notably, a high level of participation from retail investors contributes to the success. Multiple factors explain this, including a relatively mature equity investment culture, a pension system allowing individuals to choose capital allocation and also a high degree of digitalization, which has enabled retail investors direct market access via online brokers.

Across the region, Nasdaq has adapted First North, the growth market MTFs for SMEs, to the needs of not only smaller companies, but also smaller investors. For instance, for issuances too small to require a prospectus, issuers instead deliver a standardized 'company description', a cost-efficient document which is easy for investors to digest and compare. Nasdaq also produces free-of-charge 'company fact sheets', with data points for every single listed company on the Nordic and Baltic markets, providing a basis for visibility, comparability and further research.

"Founded on a mix of cross-border integration and local ecosystems."

\- LAURI ROSENDAHL

What is important to underline however, is that one size does not fit all. Local ecosystems need to be adapted to the needs of especially early stage growth companies. Hence, in addition to its European headquarters in Stockholm, Sweden, Nasdaq also has significant presence in all the countries where it operates markets, as well as in key financial hubs such as London.

I truly believe that the success of our well-integrated, safe, transparent and liquid markets for both small and large investors, domestic and foreign, and for issuers, could serve as an inspiration for others. In the coming years, Nasdaq will launch a number of initiatives that go beyond our traditional home markets in the Nordics and Baltics. Our ambition is to expand our regional footprint and become a truly European financial services provider, leveraging the success of the financially integrated, yet very different, regional markets, in which Nasdaq's European presence is founded. ●

Piia-Noora Kauppi

Managing Director,
Finance Finland (FFI)

New trends in the Nordic-Baltic financial services sector

The Nordic-Baltic financial markets, serving almost 33 million citizens, are at the forefront of rapid modernisation. Northern Europe has the same on-going main trends as the rest of the finance industry but is also leading the way in some developments.

Regional integration: across borders is developing rapidly, and cross-border projects are underway in for example payments infrastructure and the sharing of know-your-customer (KYC) data. Project P27 is to establish the world's first integrated region for domestic and cross-border payments in multiple currencies through an open-access, common infrastructure. This should enable state-of-the-art payment experiences to customers across the Nordics. With KYC, the banks' top priority has been to develop a Nordic platform with standardized processes for handling KYC data. The objective is to >>>

>>> simplify the KYC processes for corporate customers while strengthening financial crime prevention.

Building common digital infrastructure has a natural way of enhancing cooperation. The strong traditions of digital economy and mutual collaboration, combined with consumer confidence and the sector's integration with public sector data and registries, have been key for the digital transformation of our region.

Collaboration between the traditional financial sector and new fintech is important for us to succeed in the global financial market competition. Caution should also be kept in mind: the many new digital services also increase the risk of cyber-attacks against the financial sector and businesses in general. The Nordic-Baltic financial sector invests heavily in cybersecurity and engages in mutual information exchange within the limits of the current legal framework.

The Nordic-Baltic financial sector seeks to contribute to the EU's driving force for sustainable finance. We feel that the financial sector plays a key part in the decisive European effort to transition to low carbon economy, and we aim to be actively involved in the process.

Investment products that recognise and promote environmental and social aspects have been growing for several years already. Professional asset managers who offer these products play an important part in supporting sustainable economic growth, but the direction of development is ultimately driven by the investors. A similar beneficial trend in the development of sustainable products should ultimately spread to the entire financial sector.

"The Nordic-Baltic financial sector plays a key part in the transition to low-carbon economy."

- PIIA-NOORA KAUPPI

The Nordic-Baltic financial sector has looked into ways of financing the welfare of our ageing population and managing the rising age-related expenses. Common to our region is broad public support for publicly financed welfare with elements of market solutions. We want care services, and especially long term-care, to be more open for market solutions, and private insurance to be a more pronounced complement to the publicly financed welfare.

All in all, the strategic agenda for the Nordic-Baltic finance industry is driven by the quest to constantly improve the customer experience and the ability of the sector to bring benefits to the society. ●

Dan Sørensen

Member of the Executive Board, Nykredit Bank

Basel III finalisation will be a major challenge for the Danish financial system

From an outsider's perspective, the last 18 months must have seemed like rather turbulent times in the Danish financial sector due to the AML issues discovered in a large Danish bank. But if we look beyond this very specific issue, it emerges that Danish credit institutions recently have come under much stronger national AML legislation while the Danish FSA has been further empowered in this area in terms of both funding and enforcement tools. Denmark has come far on AML in a very short time and is maybe now even ahead of the curve in terms of stronger regulation and possible future sanctions. Going forward it will be interesting to see the effects of these recent developments as they mature and are fully implemented.

Looking forward, the main issue for the Danish financial sector will therefore rather be Basel III Finalisation. European banks have a much larger share of low-risk lending on their balance sheets compared to e.g. US banks, something that will be severely punished by the new 72.5% output floor which will greatly increase REA levels and thus capital requirements in spite of no clear risk reduction effects. Danish mortgage lending is especially low risk and therefore even more susceptible to this. Danish credit institutions will need another EUR 10bn in capital – corresponding to a 34% increase in capital requirements. In spite of this, EBA has made clear that they recommend a full implementation of the Basel III Final standard with no accommodations to the European context and applying the output floor to the full stack of European capital requirements. This seems ill advised. There is no clear reason why the European financial sector – and thereby the real economy – should be treated so harshly in spite of the lower risk on balance sheets. A better solution could be implementing the output floor as a parallel backstop requirement based on the Basel capital requirements only rather than the full stack of European requirements. Such an approach would even be closer to the letter in the Basel standard and would retain the incentives for real risk management in European low risk lending.

"European banks will be severely punished by the new 72,5% output floor."

- DAN SØRENSEN

Another big challenge is sustainable finance. It is clear that the financial sector must participate in the sustainable transformation of the economy. Albeit, in order to achieve meaningful transitioning it is necessary to develop common terms of reference for sustainability risk management within the existing risk management framework. The taxonomy proposed by the Commission TEG is a major step forward. However, economics of scale is key for liquidity in the large Danish covered bonds market. A 'shades of green' approach rather than a binary focus on either 'brown' or 'green' activities seems more suitable for fueling the transition. This way, splitting the cover pool into smaller parts could be avoided. As a result, pools of loans to different activities could have different shades of green depending on the contribution to a more sustainable development. ●

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IV. FINANCIAL STABILITY AND SAFETY

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 the activities that expose insurers to substantial macroeconomic or liquidity risk still requires work.

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 the detection and supervision of ML / TF and the coordination of these activities at the EU level is also an urgent issue.

Content

Toolbox for emerging risks

Francesco Mazzaferro

Head of the ESRB Secretariat, European Central Bank (ECB)

Identifying and addressing financial stability risks beyond the banking sector

The post-crisis financial reforms are providing granular data that enable policymakers to better identify emerging risks. This includes data on derivatives markets, securities financing transactions, and balance sheet items of banks and insurers. For example, the data on derivatives transactions reported under the European Market Infrastructure Regulation (EMIR) consist of around one hundred million observations per day.

Authorities are developing the infrastructure to analyse these data, but poor data quality is hampering progress. Investment in technology; collaboration between national authorities, the European Securities and Markets Authority (ESMA), the European Central Bank (ECB) and the European Systemic Risk Board (ESRB); and standardisation mean that EMIR data can now be prepared in seconds. However, more needs to be done to improve data quality. For instance, as reported in the financial press, data for February 2019 show that only 40% of swaps trades reported under EMIR are properly matched. Market participants only see their own transactions; if data quality was better authorities could publish more aggregate statistics on market structure and activity. Therefore, poor data quality not only impedes risk monitoring by authorities, but also reduces market transparency to the detriment of the financial industry.

> *"There is a lack of tools to address risks, particularly beyond the banking sector."*
>
> \- FRANCESCO MAZZAFERRO

The ability to connect datasets will further enhance cross-financial sector analysis. This kind of analysis has already been carried out, with one example being the ESRB's 2016 report on macroprudential policy issues arising from low interest rates and structural changes in the EU financial system. As the ability to connect market data with balance sheet items increases, cross-financial sector analysis will become more detailed. Eventually authorities will be able to trace how shocks travel through the financial system with much greater precision than is currently possible. This will reveal fault lines in the financial system that would otherwise have remained hidden.

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>>> Risk monitoring and identification is improving, but there is a lack of tools to address risks, particularly beyond the banking sector. The non-bank financial sector has grown a lot in recent years and, as the capital markets union progresses, the role of non-bank finance is expected to increase further. The evolution of the macroprudential toolkit has not kept up with these developments. Indeed, macroprudential tools in the EU are, for the most part, aimed at the banking sector, which leaves a gap if risks to financial stability migrate to markets or non-bank financial institutions and/or new risks emerge beyond the banking sector.

The ESRB plays an active role in developing a broader set of tools and issued a recommendation in 2018 – before the recent events affecting some investment funds – to help address risks to financial stability that could arise from excessive leverage and/or liquidity mismatches in investment funds. Last year the ESRB, alongside the EIOPA, set out the types of tools that would help mitigate financial stability risks related to the insurance sector.

The ESRB is also contributing to the development of the policy framework. The experience with macroprudential policies is still at an early stage; for example, while the concept of a monetary policy stance is well established, there is no universally accepted equivalent for financial stability. To help address this gap, the ESRB published a report in April that sets out one approach to a framework for a common macroprudential stance. This framework compares systemic risk with the level of resilience in the system to arrive at a measure of the residual level of systemic risk. If this level is higher than the level accepted by the policymaker, the macroprudential stance is loose; if it is lower, the stance is tight; and if it is the same, the stance is neutral.

In summary, authorities' ability to monitor, identify and prevent or mitigate risks to financial stability has been significantly enhanced by the post-crisis reforms. However, as evidenced by the recent discussion on crypto-currencies such as Libra, the financial system is continuously evolving. Microprudential and macroprudential frameworks need to keep pace. ●

Dino Falaschetti

Director, Office of Financial Research,
United States Department of the Treasury

A transaction-cost approach for managing systemic risks

Three C's of systemic risk
A recent book, Fragile by Design, highlights the remarkable frequency with which the U.S. has experienced "major banking crises" – once per generation since the Federal Reserve's founding. Given this track record, the authors suggest that we "should not expect politicians or regulators to do much to prevent the next banking crisis"[1].

Addressing this history, Harvard Professor Hal Scott offers a taxonomy of how problems at one bank can create difficulty for others[2]. He refers to these transmission channels as the "three C's" – that is, "connectedness", "correlation" and "contagion".

Each "C" characterizes a type of financial "externality". But given the frequency of and variation in crises, are we confident that closing only three channels will guard against crisis? If not, perhaps we should address the common root of any such "externality" – that is, transaction costs. >>>

>>> Transaction costs and financial resiliency

The economics laureate, Ronald Coase, was remarkable. He created a new peer-reviewed journal after his 100th birthday. And in a famous 1950s seminar, he won over a formidable group of Chicago economists, convincing them that the root "Problem of Social Costs" (externalities, like systemic risk) lies with the real resources that are necessary to transact in goods or services – that is, time and effort to (a) identify prospects for mutually beneficial exchange, (b) evaluate the quality and quantity of goods and services that might be traded, and (c) enforce terms of any such trade. At each step, someone has to produce valuable information and productive governance services.

Absent transaction costs, none of the three C's could exist. Consider the first C – "connectedness." And notice that, when connections between Bank's A and B are transparent (the extent to which A's health depends on whether B can pay back a loan, for example), people can readily price how problems at B can become problems for A.

> *"Reducing transaction costs and increasing accountability is fundamental to managing systemic risk."*
>
> \- DINO FALASCHETTI

A related story can be told about the second C – that is, "correlation." If A and B own similar assets (e.g., home loans), then realizing risks from those assets could create a systemic problem. But this channel also exists only in the presence of costly information and lack of accountability.

Likewise, the third and perhaps most important C (contagion) cannot take root without transaction costs. If I am confident about the integrity of bank B's balance sheet, and comfortable with its price, why would I run from B on bad news about A? Given these conditions, a run on A cannot tip me to anything I didn't already know, or sow seeds of doubt about what I thought I knew. Instead, investors run when bank A's trouble tells bank B's investors that transaction costs may have left them blind to important risks.

A better way – address the root of any systemic risk

If transaction costs lie at the root of systemic risk[3], then proposed reforms like Scott's call for "a more complete public guarantee of short-term liabilities" do just the opposite. Managing systemic risk from the top down relies on what the Nobel laureate F. A. Hayek referred to as the pretense of knowledge. It has failed time and again.

Dodd-Frank's preamble, instead, charges regulators and overseers to focus on a more robust governance framework – one that ends bailouts by increasing "accountability and transparency in the financial system." Economizing on transaction costs and strengthening market discipline provides fundamental means to this end. ●

1. Calomiris, Charles W. and Stephen H. Haber (2014). Fragile by Design: The Political Origins of Banking Crises & Scarce Credit. Princeton University Press.
2. Hal S. Scott (2016). Connectedness and Contagion. MIT Press.
3. Information markets may be able to help here. See, e.g., Matthew Beville, Dino Falaschetti, and Michael Orlando, "An Information Market Proposal for Regulating Systemic Risk," University of Pennsylvania Journal of Business Law, Spring 2010.

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AML/TF detection, supervision and EU coordination

Anneli Tuominen

Director General, Finnish Financial Supervisory Authority, Finland (FIN-FSA)

A common authority for EU AML/CTF supervision is needed

Although the EU has requested several improvements for AML/CTF supervision and information exchange between authorities in recent years, a lot of gaps remain. For major improvements to take place, a centralised EU AML/CTF supervisory authority is needed, a body similar to the ECB.

The past few years have revealed serious flaws both in the AML and CTF framework and related supervision conducted by national authorities in the EU. Various bodies, the most important being the Financial Action Task Force and the European Commission, have analysed the reasons for failures.

In July this year, the European Commission published a report that analyses recently publicised money laundering scandals. It highlights problems that EU AML /CTF supervisors have been facing in recent years.

The main conclusion was that most supervisors have been understaffed. Additionally, it was reported that sanctions have not been issued, even in cases where clear breaches of AML/CTF legislation were found.

Moreover, in cases where the target institution was a banking group operating in several jurisdictions, home supervisors have had a tendency to trust the supervision of host Member States. There was also very little or no cooperation and information exchange between AML supervisors, prudential supervisors and financial intelligence units (FIU).

The authorities seemed to lack understanding as to how information exchange should be organised and what type of information is essential for other authorities. Different responsibilities and provisions on data protection also hampered cooperation.

These findings need to be taken seriously. What kind of corrective action is required in the EU, since global actions need a separate discussion?

So far, the European Union has concentrated on legislative changes improving cooperation and information exchange between different authorities. On the supervisory side, the EBA's role will be strengthened; a new coordinating committee for AML matters will be established and a new database consisting of information on breaches of AML regulations and ineffective application of AML policies will be set up.

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>>> Even if the aforementioned measures were to be implemented, however, this will not be sufficient to restore the credibility of the EU AML/CTF supervisory regime. The proposed changes do not convert the EBA into a supervisory authority; its role will still be limited when it comes to actual inspections and sanctions.

Major improvements can only be achieved through one centralised supervisory AML/CTF authority in the European Union, a body similar to the ECB. This authority should be adequately staffed in order to be able to carry out its supervisory tasks independently with the assistance of national supervisors. Supervision should be risk-based, meaning that the central body should concentrate on the supervision of the most significant entities and the riskiest areas. National authorities should assist it in this task and additionally look after purely domestic issues.

Benefits of one central authority would include swiftness of decision-making, an equal level of supervision for the whole EU and a clear definition of responsibilities for supervision of multi-jurisdiction institutions. The central authority could also give guidelines for the supervisory regime, and through its sanctioning decisions it could set guidance for all financial institutions.

One area that needs to be taken into account is cooperation between supervisors and FIUs. As FIUs receive more and more information concerning apparent ML cases, they would be able to give supervisors a more precise picture of the ML situation. A European central authority could act as a focal point for FIU information and disseminate it to concerned national authorities. This would also apply to law enforcement authorities in cases where money laundering investigations could initiate supervisory actions.
Finally, new information technology should be utilised to its full extent. There are currently several innovations in the development phase for a more effective KYC process and exchange of information. A centralised EU body could help the private sector to create more common definitions for suspicious customers and transactions. This would benefit all of us. ●

Liga Kļaviņa

Deputy State Secretary on Financial Policy,
Ministry of Finance of the Republic of Latvia

Improving AML/TF detection, supervision and EU coordination

Over the two last years we have experienced that cases of money laundering and terrorist financing (ML/TF) have moved from the headlines of the press and media to the substantial discussions and even materialized in concrete actions taken by the EU member states, institutions and market players. Undoubtedly, those member states involved in the misuse of their banking and financial system were under pressure to deliver tangible and credible results in de-risking of the sector, strengthen its ability to fight ML/TF and achieve international standards of compliance.

Controlling and radically reducing ML/TF risks as well as combatting all forms of financial crime, are the number one priority of the Latvian Government. We have gone through extensive overhaul of the regulatory architecture reforming entire financial supervisory, regulatory and legal system thus addressing recently identified vulnerabilities and strengthening various lines of defence. These efforts are already yielding important results: Latvia has cut non-EU deposits from 35% to 8% since 2015. In March 2019, domestic and EU deposits constituted 92% of deposits in Latvia. Around 97% of companies >>>

>>> established in Latvia have already disclosed their beneficial owners and this information is publicly available. Latvia has greatly increased the declaration of beneficial owners and has eliminated over 17 000 shell companies since November 2017. Latvia has implemented the Fourth AML (Anti Money Laundering) directive and has fully transposed Fifth AML directive six month before the set transposition deadline.

Variety of ML/TF cases in terms of geographic location and complexity of underlying schemes reveal that national political ambition, ownership and resources might not turn to be sufficient to localize and counter illicit financial flows. Acknowledgement of the problem being supra national might lead to the respective conclusion of the need of an overarching solution and better coordination globally.

Detection of the ML/TF can be strengthened at the level of financial institutions, i.e. through the possible development of new IT systems and artificial intelligence. Important question is the potential of an institution or sector to develop them in joint phase with the financial technology and emerging financial innovations. Joint EU action could have been beneficial in terms of both - effectiveness and costs. While going forward, it is crucial that other countries, some of which have already set their plans in motion in the region, are equally committed to build deep level of trust, cooperation, and sharing of information and technology.

To avoid differences in the regulatory outcome of AML/TF rules and to reduce the risks of possible regulatory arbitrage and inconsistent supervisory outcomes within the single market need of a uniform and directly applicable regulation is emerging. Supervisory practices of AML/TF, in turn, require more than set of rules but institutional harmonisation and coordination of practices, expertise and capacity at the EU level.

Thus, gradual orientation towards the concept of a single EU institution for ML/TF supervision has to be considered. We need ambitious proposals for greater European and international cooperation, more effective, centralized and coordinated oversight as well as much deeper levels of cooperation when it come to the sharing of relevant information. Some analogies of a concept of the Single rule rulebook and Single Supervisory mechanism within the Banking Union can be made. The distinguishing features is the scope including all EU member states and the need to align the practices with the global standards.

With the rapidly changing financial world, traditional financial services being replaced by innovative solutions and future technological challenges, we have to change and find solutions so to keep the crucial values of integrity, stability and competitiveness of EU financial system and economy unchanged. Single EU institution when it comes to the supervision and coordination of AML/TF practices in the EU could serve this purpose. •

Matthew Elderfield

Chief Risk Officer, Head of Group Risk and Compliance, Nordea Bank Abp

Combatting financial crime – a team effort

During the last years, Nordea has significantly strengthened the transaction monitoring capabilities through investment in technology, additional employees and more sophisticated assessment techniques. Nordea has invested more than 700 m EUR within risk and compliance and resilience since 2015 and today more than 1500 employees working solely on combatting money laundering and other types of financial crime.

These investments have significantly strengthened the risk and compliance platform and provide vital support to our financial crime prevention efforts, making Nordea a safer and more trusted bank. This is an ongoing and very important task and to be even more efficient in combatting financial crime, we invest heavily in developing new tools. In the coming years, we expect especially new technology to help us be even better at detecting and analysing suspicious behaviour.

To improve efficiency and harmonisation in the fight against financial crime, the leading >>>

>>> Nordic banks have also initiated a joint Nordic KYC utility. The banks' top priority in collaborating has been to develop a common Nordic platform with standardised processes for handling KYC data and administration. The objective is to simplify the KYC processes for corporate customers while strengthening financial crime prevention in the Nordics.

However, banks cannot fight this battle alone. The next step is to improve the whole system for how we work together. This is a broader societal issue and we encourage exchange of information and closer collaboration between banks and authorities, to prevent financial crime. We must together ensure that the risk of criminal activities is minimized in the financial system.

The discussions should not be about the number of SARs (suspicious activity reports), inspections or sanctions.

"Anti-money laundering is a broader societal issue and we encourage closer collaboration between banks and authorities."

\- MATTHEW ELDERFIELD

Focus must be on preventing crime in true collaboration. I would suggest an approach with national or cross-border joint task groups focusing on specific themes, such as trafficking. The taskforce would work together end-to-end, from the banks' KYC, transaction monitoring and SAR filing, to prosecution of suspected criminal activities. Tangible results would come quickly, while the methods are tested in an iterative approach to then be used in other areas.

I also support the creation of an EU-level agency, with the purpose of combating money laundering and financial crime. This is needed both on the supervisory side – harmonising practises, as well as coordinating and overseeing local supervisors work - and on the crime prevention side, where a European FIU should be e.g. collecting SARs, analysing and working on cross-border cases in collaboration with the local FIUs and private sector. ●

Jesper Berg

Director General, Danish Financial Supervisory Authority (Finanstilsynet)

What is the right medicine to strengthen the fight against ML and TF in the EU?

The fight against money-laundering and terrorist financing has come to the forefront of public awareness in recent years following several much publicized cases. The issue is high on the political agenda and recognized as one of the key threats to the integrity of the financial system.

An obvious question following the numerous cases involving violation of AML/CFT rules is how to improve the EUs efforts to combat ML and TF. Most agree on the need for strengthening the first line of defense in financial institutions, increasing supervisory resources and enhancing convergence of supervisory approaches across countries within the EU. However, how do we avoid creating overlapping responsibilities with the risk that no-one feels responsible? What would genuinely add value?

Technology holds the potential to help financial institutions in their efforts to combat ML and TF, moving from manual procedures to a larger degree of automated procedures – and taking advantage of the huge amount of electronic data available while at the same time making life for customers of financial institutions easier. This is a greenfield area, where authorities can add value, including by addressing the tricky data protection issues and helping financial institutions overcome governance issues inherent in co-operating in this area. Thus, EU authorities should contribute to work to build a digital exchange of information on customers and develop a com-mon data infrastructure that can make a difference in combatting ML and TF.

AML and CFT efforts are very granular and need to be close to where the crimes are committed. Although cross-border transactions often entail in-creased risk, the true borders are around the individual financial institutions – and any transaction to and from individual financial institutions are subject to AML and CFT controls. Therefore, we need to enhance the capacity of every single institution to fight money laundering and terrorist financing.

Supervision of efforts to combat ML and TF take place within the context of the national legal regime and in close co-operation with other national authorities, mainly the FIU, the police, other relevant authorities (e.g. tax authorities) and the courts.

"Technology holds the potential to help financial institutions in their efforts to combat ML and TF."

\- JESPER BERG

This requires a strong understanding of domestic legal practices and government infrastructure (e.g. the domestic tax system, the domestic ID systems etc.) and daily co-operation with domestic law enforcement and other relevant domestic entities. A domestic AML and CFT supervisor is best placed to participate in this ecosystem.

This does not mean that there is no place for increased efforts at EU-level. National supervisors need to cooperate closer in order to coordinate their efforts and to be able pursue cross-border cases. We need to increase supervisory convergence by national supervisors, to enhance the legal framework and to increase resources of AML supervisors. Establishing AML supervisory colleges is one way forward.

In my view, this is the best way forward to strengthen the fight against ML and TF. ●

José Manuel Campa Fernández

Chairperson, European Banking Authority (EBA)

Progress towards addressing money laundering and terrorist financing risks in the EU

The recent spotlight on cases of money laundering (ML) in the EU has identified clearly to the public several underlying weaknesses in our framework. A number of these weaknesses were already known to authorities and the legislators have taken action. AMLD4 and AMLD5 are specifically designed to address such concerns including: continuing the journey to an effective risk based approach by AML/CFT supervisors; updating the legislation in light of new technology; and improving coordination and cooperation amongst all relevant authorities. The EBA has contributed with standards, guidelines and opinions. But some potential weaknesses remain and the journey is not over.

I would focus on two:

1. ML and terrorist financing (TF) do not respect borders. The minimum harmonisation nature of relevant Directives means that differing national implementations and interpretations are possible, and the ensuing patchwork of national approaches creates an inherent, but not insurmountable, risk of gaps. As recent cases have shown such gaps can, and will, be exploited;
2. the need for robust practical implementation of the new legislation is more immediately pressing. This is key to ensuring that AML/CFT supervision across the EU converges around effective identification and mitigation of risks by financial institutions and supervisors and that proactive and effective supervisory information sharing and cooperation takes place.

"The need for robust practical implementation of the new legislation is more immediately pressing."

\- JOSÉ MANUEL CAMPA FERNÁNDEZ

The EBA will take some actions, assisted by modest adjustments to our role in AML/CFT under the ESAs Review, to help overcome these challenges. We will continue as a matter of priority to support NCAs with their national implementation, with training, individual feedback and thematic peer reviews.

We can promote effective cooperation with the roll out of AML/CFT colleges and strengthening the link between AML/CFT and prudential supervision, nationally and across the EU. We can also help to address remaining information gaps by building a database of relevant information, risks and trends that we can proactively disseminate to those that need to know.

The EBA will deliver on the tasks it has been mandated, but many argue more will be needed. In an integrated single market, our effective defence against ML/TF activities is as strong as our weakest link. Effective control would require that the minimum harmonization nature of EU regulation is enhanced. It would also need to ensure that proper governance and coordination exists between the different national agencies involved in the effective implementation of AML/TF regulation. Further empowerment at the EU level could help in this process. Finally, the EU also needs to ensure that adequate coordination and collaboration with third countries exists to really achieve the important objectives of preventing money laundering and terrorist financing across the single market. ●

Martin Merlin

Director, Bank and Insurance, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

The European AML/CFT regime of the future

The recent money laundering scandals in a number of European banks have exposed weaknesses in the current EU arrangements for the fight against money laundering and terrorist financing. There is increasing realisation that more efforts are needed to address current fragmentation of the EU AML/CFT regime, which results in different compliance and supervisory enforcement and inadequate cross-border collaboration.

"There is scope to improve AML prevention and detection, and technology will play a key role."

\- MARTIN MERLIN

The discussion on how to reinforce the current EU AML/CFT regime should focus on the following priorities:

- addressing regulatory and supervisory fragmentation;
- capturing new business models and emerging risks;

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- being sufficiently adaptable to the cross-border dimension of financial activities;
- ensuring comprehensive cover of the financial sector, while at the same time optimising the use of available supervisory resources by focusing on entities, sectors or jurisdictions deemed riskier;
- reinforcing the security and privacy of personal information.

Detailed knowledge of money laundering/terrorist financing risks throughout the EU will be needed to accurately map risks and to effectively direct supervisory efforts and resources.

Technological innovation will play an increasingly important role in the future, particularly in the case of banks and payment systems, where AML/CFT defence systems' use of technologies such as electronic signatures and seals, biometric data sensors and facial recognition can facilitate and strengthen onboarding processes.

Financial institutions' ability to rely on verified information – e.g., via up-to-date dependable central databases of beneficial ownership or bank account registers, or immutable records shared between obliged entities, should enhance AML/CFT compliance, while greater use of technologies such as artificial intelligence in transaction monitoring offer the potential to improve detection rates.

Technology also holds great potential from the perspective of supervisory authorities and financial intelligence units. RegTech solutions, such as those designed to improve regulatory reporting, could ensure better access to key information within supervised entities, while more powerful analytical tools relying e.g. on artificial intelligence, will allow more accurate and proactive analysis by financial intelligence units.

A more effective sanctions toolbox with more focus on deterrence should also be reflected on: clarity on sanctioning tools available, including tailor-made penalties, and when to use them.

In an ideal world, a zero failure AML/CFT regime should be the objective. However, a more realistic approach is to acknowledge that, irrespective of efforts, there will always be tail risks. The risk-based approach upon which the AML/CFT regime relies assumes that not all dirty money will be stopped, nor will every asset be detected, traced, and seized. But there is scope for improvement as regards prevention, timely detection and action, and the EU will need to adjust its AML/CFT framework to respond to these challenges.

Sovereign / financial sector / Central Bank loop

Andreas Dombret

Adjunct Senior Research Scholar, Columbia University

Sovereign-bank nexus still needs to be addressed 11 years after the global financial crisis

Over the years since the collapse of Lehman Brothers in 2008 significant progress has arguably been made on many fronts of the regulatory agenda. The most important regulatory measure to date was agreeing on the Basel III framework, which has introduced, amongst others, much stricter capital requirements and new liquidity rules on a global level. With full implementation of the Basel III rules, regulatory capital requirements will be significantly higher and, at least equally important, capital will be of higher quality than under the Basel II regime. All of this represents considerable progress and is bound to make the financial system much more stable than before, yielding to increased trust amongst market participants. The calculation is quite simple and, at the same time, rather convincing: More equity that can absorb losses and helps mitigate risks makes banks, and thus the entire financial system, a safer place.

> *"Let's kick-start a paradigm shift to end the regulatory privileges of sovereign exposures."*
>
> \- ANDREAS DOMBRET

But has the sovereign-bank nexus been broken by Basel III? Are higher capital and new liquidity requirements enough to effectively safeguard financial stability? Can the international financial community lean back and argue that the job is done? Certainly not. An example that is a rather good illustration of the limits of capital as an all-purpose tool is the still unsolved regulation of sovereign exposures. And these sovereign exposures are directly linked to the sovereign-bank nexus Europe experienced, again, from May 2010 onwards.

Under the current regime, banks do not need to hold any capital against the risks associated with loans to sovereigns - unlikely any other loan category or asset class. This is based on the assumption that loans present itself as a major cluster risk because the default of a sovereign as single debtor can well cause bank insolvency with wide spread consequences.

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>>> Consequently, changing the rules appears imperative to me any many others, both inside and outside of Europe. If banks actually were required to hold adequate capital against the risks of their government bond portfolios, they would be much more resilient to financial distress. And at the same time, banks would have less financial incentive to acquire large volumes of domestic and international government bonds if these were not privileged any longer, or less privileged. Furthermore, this may well incentivise governments to reduce their overall debt.

The second important issue that regulators and policy makers need to tackle is diversification - as specified in the Basel large exposure regime which took effect on January 1st of this year. Large exposure caps, once introduced, would prevent banks from becoming overexposed to a single borrower and the risk of its default. Currently, the regime is restricted to private borrowers, and sovereign bonds or loans do not fall into its scope. It is important also to end this regulatory privilege and to create a true level-playing field for both private and sovereign borrowers alike.

Therefore, many believe a cap on loans to an individual sovereign is badly needed and also should be introduced, and I agree with them.

As an international agreement seems rather unattainable at present I believe it therefore to be all the more important to move forward at the European level and to kick-start a paradigm shift to end the regulatory privileges that sovereign exposures still enjoy today.

Akira Otani

Deputy Director-General,
Bank of Japan

Possibility of an adverse feedback loop in Japan

Would Japan face an adverse feedback loop among the government, central bank, and financial institutions? In Japan, the government debt to GDP ratio is 230%. A large part of Japanese government bonds (JGBs) is held by the Bank of Japan (BOJ) and Japanese banks: BOJ and Japanese banks hold 46 % and 17% of JGBs issued, respectively. This situation seems to meet prerequisites of the materialization of an adverse feedback loop.

> *"An adverse feedback loop would not materialize in Japan in the foreseeable future."*
>
> - AKIRA OTANI

In fact, some economists think the answer to the question could be yes. They regard the BOJ's exit from its ultra-accommodative monetary policy, by which the 10-year long-term interest rate is controlled at around 0%, as one of the potential triggers of an adverse feedback loop. It would sharply raise the long-term interest rate. An increase in interest rate would not only increase interest payments by the government but also induce public funds injection into the BOJ to make up for losses from its JGB holdings. In addition, Japanese banks' possible losses from JGB investments caused by an increase in interest rate could exert negative downward pressure on economic activity >>>

>>> through worsened financial intermediation function. This mechanism would further deteriorate the government fiscal position, resulting in more rise in the long-term interest rate.

I think, however, an adverse feedback loop would not materialize in Japan in the foreseeable future. Behind my assertion lie the following four factors:
- Even when the BOJ exits from its ultra-accommodative monetary policy, the long-term interest rate would not rise sharply but moderately. The BOJ would maintain a massive amount of JGBs on its balance sheet. This stock effect would constrain an upward pressure on the interest rate.
- The Japanese government reiterates its commitment to maintaining fiscal discipline. In addition, when the BOJ implements its exit strategy exits, we should have higher inflation and nominal growth rate. Nominal GDP, which determines the size of tax revenue, will grow faster than the pace of increase in the government's interest payments on JGBs, which have long maturities. As a result, the government's debt to GDP ratio is projected to decline even after the BOJ's exit.
- The BOJ makes provisions against the possible losses from its JGB holdings.
- Japanese banks continue to diversify their portfolios, ranging from JGBs to riskier assets, under the prolonged low interest rate environment. Under such circumstances, in case of 100bps increase in the long-term interest rate -- of which assumption is fairly severe taking account of the stock effect from the BOJ's JGB holdings -- the losses of Japanese banks' JGB holdings are estimated to account for 10% of their capital. Therefore, their capital adequacy ratios remain to exceed the regulatory required ratio.

Considering that the adverse feedback loop is not a candidate for destabilizing financial system, what is the major risk to financial stability in Japan? The reasonable answer would be the long-lasting low profitability of Japanese banks. It is caused by structural factors such as the decrease in growth expectations and the secular decline in loan demand associated with the shrinking population, as well as the prolonged low interest rate environment. In response to the decline in their profitability, major banks have aggressively expanded their global activities. Regional banks have become more active in domestic lending to middle-risk firms and the real estate industry, as well as in securities investment. However, as they have generally not been able to secure profits commensurate with the increase in risk-weighted assets, their capital adequacy ratios and stress resilience have declined moderately. Should this situation persist, downward pressure on the real economy from the financial system could intensify in the event of stress, as the capital of financial institutions would decrease substantially due to increased credit costs and securities-related losses. ●

Klaus Kumpfmüller

Executive Director, Austrian Financial Market Authority

Addressing the sovereign-bank loop: setting the right incentives in the Banking Union

We have undoubtedly made progress in fostering financial sector resilience since the onset of the financial crisis. However, progress has focused more strongly on the liabilities side of the balance sheet: capital ratios and the quality of banks' capital have improved significantly. Similarly, Solvency II has increased the robustness of the insurance sector. Of course, progress made on the asset side should not be overlooked. Tough new rules have been agreed at European level to tackle legacy risks and NPLs. With some assistance from a favourable economic environment, NPLs are decreasing throughout the EU.

However, we have to acknowledge that work still needs to be done to complete the Banking Union. Concentration risks in sovereign exposures remain a critical link in the sovereign-bank nexus. 8 years on from the sovereign debt crisis, and the balance sheets of financial institutions still contain roughly the same level of sovereign exposures. The home bias remains strong in many Euro Area member states, ranging from less than 3% to up to 91% of sovereign bonds held by domestic banks. >>>

>>> Sovereign bonds are, and will remain, an important asset class in banking and insurance business. This should be respected and accepted. Still, tackling the home bias in sovereign bond holdings is an important milestone towards completing the Banking Union. European Banks must be European in their sovereign exposures – less home bias, more European focus. With the economic cycle maturing, we should start setting the right incentives. Euro Area banks should be incentivised to hold a well-diversified Euro Area sovereign bond portfolio. To achieve this, only well-diversified sovereign portfolios should continue to fully enjoy the privilege of zero risk-weights. Overly concentrated portfolios should be subject to own funds requirements for disproportionate exposures to any Euro Area member state.

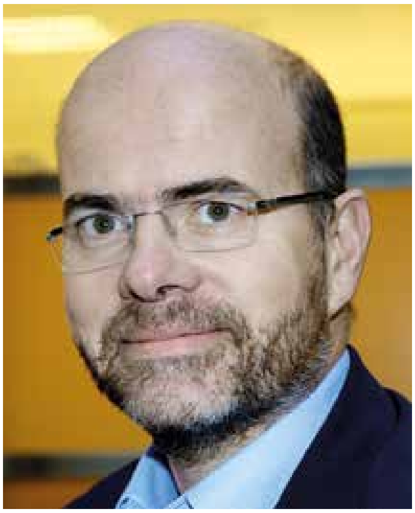
In practice, excessive exposures could be determined by measuring a bank's portfolio against a benchmark portfolio. The benchmark could be the distribution of sovereign exposures based on the proportion of a member state to Euro Area GDP. Thus, own funds requirements would only apply to exposures substantially exceeding the benchmark shares.

"European Banks must be European in their sovereign exposures – less home bias, more European focus."

\- KLAUS KUMPFMÜLLER

Ultimately, the effects should be largely reciprocal throughout the Euro Area: a bank based in one-member state would be incentivised to shift its disproportionately high sovereign exposure to other member state debt that is hitherto underrepresented in its portfolio. The details of such an approach would need to be carefully calibrated to achieve the aim of effectively reducing concentration risks in sovereign exposures, while simultaneously not penalising the financial sector for holding Euro Area sovereign debt.

It is in our mutual interest to finally break the link between bank and sovereign crises in Europe. To resolve the deadlock on the question of generally applicable risk weights for sovereign exposures, we should embrace an evolutionary approach both with regard to EDIS and the treatment of sovereign exposures. We should start moving towards these goals in small, mutually reinforcing steps. However difficult, it remains a common responsibility of all stakeholders to find a reasonable treatment for sovereign exposures. ●



Bernard de Longevialle

Head of EMEA Financial Services, S&P Global Ratings

The risk of negative feedback loop has not been addressed

The negative feedback loop between sovereigns and domestic banks in a financial shock has been a key priority for EU regulators and policymakers. However, progress has been partial at best.

We certainly do not rule out the possibility of future banking crises, so the attendant fiscal cost of 'lost' GDP remains a key risk. However, we do see banks as safer thanks to more-demanding capital, funding and liquidity requirements and the ECB/SSM's proactivity in catalysing the balance sheet clean-up. Regulators now rightly try to strike the delicate balance between strong balance sheets and strong businesses, but we do not see the two as mutually exclusive.

Resolution will mean that even if systemically important banks fail, they are less likely to weigh on the taxpayer. Resolvability is admittedly a huge undertaking to deliver but relies heavily on adequate bail-in and funding resources. These resources are not yet in place and, without them, EU banks and their regulators will remain in an awkward position--halfway between the eras of bail-out and bail-in.

Banks' intrinsic creditworthiness is rarely stronger than that of their sovereign. But we see these positive vectors combining in Italy, where we now anticipate that UniCredit could be more resilient to sovereign default. However, seeing even strong banks rated above their sovereign will remain an extreme rarity while they retain a heavy domestic focus and continue to invest heavily in domestic government debt. On this last point, very little has changed – neither for banks, nor for insurers.

Bank capital rules continue to encourage many banks to retain bulky exposures to their domestic sovereign. In the Eurozone, we find that banks' exposure to their home sovereign was on average about 74% of banks' Tier 1 capital as of September 2018, with big variation by country. This is down from 107% as of end-2014, but domestic sovereign defaults could still wipe out large parts of many banks' regulatory capital bases. By contrast, the banks' post-crisis retrenchment to their domestic markets has amplified the weight of their domestic loan exposures.

European insurers face similar exposure to the negative feedback loop with their respective sovereigns as banks, although the risk to their credit ratings is less pronounced. They too are incentivized by regulatory capital rules to hold domestic and Eurozone sovereign debt, particularly those utilizing the Solvency II standard formula with its 0% risk weights and need to hold long duration assets. Median exposure for eurozone insurers is around one-third of total investments, but again with huge national differences.

Circumstance plays its part also. In a low yield environment, banks (in their treasury assets) and insurers (in their investment of life premiums) cannot afford to focus their investments only on negative yielding assets. And yet they need to find assets that qualify for liquidity buffers and do not accentuate investment risk for policyholders.

Will this fundamentally change anytime soon? We see no reason to think so. ●

Dino Kos

Chief Regulatory Officer, CLS

Acting now before the inevitable storm – The sovereign-bank nexus

The regulatory treatment of sovereign exposures is not a new issue. The Basel Committee struggled with the subject going back to the initial Basel Accord in the late 1980s. Back then, the question was whether some or all sovereign exposures should be zero risk weighted. More recently, the inadequacies of the current approach have been linked to the "sovereign-bank nexus" and again elevated this issue to the forefront of the post-crisis policy debate.

The result was a flurry of activity by international standard-setting bodies and experts, but the full scope of the issue has yet to be resolved. Notably, notwithstanding years of work, in 2017 the Basel Committee could not reach consensus on how to change the regulatory treatment of sovereign exposures. A public consultation never left the door. The Basel Committee's discussion paper on sovereign risk labeled proposed changes to the regulatory treatment of sovereign exposures as "potential ideas" rather than "recommendations". Capital regulations continue to allow preferential treatment of sovereign exposures.

While addressing the sovereign-bank doom loop is difficult, promising ideas have been put on the table. Some combination of adjusting risk weights and, more importantly, adopting concentration limits on sovereign holdings provides a way forward to reduce this risk over time. What is required is urgency and action. So what is holding back progress now – nearly a decade since the onset of the Greek crisis that first elevated this risk?

Ironically, market pressure has eased as the demand for sovereign debt has surged. Thirteen EU Member States, plus Switzerland and Japan, have negative yield on government debt securities with maturities of up to five years. Many of these have negative yields out to 10-year maturities.

Governments have no difficulty financing themselves and have taken advantage to issue large amounts of debt, despite an overall deterioration in sovereign ratings. As sovereign yields have fallen, so have borrowing costs for banks. In the short-run, negative yields relieve the pressure to act. As yields have gone deeper into negative territory, the value of the bonds banks hold has increased – and is actually helping balance sheets – for now.

"Current benign environment is a window of opportunity to act before the inevitable storm moves in."

\- DINO KOS

However, in the medium to long-run, the current negative rate environment is unlikely to persist. Any number of factors could cause a reversal. The market is increasingly like a coiled spring that, when released, could set off a rapid and disruptive upward lurch in bond yields.

The time to address the regulatory treatment of sovereign exposures is now. Not only are proposed solutions out there, but the current benign environment is a window of opportunity to act before the inevitable storm moves in . As JFK once said, "There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction."

The views outlined in this article are my own and do not reflect the views of CLS.

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Cyber-security and cyber-resilience

Morten Bech

Head of Secretariat, Committee on Payments and Market Infrastructures (CPMI), Bank for International Settlements (BIS)

Cyber-risk requires an innovative implementation of global standards

Good delivery gold bars worth $81 million would weigh as much as an adult hippopotamus. Yet the criminals who looted an equivalent value of funds from the Bangladesh Bank's account in New York in 2016 never needed to break into a sweat. Instead, they moved the stolen money with a few mouse clicks.

Technology has vastly improved access to financial services, to say nothing of their quality and convenience. At the same time, of course, malefactors have turned these advantages to their own nefarious purposes.

The CPMI's response to the Bangladesh Bank heist was a strategy published last year: Reducing the risk of wholesale payments fraud related to endpoint security. This followed the CPMI's and IOSCO's Guidance on cyber resilience for financial market infrastructures, which led the way for standard setters in this field. Most bank supervisors use this guidance too, as confirmed by the Basel Committee on Banking Supervision in their report on Cyber-resilience: Range of practices in December 2018.

> *"To meet the challenge posed by cyber risk, new ways of collaborating with the financial industry are being explored ..."*
>
> \- MORTEN BECH

Central banks and standard setters are now innovating to implement these recommendations. For example, CPMI-IOSCO have set up industry-led working groups to cooperatively investigate solutions to common issues (such as data integrity, information-sharing and risks from third-party service providers). But cyber risk cannot be boiled down to a pass or fail test; managing it requires a cooperative approach with all stakeholders working together.

Exploring areas for cooperation highlights the financial system's high degree of interconnectedness. It is precisely this new kind of risk that the CPMI's endpoint

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>>> security strategy is designed to address. The strategy is targeted not just at payment systems but takes in the whole ecosystem and its stakeholders.

Even so, many stakeholders are still unsure what they should be aiming for. To help them, the CPMI is working with its members and the wider industry to develop a list of emerging practices. Available by the end of this year, this will be a living document that will be updated as jurisdictions across the world make progress in their joint endeavour.

So criminals and standard setters are both innovating. Criminals focus on the same crimes, yet constantly renew their methods. Standard setters focus on a resilient financial system, while ceaselessly finding new ways to achieve it. To meet the challenge of cyber risk, collaboration with the financial industry is being explored, cooperative partnerships are broadening, and the fruits of these innovations will be shared globally. A global threat must be met with a global response. ●

Nathalie Aufauvre

Director General Financial Stability and Operations, Banque de France

Addressing cyber-risks: shaping the future of global finance

Financial market infrastructures (FMIs), together with banks and other financial institutions, have these past years constantly gained in technological sophistication, allowing for higher efficiency and speediness in the provision of services, while their role in the smooth functioning of a deeply interconnected and global financial system has never been that pivotal. If this trend has its own benefits, the fact that it takes place in a context marked by the rise of cyber threats has led financial authorities to heighten their vigilance over the associated risks, considering not only the FMIs in isolation but also their ecosystem.

In particular, as FMIs' reliance on critical service providers has kept increasing, overseers and standard setters have deemed necessary to develop dedicated approaches, with a view not only to heightening awareness of the resulting operational risk but also to ensuring safe contractual and functional arrangements between market infrastructures and their providers. A number of initiatives are underway to address the contagion risk - which is at stake here - both at European (e. g. launch of a European Cyber Resilience Board) and international levels (within the G7 notably). Furthermore, the most significant providers (those in particular to which systemic FMIs are exposed) have been incentivized to take strong measures to prevent cyber criminality along the chain.

But of course, outsourcing is only one part of the challenges related to cyber risk and the aforementioned steps are part of a broaden set of efforts undertaken consistently with a recent change of paradigm: cyber risk is not a matter of "if" a crisis occurs anymore, but of "when" it will occur and "how" it will be managed. Therefore, an obvious need for international cooperation arises to enhance preparedness and prompt response in case of major cyber incidents.

> *"An obvious need for international cooperation arises to enhance preparedness and prompt response."*
>
> \- NATHALIE AUFAUVRE

This is the reason why the G7Ministers of Finance and Central Banks Governors decided in October 2017, first, to create a communication protocol between financial authorities, and then to test the protocol through a large-scale three days-long exercise, simulating the impact of a significant cyber incident on the financial system. This complex undertaking, performed in June 2019, was the first of its kind involving twenty-four financial authorities: ministries of finance, central banks, bank supervisors and market authorities as well as the private sector in France, Italy, Germany and Japan.
The full potential of the exercise will only be delivered when all lessons will be drawn (what worked well and what need to be improved) without complacency. However, it already confirmed how valuable >>>

>>> crisis simulation exercises are in the building of an operational preparatory capacity to respond to the genuine and growing threat to financial stability posed by the increase of cyber risks. G7 Ministers and Central Bank Governors acknowledged that cooperation among public authorities has an important role to play as regards cyber security in the financial sector. They underlined the importance of deepening their engagement in establishing a programme of cyber exercises for the coming years notably.

The development and the maintenance of crisis management frameworks and communication protocols, ready to be immediately activated in the event of a cyber crisis, as well as the regular practice of coordinated crisis management exercises should also be encouraged at a wider scale. As cyber-risks are not restricted to a country's borders, the exercises should take into consideration the multiplicity of stakeholders from the financial sector itself and possibly with utilities (energy, telecommunication).

There will be no efficient and effective answers to cyber risks without any international cooperation among all stakeholders. ●

Jason Harrell

Executive Director and Head of Business and Government Cybersecurity Partnerships, The Depository Trust & Clearing Corporation (DTCC)

Mitigating risk during tech and outsourcing boom

The financial services industry has experienced a rapid acceleration of technological innovation in recent years. The interconnectedness of the global marketplace has simultaneously risen to an unprecedented level. Consequently, firms are exploring the benefits of technologies like blockchain, artificial intelligence and robotics while increasingly relying on third-party vendors to handle some functions. New technology and outsourcing can lead to significant efficiency improvements and reduced operational costs, but those benefits come with a possibility of elevated risk.

Moving certain operational and non-core functions to outsourced providers or using third parties to develop products and services opens the door for external vendors to gain some level of access to the firm and its confidential data. To further complicate matters, the vendors themselves sometimes employ external providers to deliver their services. While this expansion of the supply chain allows firms to minimize costs and provides an opportunity to introduce innovative solutions more rapidly, it also widens the surface area that could be used for a cyberattack against the firm and, due to the interconnectedness of the financial industry, against the sector as a whole.

A firm's ability to swiftly onboard new technology is often perceived as a positive, enabling the deployment of new technological solutions, ultimately leading to client adoption and enhanced client satisfaction. However, a rush to implement new technology introduces potential risks, and so it is vital that firms understand exactly how it is going to be applied and prepare for any potential vulnerabilities that may arise after implementation.

Regulators and standard setting bodies (SSBs) have taken notice of these new risks and are collaborating with the industry to establish best practices to guide how firms should manage these potential operational impacts.

The UK Supervisors, including the UK Bank of England, Prudential Regulation Authority, and Financial Conduct Authority, recently published a discussion paper detailing the Supervisors' view on what would be required to enhance an organization's resiliency and the steps the supervisor could take to support the sector. In the US, the industry has rallied around the National Institute of Standards and Technology's (NIST) Cybersecurity Framework (CSF), a collection of cybersecurity best practices and evaluation criteria. Building upon the advancements of NIST, the Financial Services Sector Coordinating Council (FSSCC), which collaborates with government agencies to protect the US infrastructure from cyberattacks, has introduced a new Cybersecurity Profile, a framework that integrates supervisory expectations to help guide financial institutions in demonstrating compliance with cyber risk management requirements.

"Effective defence mechanisms and resiliency plans are achieved by working collaboratively..."

- JASON HARRELL

As an industry-owned critical market infrastructure, DTCC continues to take steps to further enhance cyber and operational resiliency beyond our own operations. We have been involved in numerous industry-wide testing initiatives, support the sharing of threat information and remain focused on helping to improve cyber and operational resilience sector-wide.

Furthermore, we work closely with participants in other critical sectors to help them determine what controls they possess and how they can continue to improve to guard against cyberthreats. Effective defence mechanisms and resiliency plans are achieved by working collaboratively and implementing best practices, ensuring there are robust measures in place capable of both defending against threats and ensuring the resiliency of critical operations across financial market infrastructure. ●

Tony Blanco

Secretary General and Member of the Executive Board, La Banque Postale

Increased international cooperation is crucial to fight cyber criminality

Cybersecurity has become a major concern for companies. And rightly so, considering the cost of cybercrime, now estimated to exceed $600 billion a year.

The financial sector is a primary target for cybercriminals as it daily manages massive flows of private and financial data in a highly interconnected way. Cyber-attacks prevention and detection therefore has become a top priority for financial institutions and their supervisors. Today, every IT risk manager can confirm that "the question is no longer whether the company will be attacked or not, but when". Corporates, employees and citizens are increasingly responsive to cyber risks and willing to improve protection. Company business continuity plans are strengthened and supplemented with specific cyber-resilience sections, and employee training is reinforced.

However, company level actions are not sufficient to address the growing challenges that the financial sector is facing.

The development of both massive (e.g. wannacry) and bank-specific attacks (e.g. Carbanak) has highlighted the increasing sophistication and level of organisation of attackers and the risks at sector and global levels. The development of IA and Big Data creates additional challenges: future cyber-attacks are likely to be conducted using all the potential it offers. Increasing digitalisation and use of outsourcing in the last years also create additional complexities.

Trust in the security of the financial system is a critical asset that must be protected.

In that context, the highly interconnected nature of the financial sector requires increased cooperation between institutions and between states, notably to share best practices. We welcome the EU propositions about the creation of European network of cybersecurity skill centers that will reinforce European cooperation and resilience.

La Banque Postale supports the EU Cybersecurity Act which provides a safe common market for cybersecurity products and services. It adds a new dimension to the 2016 NIS Directive, which ensures a minimum common standard for information networks in the EU, by setting up an incentive framework for cybersecurity certification both for solution and service providers.

As an example, when considering outsourcing, banks need to be fully aware of technical specifications supporting the solution, and often require costly dedicated modifications to meet these requirements. Turnkey solutions (like cloud solutions) offered by worldwide providers could be certified or labelled "cyber resilient" by a European authority, thus ensuring a security standard both for banks and customers.

"Cyber criminality is ever more organised: to fight it, international cooperation is critical."

\- TONY BLANCO

Also, in order to offer innovative services, companies need to test quickly and efficiently their security systems. For this purpose, they often call on communities of cyber hacking experts, using "Bug Bounty" platforms to detect weaknesses (as La Banque Postale did to test the resilience of its digital subsidiary Ma French Bank).

As a natural extension of the Cybersecurity Act, we should consider whether to build a European framework for these platforms, providing certifications at the EU level.

Cyber criminality is ever more organised and sophisticated: to fight this global threat, accelerating international cooperation between states and companies is critical.

Medium-sized bank resolution

Pablo Hernández de Cos

Governor, Banco de España

Resolution of mid-sized European banks

The global financial crisis required significant public-sector intervention to bail out banks in order to prevent financial instability and the subsequent deep and negative impact on the real economy. After the crisis, the authorities, through the work of the Financial Stability Board, reviewed the resolution framework and shifted the paradigm, moving from bail-out to bail-in. Additionally, for global systemically important banks (GSIBs) it was agreed to ask for minimum total loss absorption capital (TLAC) that should cover both potential losses and the funds needed to recapitalise the bank.

Europe has also developed a new resolution framework with three particular features. First of all, the creation of the Single Resolution Board (SRB) as a key pillar of the Banking Union. Secondly, the adoption of the new paradigm centred on the bail-in, but also including other resolution tools (sale of business, bridge institution and asset segregation). Thirdly, the new resolution framework and the accompanying MREL (minimum requirements of own funds and eligible liabilities) requirements apply to all banks, not only to GSIBs. This may pose some challenges for mid-sized European banks with a retail business model and almost no tradition or practice to tap wholesale markets for capital or debt that absorbs losses.

> *"The build-up of MREL in mid-sized banks should insulate tax-payers from rescuing failing banks."*
>
> \- PABLO HERNÁNDEZ DE COS

The BRRD clearly states which are the objectives to be protected in resolution: continuity of critical functions, financial stability, minimising the use of public funds, protecting the guaranteed depositors and the assets and funds of bank customers. The authorities, in cooperation with banks, develop a resolution plan that also includes a minimum MREL requirement, precisely to protect those objectives and minimise the use of tax-payers money. Therefore, if a bank of any size performs critical functions and its liquidation may threaten financial stability, it needs to have enough MREL for its orderly resolution.

The level of MREL a bank needs is calibrated depending on the resolution tool to be used. The resolution tool needs to be credible and feasible. As such, only >>>

>>> bail-in seems credible and feasible for large and complex banks since it appears to be almost impossible to find a buyer for a large and complex bank when resolving it. The past crisis provides support for this hypothesis. However, for mid-sized and small banks, sale of business and the bridge bank seem reasonably credible and feasible resolution tools. The successful resolution of a Spanish bank two years ago by the SRB is an example of how a domestically systemic bank with 150 billion euros of total assets can find a buyer in resolution.

Which is the level of MREL needed for a sale of business tool? In this case, it should be taken into account that the buyer will probably recapitalise the bank, as it will also provide the liquidity the bank may need when opening after resolution. The MREL requirement should cover the loss absorption amount but it also seems reasonable for coverage of the recapitalisation amount to be partially fulfilled by the buyer.

However, as it is not fully certain that a buyer will appear in resolution, a safe margin for the recapitalisation amount should be covered by each bank with a transfer strategy. In any case, the resolution plan must develop a credible strategy for sale of business, in particular, the creation of vendor data rooms that would allow a third party to run an efficient due diligence process in the event of resolution.

Last but not least, the BRRD2 will allow for a longer period to fulfill the MREL requirements (1st January 2024 in most circumstances). Small and medium-sized banks may need this longer period of time to build up the required MREL, without threatening their business model and profit generation. Given their smaller size, MREL issuance liquidity might also be a matter of concern. In any case, there are windows of opportunity for these banks to start to tap wholesale markets. It will be challenging but not impossible.

The combination of a longer period of time and the use of the whole array of tools provided by the resolution framework in Europe should allow mid-sized banks, with critical functions to protect and with a potential impact on financial stability in case of liquidation, to build the needed MREL that will insulate tax-payers from jumping in again to rescue failing banks. ●

Fernando Restoy

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

A European FDIC?

The Single Resolution Mechanism (SRM) represents a crucial step in the development of the banking union. Yet the common regime for the resolution of systemic banks must coexist with a wide variety of – typically inefficient – national insolvency regimes for non-systemic institutions, creating significant obstacles for the management of banking crises in the euro zone. In particular, the current regime fails to provide robust procedures for handling the failure of mid-sized institutions. It also falls short of fully breaking the link between banks and sovereigns.

Thus, the current crisis management framework needs further development, if it is to help maintain financial stability more effectively and make the banking union work as intended. This requires a regime that can deal effectively with all types of crisis-hit institution. The unavoidable (if counterintuitive) insight is that the resolution regime for non-systemic institutions may need to be more flexible than the current one for systemic banks.

"Ideal option for the full development of the Banking Union is a FDIC-like formula, managed by SRB."

- FERNANDO RESTOY

What looks to be the ideal option for the full development of >>>

>>> the banking union is an FDIC-like formula, managed by the Single Resolution Board (SRB). This approach, which calls for a unified bank-specific insolvency regime, would help authorities manage a crisis affecting non-systemic banks by ensuring that their value is more effectively preserved.

It would also help the SRM work more smoothly for systemic banks by underpinning the no-creditor-worse-off assessment. Further, by streamlining insolvency procedures, it could widen the range of entities that it could safely apply to, reducing the scope for instability arising from the failure of mid-sized banks. Finally, by combining a new-minted European Deposit Insurance Scheme (EDIS) with an integrated crisis management framework for all types of bank, this option would make a further advance towards breaking the bank-sovereign link.

Certainly, this approach would meet with challenges. In particular, the necessary transfer of insolvency responsibilities would touch on highly sensitive areas of national legal systems, including employee protections as well as the treatment of contractual and property rights. And this is to say nothing of the economic, political and logistical implications involved in making the SRB responsible for all the euro zone's 4,000 and more credit institutions. Most challenging of all – given the difficulties of setting up an EDIS, even with a pure paybox function – would be to reach an agreement to establish an empowered EDIS within the SRB, with additional quasi-resolution functions for non-systemic banks.

Against that background, a less ambitious phased-in approach might be considered. This would aim at eventually converging on something close to a European FDIC but based initially on a partly harmonised yet still decentralised insolvency framework with an enhanced role for domestic deposit guarantee schemes. ●

Karl-Peter Schackmann-Fallis

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

Making a clear cut: proportionality in the resolution regime

There is no doubt, that the past years have seen valuable efforts to make even large financial institutions resolvable, creating a more resilient financial system and better avoiding taxpayer bail-outs. To put it into practice is requiring continued efforts by everyone involved, including small and larger financial institutions. For the way forward, we see room for a fine-tuning of requirements to eliminate unnecessary burden.

For banks falling under the resolution regime, a more tailored calibration of their MREL-requirements will be crucial. The SRB increasingly addresses questions of quantity and quality of MREL also by taking into account the resolution strategy of an institution. However, it will also be key to consider further bank specific factors including size, business and funding model, risk profile, SREP and stress test results as well as the degree of systemic relevance. Also, specifics like the legal form of an institution should be taken into account.

"There is no need to require MREL for institutions that do not fall under the resolution regime."

\- KARL-PETER SCHACKMANN-FALLIS

The vast majority of the German Savings Banks are considered not to fall under the current resolution regime. As they do not perform any critical functions and neither pose a threat to financial stability, their resolution plans foresee that national insolvency proceedings are applied, if bad comes to worse. Nonetheless, the BRRD still fully includes less significant institutions in its scope triggering a number of burdensome work-arounds. Hence, resolution authorities are obliged to set MREL requirements, which they fulfil by equalling them to an institution's own funds requirements. In a second, somewhat makeshift step, these institutions are exempted from reporting and disclosure requirements for MREL. Further work-arounds are in turn triggered when looking at the national level, where yet another exemption has to be granted regarding the permission regimes for eligible liabilities. All this creates unnecessary administrative burden and uncertainties for resolution authorities and financial institutions concerned alike.

The inclusion of the German Savings Banks in the resolution planning process is all the more superfluous when considering that not one of them has gone into insolvency since they founded their Institutional Protection Scheme (IPS) in the 1970s.

The main aim of an IPS is to provide support to prevent an insolvency from happening and it has successfully done so since the beginning with the result that no customer has lost deposits or had to be compensated.

With the European banking market's so far only limited experience in resolving failing institutions, the years to come will have to prove the functioning of the comparatively young resolution regime, probably triggering certain learning and adjustment processes. This should allow for a better differentiation of what is warranted and proportionate, lead to a reduction of complexity and lastly ease the burden for all actors involved where possible. ●

David Vegara

Executive Board Member,
Chief Risk Officer, Banco Sabadell

A proportionate resolution framework

The post-financial crisis regulatory reforms included not only a wide range of prudential and governance requirements intended to reduce the likelihood of the failure of financial institutions, but also measures to enable failing institutions to be 'resolved' in an orderly manner and without cost to taxpayers. More recently, updates to the resolution framework pave the way for a more stable and predictable framework.

Crucially, the MREL requirements and its demanding implementation schedule will add to the current highly challenging environment for banks and their business models, particularly for small banks.

In addition to issues related to market access and funding costs, the resolution framework imposes other requirements that will be a challenge for banks of all sizes. It is important to note that, given the fixed costs and reliance on external providers that are part of these requirements, the costs of compliance are inversely proportional to the size of the bank. These recurrent costs are mostly related to:

- Financial costs. MREL funding, contributions to the Single Resolution Fund and Deposit Guarantee Fund.
- Operating costs. Potentially higher than financial cost, such as the development of management information systems capabilities for resolution.
- Operational continuity. Expanding the scope of the business continuity arrangements introducing, for example, resolution proof clauses within its critical providers or developing specific contingency plans for accessing Financial Market Infrastructures under a resolution scenario. The bargaining power of mid-sized banks with key providers is lower than that of its larger competitors.
- Governance arrangements. The entities must develop solid crisis management procedures to prepare for a potential entry into a pre-resolution or resolution scenario.
- Regulatory uncertainty and architecture costs. Uncertainty regarding the impact of future requirements is one of the various factors weighting on the valuation of European banks.

In summary, the current resolution framework separates entities into different tiers, comprised broadly of:

- Systemic financial institutions with active participation in capital markets that are subject to the resolution procedures and have the scale to cope with the recurrent regulatory costs.
- Mid-sized institutions, for which resolution could be considered in the public interest, have access to the capital markets, but whose business models could be affected by stringent MREL and operational requirements.
- Non systemic institutions that are subject to national insolvency procedures, have limited access to the capital markets and are struggling to cope with the regulatory costs.

"The resolution framework should be adapted to ensure that the principle of proportionality is respected in its application."

- DAVID VEGARA

In this context, the main features of the resolution framework need to be completed, including the key issue of liquidity in resolution. Additionally, the resolution framework should be adapted to ensure that the principle of proportionality is respected in its application.

Finally, in order to give credibility and predictability to the resolution framework, the European Deposit Insurance Scheme (EDIS) needs to be implemented and a harmonized insolvency law for banks agreed upon. There is no true banking union without EDIS. ●

Elke König

Chair, Single Resolution Board (SRB)

A common set of rules for liquidation for small and medium-sized banks

The definition of a bank's size as small, medium or big is relative. The Banking Union (BU) established a definition for significant institutions and a dedicated framework. However, there are many other institutions as well as significant institutions, which are not small but for which resolution will not be the option in case of failure. The EU framework makes clear and we have repeatedly stressed that resolution is for the few, not the many.

The decision to put a failing institute into resolution depends on the outcome of a "public interest assessment" (PIA), determining if the preservation of a bank's critical functions is required to maintain financial stability. If the PIA's outcome is negative, a failing bank will be sent into national insolvency. In order to increase transparency the SRB recently published a paper on PIA presenting >>>

>>> the methodology and how the SRB assesses the criteria set out by EU law.

In due consideration of proportionality in resolution planning, the loss absorption requirements for each institution are carefully adjusted to the choice of resolution tools. Banks, for which in case of failure no resolution is foreseen, do not have to build up Minimum Requirement for own funds and Eligible Liabilities (MREL) on top of their supervisory capital requirements for going concern. Hence, those banks do not face further costs apart from the regular costs for supervisory compliance and basic recovery and resolution planning. In contrast, for banks, whose preferred strategy is resolution, the SRB's MREL policy and its expectations for resolvability provide for certain adjustments to allow for proportionality as well.

The SRB can also grant transitional periods for banks, based on features such as market conditions or a bank's liability structure or market access, in order to allow for a gradual build-up of MREL requirements. However, the rules require, that before using the SRF significant losses must be absorbed by the bank's equity- and bondholders. And it is undisputed that sufficient MREL is needed to implement any resolution strategy. In this regard the SRB must strike a careful balance between feasibility of the build-up of MREL and the credibility of the resolution strategy.

Building up the capital buffers may be challenging for smaller fully deposit funded banks. For this reason, a common set of rules for winding down such banks could be beneficial - for some SRB banks and all less significant banks. While we have one common European resolution scheme, in the BU we are faced with 19 different national insolvency laws when winding-down a (cross-border) bank. A set of common standards, practices and harmonised rules for the liquidation of banks would considerably facilitate resolution planning, increase predictability and prevent diverging outcomes in different member states. Needless to say that administrative procedures might be preferable to judicial procedures. At the end of this process might stand the creation of a European bank liquidation regime - a European FDIC. Not only would this ensure centralised decision-making, but also the application of a harmonized and effective toolbox supported by a European deposit insurance.

With this being a long decision-making process, legislators should wait no longer.

Arthur J. Murton

Deputy to the Chairman for Policy, Federal Deposit Insurance Corporation (FDIC)

Resolutions under the Federal Deposit Insurance Act

The FDIC is charged by the United States Congress with the responsibility for insuring deposits and serving as receiver of insured depository institutions (i.e., banks) following failure. The FDIC's powers and authority under the Federal Deposit Insurance Act have proven flexible over time, allowing the FDIC to develop strategies and capabilities to manage the failure of banks across financial crises and rapidly changing conditions.

Since the 2008 financial crisis, the FDIC has served as receiver for more than 525 failed banks. Nearly all of those banks were small community banks. Approximately 95 percent of those resolutions conducted by the FDIC involved the sale of the failed bank's franchise and assets to an open institution, generally to a single acquirer that assumed nearly all of the failed bank's liabilities. This type of transaction, termed a purchase and assumption (P&A) transaction, is often both the easiest for the FDIC to execute and the least disruptive. P&A transactions, nonetheless, require lead time to identify potential buyers and to allow them to conduct due diligence of the failing bank.

In addition to being P&A transactions, in the vast majority of those cases, acquiring institutions assumed all of the deposits – including uninsured deposits – of the failed banks. These "all-deposit" transactions only could occur following a determination by the FDIC, as required by law, that they would result in the least cost to the Deposit Insurance Fund (DIF) of all possible resolution options. For most small community banks, that test is met because the amount of uninsured funding is minimal and the transfer of those liabilities as part of the transaction helps to preserve franchise value of the bank.

In short, the typical FDIC resolution experience since the most recent financial crisis involved the failure of a community bank for which the FDIC had enough lead time prior to the bank's failure to market the franchise and conduct an auction. The typical outcome was a P&A transaction in which all deposits were transferred to the acquiring institution and depositors suffered no loss.

The FDIC builds on its experience to prepare for challenges not faced in the past. Larger banks, for example, can pose unique challenges in resolution due to differences in their funding structure, relative size, and complexity of operations and relationships with affiliates, counterparties, and the larger economy.

Larger banks tend to rely to a greater extent on uninsured deposits and market funding. This funding structure impacts both the timing of a resolution and the availability of resolution options. Funding structures that rely less on insured deposits generally compress the failure timeline. Uninsured deposits and market funding are more likely to be withdrawn rapidly if a bank exhibits signs of financial distress. While a bank's failure resulting solely from capital inadequacy typically unfolds over months (or longer), a failure triggered by a bank's lack of liquidity can unfold much more quickly.

The size of a failing bank also may limit the FDIC's resolution options by significantly reducing the number of potential P&A acquirers. Certain banks may be too large to be acquired by any other open institution in a P&A transaction, due to legal limitations on liability concentration, operational or economic conditions, or other regulatory hurdles.

Considering this, larger banks may be less likely to be resolved through a P&A transaction and more likely to be resolved through the use of a bridge bank. The purpose of resolution planning for larger banks, therefore, is to focus on challenges presented by resolution involving the use of a bridge bank, where the FDIC would be tasked with continuing the failed bank's operations to avoid disruptions to depositors and to maximize value to the receivership in the ultimate disposition of the bridge bank.

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CCPs: completing the post-crisis agenda

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

EMIR 2.2, the way forward for Level-2 requirements

In April 2019 the EU Institutions politically agreed amendments to the EMIR Regulation regarding supervision of CCPs, also called "EMIR 2.2".

The outcome of this agreement is to be welcomed, especially in light of the main objectives of the legislative proposal, namely ensuring financial stability through EU-level oversight over international financial infrastructures that are critical for the operation of the European markets.

With EMIR 2.2 coming into force, ESMA will receive an enhanced role in monitoring recognised Third Country Central Counterparties (TC-CCPs) and, for those TC-CCPs that are determined to be systemically important Tier 2 CCPs, ESMA will take over direct supervisory tasks. In this context it should be noted that the relevant Central Banks of Issue (CBI) will also be granted a role in some important decisions on Tier 2 CCPs.

In view of the political agreement and the challenging implementation timeline, ESMA has already been requested by the European Commission to provide its Technical Advice on three central Level 2 measures which will then be proposed by the Commission as Delegated Acts. These central Level 2 measures cover the tiering criteria, comparable compliance and supervisory fees that the CCPs will be charged.

Following consultation, ESMA aims at finalising the Technical Advice in Autumn 2019. Looking at the tiering criteria, the agreed Level 1 text of the EMIR 2.2 establishes already five tiering criteria which ESMA shall take into consideration to determine the systemic importance of a TC-CCP:
1. the nature, size and complexity of the TC-CCP 's business;
2. the effect of the failure of or a disruption to the TC-CCP;
3. the TC-CCP 's clearing membership structure;
4. the existence of alternative clearing services;
5. the TC-CCP's relationships, interdependencies or other interactions.

ESMA's role is to propose in its Technical Advice how to further specify these criteria through a set of quantitative and qualitative indicators. The aim, and the challenge, is to strike the right balance between having a comprehensive set of indicators and information to fully grasp the profile of a TC-CCP, while keeping the burden for TC-CCP to a minimum.

>>>

>>> Regarding comparable compliance, EMIR 2.2 allows for a Tier 2 CCP to submit a request to ESMA to assess the extent to which compliance with EMIR requirements is satisfied by its compliance with the comparable requirements applicable in the third country. ESMA's approach in the Consultation Paper provides for a requirement-by-requirement assessment, at the CCP-level and on an outcome basis. The proposed approach aims at ensuring that, where comparable compliance applies, a Tier 2 CCP, by complying with comparable requirements in their home country, will always comply with the core provisions of EMIR and satisfy the regulatory objective of the other provisions.

"ESMA will receive an enhanced role in monitoring recognised Third Country Central Counterparties."

\- VERENA ROSS

Turning to the third Level 2 measure and ESMA's Technical Advice on supervisory fees, the Consultation Paper addresses the following key items: ESMA's applicable budgeting approach, the main activities that ESMA will need to carry out and the relevant high-level costs for the supervision of TC-CCPs, the one-off fee for initial recognition of TC-CCPs and how comparable compliance will be reflected in the fees that TC-CCPs will be charged.

After the entry into force of EMIR 2.2, ESMA will continue its close cooperation with the regulators and supervisors involved with CCPs around the globe. We are very committed to build further on the existing good cooperation we have put in place with our counterparts in US, Asia and beyond. ●

Erik Tim Müller

Chief Executive Officer, Eurex Clearing AG

CCP recovery and resolution – preserving the EMIR incentive structure

Following the G20 commitments made in Pittsburgh, CCPs have moved into the spotlight by managing risks from financial markets in a neutral and independent manner. As rigorously regulated and supervised entities, they increase transparency, reduce overall systemic risk and – perhaps most importantly – internalize the costs of financial crises by organizing the private mutualization of losses, protecting the state and citizens from new public bail outs.

The EU has set the global regulatory benchmark with its European Market Infrastructure Regulation (EMIR). Most importantly, the EMIR framework has enshrined a robust incentive structure where all stakeholders of the CCP ecosystem have an impetus to support the stability and integrity of our financial system.

CCP Recovery and Resolution must continue building on the key achievements of EMIR– and prevent public funds from being used when facing severe market turmoil, in the interest of taxpayers and the broader society. The key to preserving the building blocks established by EMIR is to ensure that all participants – both the clearing members and the CCP – remain incentivized to contain a financial crisis within the EMIR waterfall.

"CCP Recovery and Resolution must continue building on the key achievements of EMIR."

\- ERIK TIM MÜLLER

Regarding the incentives of the clearing members, compensation claims should be clearly restricted to cases of operational misapplication of recovery measures or be captured under the No Creditor Worse Off (NCWO) >>>

>>> safeguard to act as a check on possible arbitrary decisions of resolution authorities. Allowing for unjustified and automatic compensation claims on tools agreed in the CCP's rulebook would instead void the deterrent effect that the mutualization of losses has on clearing members – thus breaking the carefully crafted incentive structure of the CCP.

Turning to the incentives of the CCP, recovery is effectively a life or death situation. As for any other company, CCP equity should be written down completely as soon as resolution is triggered. This creates the greatest incentive for the CCP to support a successful recovery, and beforehand, a strong waterfall. Any mandatory use of additional CCP equity before the end of recovery should carefully consider whether this added burden supports the incentive structure of the CCP or instead weakens the CCP at a critical moment.

Last but not least, strong safeguards concerning the use of public money should be ensured at all times to avoid a reintroduction of moral hazard at the heart of financial markets.

Therefore, the recovery and resolution framework should outline clearly stipulated methods for recouping public funds from market participants and allow its use exclusively on a temporary and refundable basis in highly exceptional circumstances.

With the world economy's performance slowing down, it is fair to assume that times ahead will not be a walk in the park. This underlines the importance of CCP recovery and resolution as the missing puzzle piece in the stability agenda. A strong CCP recovery and resolution framework will avoid public bail outs – and above all, continue to establish financial stability as prerogative and the very basis for sustainable growth. ●

Roger Nolan

Chief of Staff, LCH Limited

Building an efficient and effective CCP recovery and resolution framework

The framework for CCP Recovery and Resolution (R&R) remains a key topic for policy makers. To ensure that CCPs and their clearing community remain reliable circuit-breakers in case of a financial crisis there are two key aspects to consider:

- the importance of standards and incentives put in place by EMIR underpinning the mutualisation of market risk by its members, and
- the importance of regulatory cooperation in considering the potential resolution of an international CCP.

Firstly, CCP R&R is a direct complement to the existing EU and international regulatory frameworks (EMIR/PFMIs). As such it should uphold the existing incentives for the CCP membership to support the strong prudential requirements defined by these standards.

As clearing members introduce risk in the system by their trading activities, they provide the vast majority of resources in the CCP's default waterfall, which is calibrated according to their risk exposure. The role of the CCP is to manage these risks. The CCP operates a 'defaulter pays first' principle. In the case that the defaulters' resources are insufficient to cover losses, the CCP's resources would then be used, before any non-defaulting members'. This approach ensures the CCP is appropriately incentivised to have a strong risk management framework. It also ensures a proportionate balance of responsibility between the CCP and its members. Subsidising members' losses with additional CCP resources (such as its operational capital or additional skin in the game) would not only affect these incentives, but it could also weaken the CCP at the worst possible moment: during a financial crisis.

Secondly, CCP R&R aims to address future possible unprecedented and extreme events.

The resolution of a CCP would not happen in isolation. Rather it would follow significant widespread market turmoil, including the resolution and failure of other major banks and market participants. To reach the stage where a CCP would use recovery tools or be put into resolution would assume that the capital framework and resolution processes of these defaulting banks had already failed, and that the CCP's recovery tools had also been ineffective.

Under this scenario strong cross-border cooperation between authorities representing diverse CCP memberships would be vital to ensure effective resolution of a CCP. However, this must be executed in conjunction with the multiple bank resolutions at stake which would have led to the crisis situation.

> *"CCP R&R should uphold the existing incentives to support strong prudential requirements."*
>
> \- ROGER NOLAN

International, mutualised CCPs, supervised by multiple regulatory bodies, subject to wide-ranging coordinated resolution planning facilitate closer supervisory cooperation among regulators, both in normal and crisis times. Such cooperation can be based on the specific third country provisions of CCP R&R as well as the detailed arrangements suggested in EMIR 2.2 which would also avoid ex-ante divergence in the application of CCP resilience, recovery and resolution tools across jurisdictions.

These two aspects are vital to maintain the benefit of clearing for the wider system which is to incentivise the mutualisation of risk and prevent contagion. ●

Jochen Metzger

Director General, Payments and Settlement Systems, Deutsche Bundesbank

EU regulation on recovery and resolution of CCPs – Just another brick in the wall?

The proposed EU regulation on a framework for the recovery and resolution of central counterparties (CCP-R&R) is a welcome addition to the post-crisis regulatory initiatives. The membership of central banks in the resolution college underpins their role in the resolution planning process. This way, the central banks can ensure that resolution planning addresses the existence of adequate financial resources and does not rely on the provision of central bank liquidity.

EMIR 2.2 will set the stage for CCP-R&R to be incorporated through its envisaged third-country (TC) regime. The proposed criteria for determining whether a TC CCP is (or is likely to become) systemically important – to be adopted in a forthcoming delegated act – entail several indicators, one of which is consideration of the extent to which the CCP is subject to recovery and resolution framework or regulation. We need to ensure that EU CCP-R&R requires a TC R&R framework on a level playing field. Other important aspects concerning TCs in the context of recovery and resolution are information exchange and enforcement of resolution proceedings. In this respect, CCP-R&R provides for cooperation agreements between authorities which support carrying out resolution tasks and also exercising powers either in Member States in which a TC CCP operates or in TCs in which an EU CCP operates. However, these powers may be rejected in certain cases, which may impact their credibility. Whether enforcement as envisaged in the CCP-R&R is viable remains to be seen.

For systemically important CCPs, the FSB requirement to establish crisis management groups (CMGs) already represents a framework for cooperation between Member States and TCs. In these groups, information on resolution planning, including tools, resources and possible gaps, is shared.

As important as cooperation agreements are, it is still preferable to avoid reaching a stage in which the application of resolution tools is required. It is worth mentioning that there are several lines of defence. Firstly, in their risk management, banks have to take into account exposures to CCPs from the trading book and from contributions to the default management process (DMP). Secondly, compliance with capital and liquidity requirements already captures potential liabilities towards CCPs and is monitored by banking supervisors.

> *"Sound risk and default management, rehearsed in fire drills, are key for returning to a matched book."*
>
> - JOCHEN METZGER

Thirdly, banks' resolution planning must factor in obligations towards CCPs. Fourthly, the CCP needs a robust risk management regime which has to be continuously enforced. Lastly, an effective DMP and recovery plan – bearing in mind that the border between the two is fluid – will be key to escaping resolution. In short, sound processes, well tested and rehearsed in fire drills, are paramount for returning to a matched or balanced book. Procedures for successful auctions with incentives for CMs to participate will help to minimise losses, mitigate the depletion of the waterfall, and ultimately avoid resolution. ●

Laurence Caron-Habib

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

CCP recovery and resolution plans must preserve clearing fundamentals

The European Commission issued its legislative proposal on recovery and resolution plans (RRPs) for CCPs in November 2016, following the publication of guidelines by the FSB and CPMI-IOSCO at the international level. As of today, the European Parliament had already adopted its position since January 2018. In the Council, the negotiations were suspended throughout the last several months, as it seemed more urgent to finalise the new framework for CCP supervision, proposed in EMIR 2.2, first. Now that the EMIR 2.2 adoption is behind us, the discussions on CCP recovery and resolutions can resume.

The complexity of this new framework is not to be underestimated, as its main purpose is to ensure the continuity of the critical functions performed by the CCPs in situations so critical that they could actually entail the failure of the CCP. In such context, the most rational approach is to come back to the basics of the functioning of a CCP and its "raison d'être", and to make sure that these are not compromised in a critical situation.

CCPs have been established with the objective of providing more security to the financial system, and they constructed around two >>>

>>> fundamental principles. The first one is the mutualisation of risks among all its members, including in the precise case of stressed market conditions. The second one is the right alignment of incentives so as to ensure that the members to the CCP will not rush to the exit at the earliest sight of trouble.

As a result, beyond the minimum pre-requisites of transparency and clear definition of triggers for each phase, following rules should prevail when establishing the recovery and resolution framework for CCPs:

- all participants of a CCP (both direct and indirect) should contribute to the allocation of losses, in proportion to their exposures. As an illustration, end-users should also be part of the variation margin gain haircutting process if this tool is to be used. Consequently, those end-users who would incur losses for the sake of CCP recovery should be eligible for compensation on a pari-passu basis with the clearing members;
- on the CCP side, it should be clearly established that in case of non-default losses, losses are to be accrued to the CCP and not to its members. Therefore, appropriate recalibration of the CCP skin-in-the-game should be part of the negotiation discussions;
- the Initial margin haircut should be excluded from the recovery and resolution toolkit. IM haircut would run counter the principle of IM bankruptcy remoteness, which has just been enshrined in the revised EMIR. Moreover, there is a strong risk that this option would encourage a massive rush to the exit at the time when the CCP would most need to maintain its most important line of defense.

"The most rational approach is to come to the basics of the CCP functioning and its «raison d'être»."

\- LAURENCE CARON-HABIB

In addition to these principles, it is essential that the future regulation establishes a legal framework that is practical and unambiguous, allowing for a transparent and efficient implementation. For example, the no-creditor-worse-off safeguard should be defined in an easily understandable way in order to be a real safeguard and be readily actionable when necessary. These are highly important considerations that should inform the lawmakers in their discussions. ●

Finbarr Hutcheson

President, ICE Clear Europe

Promoting supervisory deference through internationally agreed standards

Over many years, CCP risk management practices have been tested during periods of extreme market volatility and sometimes involving clearing member defaults. Clearing has proven to be a fundamentally safe process for managing risk, so much so that following the 2008 financial crisis G20 regulators were tasked with implementing reforms to bring the benefits of clearing, such as increased financial stability, resilience and transparency, to the OTC markets. As a part of the wider clearing community, ICE has worked with global regulators as they implemented agreed standards, such as CPMI-IOSCO's PFMIs, which are designed to foster the stability and transparency of markets and protect their geographically diverse users. Adherence to these standards has contributed to the success in these reforms and the proliferation of products and markets that allow for diversity within safe financial market infrastructure.

CCPs do not themselves contribute risk to the global financial system, nor do CCPs increase systemic risk by "concentrating" risk. Instead, CCPs reduce systemic risk by collateralising and managing risk. Cleared positions are centralised in a CCP and risk managed in a highly transparent, disciplined and sophisticated manner, conforming to global standards. With this in mind, regulators implementing the G20 reforms should not ask "what risks does a third-country CCP present to our own financial market?" Rather, they should ask "how does a third-country CCP's domestic regulator ensure that the CCP employs effective risk management practices consistent with globally agreed standards that promote resilience in all financial markets it serves?"

"CCPs manage risk in a transparent and disciplined manner, conforming to global standards."

\- FINBARR HUTCHESON

Supervisory deference and regulatory equivalence have worked well in practice for decades. The CCPs' adoption of the PFMIs, and cooperation and information sharing among supervisory authorities, enables this deference and equivalence. With respect to EMIR 2.2, ESMA consulted with the public on the criteria for ESMA's determination of whether a non-EU CCP is systemically important for the financial stability of the EU. If a CCP is deemed systemically important, ESMA describes a comparable compliance regime for such CCP. It remains unclear how ESMA's draft technical advice aligns with the well-established concept of deference and equivalence and whether the use of EMIR requirements as a "floor" for non-EU CCPs will lead to contradictory requirements, duplicative supervision and conflict between multiple CCP regulators during a time of crisis.

Counterparties, market operators and regulators have spent decades creating a global marketplace, and each must do what they can to prevent the real economic harm that fragmentation will cause. Such fragmentation will lead to higher costs for commercial firms, financial institutions and their customers. These higher costs may also limit the jurisdictions that CCPs operate in and thus reduce market access from which clearing members and clients currently benefit. This reduced access will decrease the liquidity needed for well-functioning and safe markets. The EU's goal of assuring appropriate supervision of non-EU CCPs that are systemically important to the EU can be achieved through supervisory cooperation and appropriate deference. This will facilitate continued access to liquid and safe global markets which will be critical to global market participants when the next financial crisis arises. ●

NEXT EUROFI EVENTS

22, 23 & 24 April 2020

Zagreb - **Croatia**

9, 10 & 11 September 2020

Berlin - **Germany**

April 2021

Lisbon - **Portugal**

Insurance comprehensive risk framework

Alberto Corinti

Member of the Board of Directors,
Italian Insurance Supervisory Authority (IVASS)

Is ICS "globalising" some of the alleged flaws of Solvency II?

In designing a prudential framework, the valuation approach on which to base the determination of both the available and required capital is arguably the most difficult issue to resolve. The IAIS has taken an important step in this challenge by agreeing to use the Market Adjusted Valuation approach (MAV) as a benchmark for the Insurance Capital Standard (ICS). The MAV is conceptually similar to Solvency II and many other accounting frameworks, which should allow many insurers, particularly in Europe, to leverage their existing regulatory reporting data.

It is apparent, however, that the IAIS project could result in a global standard that departs to a variable extent from the current European framework, depending on its detailed finalization. From a European perspective this could imply two somehow contradicting undesired effects.

"The right way forward depends on a careful balance between diverging objectives."

- ALBERTO CORINTI

Some are concerned that the global standard might depart so much from the Solvency II principles that it would fail to achieve the main prudential objectives of Solvency II. At the same time, this would create an additional burden for the European industry.

Others are concerned that the global standard could be so similar to Solvency II that it might replicate some of its alleged flaws. This would mainly depend on its market consistent approach, and in particular on the excessive volatility of the related solvency metrics, which could end up penalizing long-term business and the crucial role of insurance in supporting and stabilizing the economy.

From the supervisor's perspective the right way forward depends on a careful balance between diverging objectives. In my view the ICS should not abandon a market consistent valuation framework. This valuation approach facilitates proper

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>>> prudential consideration of all the main risks an insurance company is exposed to and, in particular, it allows for the sufficiently early detection of any materialization of these risks. The Solvency II experience shows that this approach also fosters enhanced risk governance within the insurer's organization as well as increased transparency in solvency reporting. At the same time, however, the framework should be adjusted so as not to unduly penalize long-term business.

In fact, based on the current proposal, the reference ICS relies on a MAV. The adjustments are a critical feature of the ICS valuation framework with the objective to reflect the long-term nature of insurance contracts. They aim is to mitigate potential excessive volatility in capital resources by avoiding reflecting changes in market conditions that do not affect the insurer's solvency. Hence, they acknowledge the asset liability management and its investment consequences.

At the same time, the ICS aims to include all the quantifiable risks and provides a quantitative measure of the actual exposure of the insurer to these risks. As such, the objective is neither to incentivise nor to penalise particular insurance markets or asset classes, but rather to ensure adequate capital coverage for the specific risk profile of an insurer, based on a predefined prudential measure.

The IAIS uses all available data in an open dialogue with the stakeholders to calibrate the risk charges. One example is the ICS's treatment of infrastructure investments: the IAIS will use the monitoring period to review the available information and to assess whether there should be a differentiated treatment for these investments.

The challenge is to properly design and calibrate these adjustments and capital charges without departing from a market consistent valuation and a risk sensitive capital determination. This is not an easy balance to be found, and indeed the main flaws of the current Solvency II framework, in my view, stem from not having found the right balance of these objectives yet. The current Solvency II review aims to address exactly these flaws. It focuses mainly on the so called "long-term measures" and on the calibration of the capital requirements. It is evident that developing and improving such a complex framework needs its time.

In this context, obviously, it is crucial that the Solvency II review and the ICS develop towards these objectives, in order produce a regulation which protects policyholders and, at the same time, do not constraints the social and economic role of insurance. ●

Joseph L. Engelhard

Senior Vice President, Head Regulatory Policy Group, MetLife, Inc.

The G20 challenge – what role for insurers in a single ICS world?

All sectors have important roles to play in facing the G20 global challenge to foster economic growth. Insurers in particular can play a leading role in providing long-term protection products which naturally lead to the growth of capital markets. In ageing societies, we can help governments meet important public policy goals via both our products and investments.

Among the many important topics covered by the Declaration is the G20 commitment to "strong, sustainable, balanced and inclusive growth." Insurers are uniquely placed to assist with this challenge. They offer protection tailored to the needs of individuals and families against adverse events that could otherwise have severe economic consequences. Protection of these most fundamental societal units against severe financial setbacks supports enhanced productivity for all and a collective contribution to inclusive economic growth and a strong social fabric.

The Declaration underscores the challenge of funding aging societies and maintaining a well-functioning fiscally sustainable social safety net. The long-term products many insurers offer play a critical role in assisting governments meet this huge challenge with both accumulation and decumulation products. >>>

>>> Long-term products are gifts that go on giving. They promote economic growth through liability-driven investments in capital markets. Long-term liability-driven investments can stabilize the financial system; their illiquid nature encourages buy and hold strategies that can ride out turbulence that may force other investors to sell into falling markets. Data from the 2008 financial crisis bears this out.

As the foregoing makes clear, the risks insurers assume arise out of geographic or demographic characteristics that create unique societal needs. Accordingly, insurance operations and the regulation of these operations are largely local and tailored to local requirements. Many global insurers, including MetLife, are concerned that the ICS is not sufficiently developed and won't allow us to meet the varying local needs for insurance products.

> *"The study should assess if the ICS will create artificial volatility or reduce...protections."*
>
> \- JOSEPH L. ENGELHARD

While there is a need for a common language to facilitate understanding among supervisors of large, global groups, an insistence on a goal of a single framework focused on near-term market movements threatens the diversity of product offerings, social support and positive impact on economic growth that insurance traditionally provides. This result runs counter to G20 calls for a virtuous cycle of growth where all may realize their full potential.

To avoid these negative outcomes, we believe it is necessary to address the remaining ICS design issues during the five-year monitoring period, which the IAIS admits should be a period of continued development of the ICS. We also believe it is critically important for the FSB and IAIS to do an impact study. The study should assess if the ICS will create artificial volatility or reduce policyholder protections. This requires studying not just how the ICS would impact insurers during a financial crisis but, more importantly, how insurers might adjust their product offerings to the detriment of the public policy goals of protecting consumers in the long-term and making long-term investments in capital markets and infrastructure.

Tobias Bücheler

Head of Regulatory Strategy, Allianz SE

Navigating treacherous waters – the ICS 2.0 and the monitoring period

After substantial development efforts since 2013, the International Association of Insurance Supervisors (IAIS) intends to finalize the global Insurance Capital Standard version 2.0 in November 2019. This will be followed by a 5 year monitoring phase in which the ICS shall be discussed in supervisory colleges of Internationally Active Insurance Groups (IAIG) prior to its adoption in 2025.

While Allianz has been supportive of the development of a truly global insurance capital standard since its inception, we are concerned about current proceeding due to design but also implementation challenges and related implications.

From a design perspective, major elements of the ICS, such as the final discount methodology, the risk margin approach and the deferred tax concept remain yet to be defined. As a result, the final ICS 2.0 will be subject to last minute changes resulting in a framework that has not been thoroughly tested. This does not bode well as a basis for the monitoring period in which only limited adjustments were initially envisioned.

Against this background we believe that it is important to allow for a comprehensive quantitative impact study (QIS) to test the ICS under different economic scenarios but also to address remaining concerns by stakeholders regarding potential pro-cyclical investment incentives, impact on long-term life insurance products and financing of the real economy. The ICS 2.0 should then be evaluated based on the QIS results and further developed as relevant. This is also important to avoid a premature relevance of the ICS for capital markets which would inevitably result when markets perceive the ICS as completed.

These challenges are further aggravated by the fact that the ultimate target picture for the ICS remains somewhat elusive. The IAIS' Kuala Lumpur agreement calls for a standard ICS to be implemented by relevant jurisdictions, possibly complemented by „outcome equivalent" regimes. The local adoption of any future ICS standard however seems unclear especially considering ongoing developments of local regimes in major markets like USA, Europe and Japan.

> *"The local adoption of any future ICS standard however seems unclear especially considering ongoing developments of local regimes in major markets like USA, Europe and Japan."*
>
> \- TOBIAS BÜCHELER

Against this background it might be worth considering whether a global equivalence framework based on an ICS benchmark could be a more viable alternative. Such a framework would allow jurisdictions to assess foreign regimes for recognition as equivalent under local rules and could provide a pathway towards a joint global language for supervision while addressing level playing field concerns and respecting relevant jurisdictional specificities.

Martin Merlin

Director, Bank and Insurance, DG Financial Stability, Financial Services and Capital Markets Union, European Commission

Ramping up insurers' contribution to European long-term and sustainable growth

The European economy needs more stable capital in order to finance tangible assets (including energy infrastructure, industrial facilities, climate change and eco-innovation technologies) as well as intangible assets (such as education and research and development) that boost growth, innovation and competitiveness.

With trillions of assets under management, the insurance sector remains a mainstay of the European financial industry. Due to the long-term nature of their liabilities, insurance groups can greatly contribute to the sustainable and long-term financing of the economy. They have therefore a pivotal role to play in the context of both the Capital Markets Union (CMU) and the Commission's Sustainable Finance Action Plan. By being able to invest counter-cyclically, they can also temper down excessive price movements in financial markets, thereby contributing to financial stability.

"It is now up to insurers to help finance the shift to a low-carbon economy and a sustainable growth."

\- MARTIN MERLIN

In the current low-yield environment, investments in equity and green infrastructure should attract insurance groups, as they provide regular income and some inflation hedge with low correlation to the returns of other investments. However, in practice, insurers have been retrenching from long-term assets and the actual share of their investments in the real economy and in green infrastructure remains limited. Further, some studies challenge the counter-cyclical nature of insurers' investment behaviours.

As part of the CMU Action Plan, the Commission is committed to identifying the barriers that are keeping insurers' allocations to long-term investments low, and to determining which policy levers can help overcome these barriers. In this regard, some stakeholders claim that the prudential framework, relying on market value and capital requirements calculated over a 1-year time horizon, have fostered insurers' short-termism in investment decisions. On the other hand, the downward trend of investments in long-term assets dates back to the late 1990s, and therefore cannot be only driven by prudential rules.

In fact, the prudential regulation should neither unduly favour nor hinder long-term investment but provide the right incentives for robust risk-management while avoiding excessive risk-taking both from a micro- and macro-prudential perspective. The European Commission has recently amended Solvency II to lower capital requirement for long-term investments in equity, including in small and medium sized enterprises, provided that insurers have implemented appropriate asset-liability management.

In the context of the forthcoming broad review of the Solvency II Directive in 2020, the Commission will further explore whether the prudential framework appropriately reflects the long-term nature of the insurance business and the ability of insurers to invest counter-cyclically, as well as the impact of Solvency II on insurers' sustainable investments.

As regards the Sustainable Finance Action Plan, building on the future EU taxonomy, the integration of sustainability considerations in financial advice or the current discussions on an EU Green Bond standard can ramp up the contribution of the insurance sector to the greening of the economy and to our climate objectives.

It is now up to insurers to help finance the shift to a low-carbon economy and a sustainable growth. ●

V. SUSTAINABILITY AND LONG-TERM INVESTMENT

Issues at stake

The EU investment gap is due to widen as a result of developments such as ageing, 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. In this respect, 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, notably by mitigating climate change risks. A further challenge is the revision of the Solvency II framework in order to enhance the contribution of the insurance sector to EU long-term investment needs.

Content

ESG agenda: EU priorities

Andrew McDowell

Vice President, European Investment Bank (EIB)

In defence of climate

The Germans famously have expressive words for everything, so it should come as no surprise that they have a great one for efforts to fight climate change: 'klimaschutz', or climate protection. What we usually call climate action, mitigation and adaptation are all about protecting the climate from our consumption and defending ourselves from the climate change we are unable to reverse.

What we call things is important. Since the beginning of the year, there have been increasing calls to establish a European Climate Bank, notably by French President Emmanuel Macron and by the new president of the European Commission, Ursula von der Leyen.

Well, the European Investment Bank, the EU bank, is also Europe's Climate Bank, in all but name. The EIB is one of the largest multilateral financers of climate action (or climate protection) projects globally. Last year, we exceeded our target for financing climate action for the ninth year running, providing more than €16 billion (30% of all our financing). We are well on our way to fulfilling our $100 billion commitment to the implementation of the Paris Agreement between 2016 and 2020.

"Just and additional trillions for climate protection".

\- ANDREW MCDOWELL

The EIB launched the world's first green bond in 2007, ushering in a market for sustainable finance and environmentally responsible investment. We learned quickly that confusion on the capital markets regarding what constitutes 'green' can hamper private investment – yet leveraging private investment is crucial. Public investment will never suffice to achieve our climate objectives or any of the sustainable development goals. Thus, in addition to being the largest multilateral issuer, we have been trying to harmonize the taxonomy, and promote transparency and accountability. EIB is a proud contributor to the European Commission's Technical Expert Groups on this.

Sustainable finance is not just about climate, so last year we launched Sustainability Awareness Bonds to fund other UN Sustainable Development Goals. We started with goal number 6 ('Ensure availability and sustainable management of water and sanitation for all'), and this year we want to expand to cover other goals like healthcare or education. >>>

>>> Over the past months, we undertook a comprehensive review of our energy lending criteria, with inputs from a range of NGOs and other stakeholders. The outcome will soon go before our board and will set our energy trajectory for the coming years.

One thing that is increasingly clear is that a move away from fossil fuels must be a "just transition". Currently, dozens of regions in EU member states actively mine coal, providing jobs to about thousands of people. For these people to find alternative employment, we need to invest in giving them new skills and make sure there are other opportunities in these regions.

The EIB is also reviewing how we measure our "additionality", the way we ensure our financing does not replace others who would have invested anyway. Our new additionality framework will make sure our investments address well-documented investment gaps resulting from market failures and positively influence the investment in terms of the scale, scope, structure, quality or speed, complementing other sources of financing.

The EIB and other international finance institutions cannot – of course – turn the tide on sustainability efforts by themselves. But we have the essential task to build the conditions and design the instruments that pave the way for other investors to increase their support for the sustainability agenda. And we will soon propose to our shareholders ambitious new objectives, because we need to step up investment for climate protection from billions to trillions. Alternative ways to structure climate finance certainly exist, such as separate entities or off-balance sheet financial instruments, and we are ready to develop these, building on our existing experience.

At the root of this, there is another evocative German word that we all know which will help us accomplish a more ambitious climate defence plan. It's "zeitgeist", the spirit of our times, driving an increasing consensus that more must be done in defence of climate. ●

Jordi Gual

Chairman, CaixaBank

Banks and the transition to a low-carbon economy

The European agenda to promote sustainable finance is advancing. The taxonomy framework for sustainable activities is a necessary step to improve transparency, establish benchmarks and facilitate appropriate risk assessments. To that end, the framework should be applicable to a broad range of economic activities– so as to recognise those that help in the transition to a low-carbon economy-and be flexible enough so that it can evolve if necessary.

The financial system, as an intermediary between savings and investment, has a key role to play in the mobilisation of the necessary resources to tackle climate change and mitigate its effects. We must foster the transition towards a low-carbon economy without causing great distortions or unnecessary inefficiencies. To do so, we should ensure that the appropriate incentives are in place.

"The financial system will support an efficient and fair transition to a low-carbon economy."

- JORDI GUAL

Firstly, enhancement of transparency and disclosure levels should be prioritised. This would facilitate the inclusion of environmental and transition risks in market prices, and help economic agents to incorporate environmental externalities into their investment decisions. This, in turn, would increase market efficiency while discouraging investment in the most carbon intensive industries. Improved transparency and disclosure levels would also help investors to assess returns on investments in green projects, >>>

>>> reduce costs and facilitate comparability between investments.

Secondly, regulatory policies should be technologically neutral. Picking winners is unlikely to lead to good outcomes. Both the optimal mix of energy sources to address the challenges posed by climate change and the technology associated are likely to evolve over time. Therefore, we should establish a framework that encourages competition and does not discriminate in favour of specific solutions.

Thirdly, the battle against climate change should also take into account the distributional effects of the policy-driven transition to a low carbon economy. In particular, some regions and industries will be impacted in terms of jobs and allocation of resources, and it will be necessary to compensate the social groups that may suffer the most in order to maintain social cohesion and avoid a political backlash.

Finally, the transition towards a more sustainable economy is a responsibility shared by all economic agents and it crucially involves the financial sector. Beyond providing financing, banks ought to integrate environmental responsibility criteria into their strategic priorities. Financial institutions which embrace these criteria will be able to generate more value in a more sustainable manner.

Climate change is a global challenge that demands global solutions; high levels of coordination between the various agents involved; and clarity on the strategic roadmap of public policies. There is still a long journey ahead.

However, we must keep moving forward and find the right balance between the need to make urgent progress tackling climate change and facilitate the energy transition in an efficient and socially sustainable way. ●

Snorre Storset

Head of Asset & Wealth Management, Nordea Bank Abp

Finance needs to play its part towards a more sustainable economy

Nordea has been committed to sustainable finance for a long time. We are fully prepared to play our part and serving our customers when sustainable finance becomes more and more the mainstream of finance. A growing number of citizens are requesting that their bank offers advice and products for saving and investing sustainably.

As the largest bank and the largest asset & wealth manager in the Nordics we take on the responsibility for offering our clients sustainable solutions. Because we should. Because we can. Because we want to.

Nordea fully supports the Commission's Action Plan for Financing Sustainable Growth and believes that the specific actions will have the effect of moving capital flows towards sustainable investments and ultimately bringing ESG into the mainstream of financial markets. The finance sector should indeed do its part and support the sustainable transition in the general economy. Setting the right incentives for the financial industry and at the same time to other parts of the economy will be key.

"There is a strong momentum to bring sustainable finance into the mainstream of financial services."

- SNORRE STORSET

Given the urgent need to transform the global economy into a more sustainable, resource efficient low carbon economy, it is important to move forward with speed. At the same time, we need to recognize the potential transition risks for certain segments of the economy.

A stepwise and measured approach is needed alongside with an early communication of regulatory priorities, so that the transition risks can be proactively managed, and thereby as orderly transition as possible to be ensured.

So far legislators and supporting expert groups have made impressive progress to make the action plan a reality. This gives the ambitious plan a lot of credibility both inside and outside the EU. We welcome the recent agreement on disclosures to increase the level and quality of ESG information to the market. This will enable investors to make better informed decisions.

We would also welcome agreement on a taxonomy. Having the same definitions on what is sustainable creates a solid foundation for all other actions in the plan. The taxonomy should be dynamic and consider how existing taxonomies and ESG strategies might be integrated.

The taxonomy likewise needs to be easy to use and reflect the reality of different sectors, which the Commission is trying to ensure by consulting stakeholders.

Financial markets need to learn to identify the environmental impact of various economic activities. This learning process has started with green bonds and it will accelerate with the measures being agreed based on the action plan. For Nordea, our customers and our investors, understanding the ESG risks will become an increasingly critical area. An approach of integrating ESG risk factors into our risk management process and methodologies is ultimately the right way forward and where to initially focus in terms of prudential regulation.

There is a strong momentum to bring sustainable finance into the mainstream of financial services with an increasing customer demand, industry supply and public interest.

An open dialogue between policymakers, the industry and the users of financial services can make this transition a reality in the next few years. ●

Dominic Rossi

Senior Advisor, Fidelity International

Sustainable finance - A game changer for industry

ESG is a dominant theme within the asset management. It is now central to the business models of all the large asset managers as ESG is one of the few areas within the active industry that is growing. This was not the case more than a decade ago. Active managers are responding principally to client demand in Europe and increasingly in Asia, and now see ESG criteria as a logical extension of their stewardship and engagement activities. It is important that regulators understand the market place is moving rapidly in the direction of sustainable finance. A taxonomy that clarifies and enhances non-financial disclosure can help.

The real driving force behind the asset management industry's adoption of ESG are its clients. This movement started in northern Europe over a decade ago, now covers the entire continent. More recently, an increasing number of Asian clients, particularly in Japan, are assessing asset managers on their ESG credentials. In the Institutional market place, it is not uncommon for an asset manager to face over 50 questions on its ESG capabilities from a potential client during due diligence. In the retail market, mutual funds are actively sold on providing access to sustainable areas of the economy rather than on fund performance and asset managers - including Fidelity - are launching new sustainable funds to meet increasing client demand.

These external forces are requiring asset managers to re-think and re-engineer their internal resources. At Fidelity International, our 140 strong equity analyst team is being re-trained to scrutinise investee companies globally on ESG performance. We are developing our own proprietary ESG rating system. Today our analysts link health and safety records at energy companies to executive compensation. We seek answers to questions we have on Scope I and Scope II Greenhouse Gas (GHG)emissions. Our work is hampered, however, by the voluntary nature of non-financial corporate disclosure and the lack of standards that would otherwise assist our ability to measure corporate performance on a relative basis.

"A global regulatory approach is vital, and the EU can play a key role in international coordination."

\- DOMINIC ROSSI

Regulation will need to keep pace with this radically and rapidly changing market place. A timely and sensible taxonomy that can bring a common dictionary to the ESG landscape would be a valuable first step. We do not see how we can move to a system of reliable labels and benchmarks until we do. The sequencing of the EU Sustainable Finance Action Plan will be key to its success in the market place. Further, we should seek a global regulatory approach that creates a level-playing field across all financial services providers and products, and the EU can play a key role in international coordination. While a global approach may seem ambitious, we should strive to avoid a repeat of the schism within the accounting world between US GAAP and International accounting standards that complicates free capital flows. ●

Eric Campos

Head of Corporate Social Responsibility, Credit Agricole S.A

The strategy of climate disclosure

In the wake of the European elections in spring 2019, EU citizens have witnessed a flowering of statements marking an important step in the development of a much-needed common and transparent language for mainstreaming sustainability in the financial sector. The European Commission adopted new guidelines on companies' climate-related information reporting consistent with the TCFD's recommendations, and 3 new key reports has been published by the EU Technical Expert Group on sustainable finance (on Taxonomy, Green Bond Standard, Climate benchmarks).

Much has been done over the last years at the national, European and international level to improve the quality of the disclosure of non-financial information (France's article 173, the European NRFD, the TCFD's work). However, much still remains to be done in order to combat two of the main threats posed to the goal of decarbonizing our economies effectively: the lack of consistency (confusion) and transparency (greenwashing) of climate-related information. If a meta-framework is needed to improve the robustness and comparability of companies' non-financial performance, the financial actors themselves – as enablers of the real

economy – should also play a significant role in order to meet their stakeholders' rising expectations for transparency and accountability.

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>>> As a leading provider of funding to the French economy with an international reach, Credit Agricole is being committed in terms of its societal responsibility. Over the last decade, the Group has been a pioneer in climate finance: disclosing the carbon footprint of its portfolios since 2011, being a world's leader in Green Bonds since 2012... Mindful of the climate emergency, Crédit Agricole adopted in June 2019 a new Climate Strategy whose ambition is to make green finance a growth driver for the Group, in line with the Paris Agreement. To live up to this complex ambition, the Group has defined the main conditions for the success of this strategy. The first one is a commitment to greater transparency, entrenched at the highest governance levels. Steered by an innovative governance based on scientific expertise and operational assessment, the climate strategy's implementation will be audited and certified by an independent third-party body, and its reporting requirement will be published in full accordance with the TCFD's recommendations by 2020.

"A transparent language is needed to mainstream sustainability in the financial sector."

\- ERIC CAMPOS

The second lies in the Group's ability to assess its corporate clients' level of alignment with a below 2°C scenario and to reallocate its own portfolios in accordance with it, by increasing its energy transition and decreasing its fossil fuel financing (with a planned total phase-out from thermal coal, and the annual publication of our coal exposure as of 2019).

In the absence of available and robust non-financial data, this assessment is in itself a challenge. To meet it, the Group decided to build-up two central tools: a "transition scoring" that will measure the clients' capacity to adapt their business models to the energy transition; and an information system that will be able to capture financial and non-financial data through a relevant reading grid. Creating these instruments, and thus securing the Group's own transparency, face two difficulties:

- an "internal" one: the criteria the Group will choose for building this relevant reading grid in an adequate information system. Here, the EU Taxonomy is likely to be of valuable help.
- an "external" one: the quality and accessibility of its corporate clients' non-financial data. Here, the Group will be dependent on the data its clients share.

Therefore, more than ever, Credit Agricole supports the efforts of the European Commission to make corporate climate-related financial disclosure mandatory, public and verifiable. ●

Sylvie Goulard

Second Deputy Governor, Banque de France

What can central banks do to manage the challenges of climate change?

The Stern report in 2006, entitled the "costs of inaction", laid bare the urgency of better anticipating – and tackling – the challenges of climate change. Even though it is difficult to assess precisely the "costs of inaction", there is today a broad consensus that they will be much higher than the "costs of action". It is also clear that these costs will have a huge impact on the global economy. As an example, according to the OECD, if no action is taken to reduce carbon emissions (and temperatures continue to rise on a 4°C pathway), global GDP could be hurt by up to 10% by the end of the century.

It is within Central banks' remit to assess how climate-related risks can affect financial stability. To do so, the Banque de France, together with seven other central banks, launched in 2017 the Central Banks and Supervisors Network for Greening the Financial System (NGFS). The NGFS understands itself as a "coalition of the willing". The rapid path at which the NGFS is growing can thus be seen as an indicator of the importance topics related to climate change are gaining among central banks globally: as of July 2019, the NGFS membership consists in 42 members and 8 observers. This April, the NGFS published its first comprehensive report. The report presents four recommendations for central banks and supervisors and two recommendations for policymakers at large, to enhance their role in greening the financial system. In the coming months, the NGFS will publish a series of technical documents on climate and environmental risk management for supervisory authorities and financial institutions, voluntary guidelines on scenario-based risk analysis and best practices for incorporating sustainability criteria into central banks' portfolio management.

The Banque de France provides the NGFS Secretariat[1]. Furthermore, as any financial institution, the Banque de France has its very own responsibility in overcoming the "tragedy of the horizon" (Carney, 2015) and has decided to lead by example by integrating climate-related criteria into its own portfolio management strategy.

Managing the challenges of climate change also means measuring the level of "preparedness" of the financial sector. In April 2019, the Autorité du Contrôle Prudentiel et de Résolution (ACPR) – the French supervisor for banks and insurance corporations, published two reports[2] on how French banks and insurers take into account and manage climate-related risks. The studies find that there is a significant progress in the governance of climate change risks and in the analysis of transition risks. However, banks and insurers can still make some progress in analyzing physical and liability risks. ●

1. NGFS: A call for action – Climate change as a source of financial risk (https://www.banque-france.fr/sites/default/files/media/2019/04/17/ngfs_first_comprehensive_report_-_17042019_0.pdf), April 2019.
2. ACPR: French insurers facing climate change risk (https://acpr.banque-france.fr/sites/default/files/medias/documents/as_102_climate_change_insurers_en.pdf), April 2019.; ACPR: French banking groups facing climate change-related risks (https://acpr.banque-france.fr/sites/default/files/medias/documents/as_101_climate_risk_banks_en.pdf), April 2019.

The Eurofi Financial Forum
Helsinki September 2019

Fostering investment in sustainable projects

Alain Godard

Director General, Risk Management,
European Investment Bank (EIB)

Climate change – no business as usual for risk management

With a pledge to provide USD 100 billion for climate action projects in the five-year period to 2020 and with some EUR 24 billion in green bonds issued over the past decade, EIB has strongly positioned itself as a leader in climate finance. To support transition to a "Paris-aligned" economy by providing financing is one side of the coin. There is, however, another side of the same coin, which is of particular relevance from a risk point of view: The requirement to assess the financial risks of climate change and of the business models and assets to which the green economy will give rise.

> *"Best banking practices call for a treatment of climate risk as a financial risk."*
>
> \- ALAIN GODARD

It is crucial to understand that best banking practices call for a treatment of climate risk as a financial risk rather than merely as a reputational issue. Measuring that, however, triggers a number of key questions:

Does the banking community have an accepted means of quantifying the climate risk in its portfolios? At present, with a few exceptions, the quantification of climate change risk still poses a challenge to banks and, crucially, no "market standard approach" for assessing such risk seems yet to have emerged. For example, significant work has been done on addressing transition risks – i.e. the risks inherent in financing assets or business models that may become non-viable (or "stranded") in the future. For EIB, however, given the Bank's heavy focus on infrastructure, it was also important to analyse physical risk right from the start – i.e. the risks to physical assets brought about by more uncertain future weather patterns. EIB's first climate risk assessment tool therefore follows a project-level approach, to be complemented with top down overall assessments, possible deep dives into the most exposed sectors as well as bottom-up analyses of individual counterparts. In developing this internal approach, the absence of well codified existing "risk tools" that are common in established fields of risk management (internal rating models, capital models, stress testing, etc.) is apparent and raises important questions around how the industry will collectively assess and report these risks in future.

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>>> **Is the banking community properly equipped to assess new and emerging business models?** Financial institutions can help enable companies' transition to a circular economy by providing appropriate financing, network development services, and advice. For linear banks (heavily exposed to "take, make, dispose" business model investments), credit risk assessment might not properly take into account the value of a circular product and its positive externalities, while linear risks like raw material price volatility and scarcity or stranded assets associated to their investment portfolio may be insufficiently acknowledged. A new mind-set in risk assessment practices, and potentially new tools, may be required.

Is the banking community fully aware of potential new risks embedded in "Paris-aligned" portfolios? As multilateral development banks are facing increasing pressure to be "Paris-aligned", and supervisors are working on taxonomies of green and brown assets, which may in due course attract differentiated capital treatments, we also need to ask the question to what extent a "Paris-aligned" portfolio is risk-proof. While being "Paris-aligned" may protect us against some transition risks, new risks can arise out of a strong exposure to green tech, for which proper assessment and monitoring is crucial. This includes supply/commodity risks and specific environmental risks related to rare earth and rare metals as well as specific cyber risks linked to digitalisation/artificial intelligence features embedded in green techs.

These are just three questions that climate risk and the new economy pose for bankers. They point to a necessary journey that will inevitably start with imperfect assessment tools, to be debated among banking practitioners. ●

Ana María Martínez-Pina García

Vice-Chair, Spanish Securities and Exchange Commission (CNMV)

Optimal role of the financial sector in the transition to a sustainable economy

This topic has become a standing item on the agenda of all international and national members of the financial sector after the lessons learnt from the recent financial crisis: the importance of climate and social matters, including gender and diversity balance, corporate governance and the need to focus on sustainable and long-term strategies.

Many international initiatives, such as the Paris Agreement or the UN 2030 Agenda, have mirrored these learnings and also show consensus on two issues:

- sustainability is crucial to ensure long-term competitiveness in the economy;
- the financial sector has a key role to play.

We can observe increasing attention to sustainability matters in the private and public sectors. In Europe, the private sector took the lead, to meet an increasing demand for financial products that take into account the social or environmental aspects of the investment itself. We have attended to the creation of collective investment schemes of different types (mainly funds) that are known as "ESG" and "collaborative" as they meet certain requirements that allow them to be labelled as such by different private associations.

In the area of domestic, public and saving banks, the sustainability trend has materialised in the issuance, among others, of the so-called "green bonds, "social bonds, "affordable housing bonds" or "water bonds". Some States and Central Banks have even issued their own green bonds.

> *"Every financial sector member has a role to play to promote the transition to a sustainable economy."*
>
> \- ANA MARÍA MARTÍNEZ-PINA GARCÍA

This responds to an increasing concern of society, and particularly of its youngest members, to invest in companies and assets that respect the environment, social rights and good governance practices. In this regard, the European >>>

>>> regulators set a milestone with the Non-Financial Reporting Directive[1] as it required certain companies to report non-financial information in their annual accounts. Thereafter, the European Commission Action Plan set out a roadmap with key items for the financial sector to consider. The European Supervisory Authorities (ESAs) have been actively working on the mandates received in relation to the Plan, as well as the rest of the financial sector, to try to smoothly prepare for the transition.

Securities regulators also have a role to play. The vast majority of us have the mandate to monitor the non-financial information disclosed by corporations and we must foster investor protection by providing the conditions that allow investors to have access to accurate and substantial information on ESG investments and risks.

Government initiatives aimed at promoting sustainability are also crucial. It is necessary to raise awareness, establish tax incentives and, in general, adopt measures that contribute to long-term investments and remove obstacles to innovative means of financing.

Every financial sector member has a role to play to promote the transition to a sustainable economy. The implementation of the European Commission Action Plan will benefit the competitiveness of EU companies and provide a level playing field for all market players. At the same time, a stronger coordination of supervisory activities across the EU will help us to make the Economic and Monetary Union more resilient. The private sector should continue to meet clients' demands and the public authorities should try to keep pace with these new trends, taking into account their legal missions, mandates and competences. ●

1. Directive 2014/95/EU of the European Parliament and of the Council, of 22 October, amending Directive 2013/34/EU as regards disclosure of non-financial and diversity information by certain large undertakings and groups.

Laurent Zylberberg

Director of Public, International and European Affairs, Caisse des Dépôts (CDC) & Chair, European Association of Long-Term Investors (ELTI)

NPBIs, a decisive support for the Invest EU programme

The National Promotional Banks and Institutions (NPBIs) are committed in boosting long-term investment throughout the European Union (EU). In less than two years the next Multi-annual financial framework (MFF) will give NPBIs the opportunity to make EU financing more impactful and more visible locally.

In this framework, the "InvestEU programme", successor of the Investment Plan for Europe (the so-called "Juncker Plan"), should contribute to resolve the intricate equation of doing more and better with less.

This instrument will be key in maximising the impact of the European budget by offering a rationalized structure and grouping a multitude of EU financial instruments currently available under a single umbrella, thus offering greater flexibility and efficiency. The InvestEU programme is a key step for embarking all actors.

It will also rely on multiple implementing partners including national actors, like Caisse des Dépôts Group (CDC), such as NPBIs. Opening direct access to the EU guarantee will bring more complementarity which are crucial in financing smaller and riskier projects by relying on three know-how methods:

- "labelling" to identify on-the-ground projects with the most added value (both economically and socially);
- "bundling" of small projects together (to collect them into 'packages' allow to meet the critical financial threshold) and;
- "blending" those projects which require both subsidies and financing. In any case NPBIs will help to crowd-in private financing resources.

The National Promotional Banks and Institutions share a common goal: fostering the economic development of their country by relying on their financial and technical expertise with targeted financing solutions for both key innovative infrastructure and economic stakeholders targeted for the development of underserved territories and actors.

"The next MFF will give NPBIs the opportunity to make EU financing more impactful."

- LAURENT ZYLBERBERG

They also share a common voice at EU level, through their European association of Long-Term Investors association (ELTI) and have over the past years demonstrated their ability to cooperate with European Institutions. Individually and through their common association ELTI, NPBIs are ready to provide their support, common experience and financial capacities for the full success of those indispensable new instruments.

The National Promotional Banks and Institutions are ready to get involved in this market-based and policy-focused instrument to achieve sustainable, inclusive and innovative goals and to helping mobilise €650 billion in additional investment by 2027 and therefore greatly enhancing the outreach of the EU support. ●

Suzanne Buchta

Managing Director, Global Head
of ESG Capital Markets,
Bank of America Merrill Lynch

The financial sector needs to accurately gauge transition risks

The financial sector will play a crucial role in the transition towards a global low-carbon economy. However, the sector currently faces a challenge of how to value accurately the risks of such a transition. One place to start could be by questioning implicit assumptions in current 'financial risk analysis', and by considering other risks that have either been overlooked or ignored. These assumptions and risks include:

1. That resources are infinite instead of limited and constrained;
2. That current technologies are stable and efficient instead of easily disrupted;
3. That client demand is entrenched in current technologies rather than shifting.

For finite resources such as water, precious metals and other rare minerals, the financial sector may need to start assuming a charge for them, similar to the congestion taxes levied by a number of inner cities or the emissions taxes charged by airlines. Taking into account the current population growth trajectory multiplied by the growth in resource use per person, the financial sector will need to reconsider the associated risks in its lending/investment portfolios in order to appropriately value the constrained resources.

In addition to changes in the level of constraint on natural resources, technological disruption can create risks where previously there were none. Consider, for example, the massive technology improvements in renewable energy over the last 10 years. Now, in a number of sunny regions, new solar installations price at or below parity to new coal builds that generate the same energy output. What does this technological shift do to the inherent risk in a coal portfolio (perhaps at least part of the reason why we see so many coal exit announcements)?

Finally, are consumer preferences changing? We have already seen the plight of high street retailers caused by consumer shifts to online purchasing, and it is not difficult to imagine a similar situation affecting energy-acute sectors such as transport. If electric vehicles become as cheap to produce and buy as diesel vehicles, might consumers not eschew the latter for the former? If so, what does that demand shift do to the value of a portfolio of loans to car manufacturers who have no electric vehicle model/factory/supply chain?

The financial sector needs to reflect on its risk analysis to take into account more fully this change in assumptions. The path towards transition will have to include more accurately capturing, analysing and valuing risks in the lending and investing portfolios of financial institutions. This will pave the way for a sounder and more climate-conscious allocation of capital, which will in turn help address future environmental challenges. ●

Ingrid Holmes

Associate Director, Head of Policy
and Advocacy, Hermes Investment
Management, Federated Investors (UK) LLP

What is the necessary role of the financial sector to accelerate the transition?

In 2014, the New Climate Economy report confirmed that the transition to a low carbon economy is feasible and that the requisite capital to fund it is available. However, it also notes that delivering this transition in way at that minimises shocks to the financial system – i.e. through what central bankers refer to as an 'orderly transition' in the timescales required - will require investors, corporates, governments and individuals working consciously and collaboratively to achieve this shared goal.

Within the financial sector awareness of the grave risks but also significant opportunities posed by the climate challenge is growing, driven by initiatives such as the Paris Agreement on Climate Change and the Taskforce on Climate-Related Financial Disclosures and the efforts of many governments to start to decarbonise their economies. In some countries, renewables outweigh fossil fuels in the power generation mix. In others, electric cars are already more cost effective than petrol and diesel alternatives. Elsewhere, corporates are adopting regenerative agriculture techniques that protect and enhance the environment, improve carbon storage and cut the dependence of farmers on agrochemicals, many of which are derived from fossil fuels.

But despite these good news stories, much more remains to be done. New EU investors disclosure rules aim to accelerate the mainstreaming the consideration of these issues into investors existing due diligence and risk management processes and will help with awareness raising. The expectation is that through this means climate change and

wider ESG factors will start to be factored into company valuations and access to and the cost of capital for firms. In time we should also expect to see new climate aligned benchmarks becoming more widely used by asset owners to award mandates.

Changes to MiFID2 and the Insurance Distribution Directive will help identify latent demand for more sustainable approaches to investing, which currently make up around 20% >>>

>>> of EU assets under management, by requiring sellers of investment and insurance products to consult clients on their sustainability preferences.

Understanding political and regulatory risk as drivers of value will also be key to banks and investors – but equally so is understanding that constructive dialogue with government is important to create the market frameworks under which the new low carbon economy will be created.

But it is not only investment decision making and valuation processes that must adapt. Given how far away we still are from delivering a low carbon world, arguably the biggest change asset owners, investment managers and indeed capital market makers such as the investment banks can make is to engage with companies most exposed to the low carbon transition. These engagements should look to address climate risks or opportunities and challenge companies to move further, and at a faster pace, through assertive stewardship. This is something the newly updated EU Shareholder Rights Directive encourages.

The financial sector is in unique position to help accelerate the transition to a low-carbon economy through being mindful of the way that it allocates its resources and engages with investee companies on the need for change. In doing so we can achieve lasting economic growth while also tackling the risks of climate change by seizing the opportunities presented by those providing capital solutions. ●

Sirpa Pietikäinen

MEP, Committee on Economic and Monetary Affairs, European Parliament

Transition to sustainable economy necessitates changing our financing model

The transition to circular, sustainable economy requires considerable adaptation by public authorities, businesses and households. It will necessitate transformation of business models but also financing models.

Globally, the investment gap to finance a transition to a low-carbon, resilient economy is US$90 trillion by 2030. This is approximately how much will be invested in infrastructure by 2030, and about the size of assets under management globally. The equation is clear. If we are to be serious about tackling climate change, sustainability needs to be part of every financing and investment decision taken today.

Public spending should be in line with these objectives. Every year US$5 trillion, a staggering 6.5% of the global GDP, is distributed to fossil fuel subsidies. It is evident that these trillions could be put in better use.

Similar scrutiny should apply to all EU funds, financing instruments and programmes, as well as the financing operations of the European Investment Bank and the European Central Bank. The InvestEU programme, a successor of the European Fund for Strategic Investments, can have an important role in financing sustainable infrastructure by mobilising private finance through EU budget guarantee and in facilitating a pipeline of investable projects together with national and regional partners. Over 30 percent of the €38 billion budget guarantee is earmarked for financing sustainable infrastructure. The Parliament has demanded raising the financing target to 40 percent.

Sustainability needs to be considered in all sectors, not just in project financing. The EU and its Member States will need a climate-proof budget that integrates sustainability indicators and assessment of environmental impact in budgetary planning and spending. The next EU Multiannual Financial Framework will need to see higher ambition on mainstreaming sustainability and climate objectives, raising it from the current 20 percent to 25 for 2021-2027, and to 30 by 2027 at the latest, as asked by the Parliament.

A climate proof budget entails critical scrutiny of distorting or uncompetitive subsidies through all sectors. Agricultural and cohesion funds alone make up over 70 % of the EU budget. These funds should be directed to finance circular and climate-proof technologies and innovation within these sectors. Similarly, public authorities themselves are large consumers. By considering environmental impact and life cycle of products and services, public purchases can have an important impact in boosting sustainable goods and services. Green Public Procurement and inclusion of innovation partnerships should become a rule.

A pipeline of sustainable projects is likely to accelerate in the future following the introduction of a future EU taxonomy that will help assess sustainability of an economic activity. A low-carbon and circular growth model is also an economic opportunity. Global Commission on the Economy and Climate has estimated that climate action could deliver over $26 trillion in economic benefits and generate more than 65 million new jobs by 2030.

"Finance is the key factor in the fight against climate change that either makes it or breaks it."

- SIRPA PIETIKÄINEN

Public spending can only be a tip of the iceberg in financing the transition to sustainability. Majority of global finance is private, and currently to a large extent invested in a way that supports unsustainable growth.

Our efforts should not only be about earmarking a tranche of finance to sustainable objectives or stopping investments to harmful activities. It should be about creating a double effect by changing the underlying market incentives themselves.

By gearing the private financial flows, we can create a true avalanche to a climate resilient, circular economy. Finance is the key factor in the fight against climate change that either makes it or breaks it. ●

Policies for addressing climate change risks

Denis Beau

First Deputy Governor, Banque de France

Supervisors must support the mainstreaming of climate change risks and opportunities

Climate change is real, it is global and irreversible, and no one can ignore its impacts on financial stability anymore. Indeed, climate-related risks are a source of financial risks as the Central Banks and Supervisors Network for Greening the Financial System (known as NGFS) concluded in its reports. It is therefore within the mandates of central banks and supervisors to ensure the financial system is resilient to these risks.

Indeed, even if policymakers bear the primary responsibility of the success of the Paris agreement, all hands are needed on deck to tackle climate change. In that perspective, the Banque de France and the Autorité du Contrôle Prudentiel et de Résolution, as a central bank and a supervisor, are determined to stimulate and support the integration of risks and opportunities in financial intermediaries' strategy, governance and risk management. The continuously growing membership of the NGFS and the remarkable work carried out within the network clearly highlight that this agenda is broadly shared among this community.

> *"The next immediate operational goal to meet is clear: strengthen the work on governance and scenarios as soon as possible."*
>
> \- DENIS BEAU

Looking at the potential courses of action for supervisors, the main short run priority should be to improve the quantity and quality of information disclosed about existing exposures in the financial sector. A number of supervisors have taken steps in that direction, including the Autorité du Contrôle Prudentiel et de Résolution which published, last April, two reports on the exposures of French banks and insurers to climate risks.

But, it is also time to go further and push for a forward looking vision of the impacts of climate risks, in order to properly size the financial effects of climate change and to ensure that financial institutions have put in place appropriate risk management structures and tools to mitigate climate-change related risks. The next immediate operational goal to meet is clear: strengthen the work on governance and scenarios as soon as possible. In practice, achieving a forward looking scenario analysis implies bringing together >>>

>>> three “bricks”: (i) a handful of severe enough but realistic transition path scenarios all the way to 2050, (ii) macroeconomic assumptions to capture the impact of climate change on macroeconomic variables, and (iii) the direct and indirect exposures of the financial system to climate risks.

There is substantial amount of analytical work to be done in order to equip central banks, supervisors and financial intermediaries with appropriate tools and methodologies to identify, quantify and mitigate climate risks, and their dialogue on those topics is of the essence. In that perspective, two of the technical documents to be published by the NGFS early 2020 will be important milestones, namely one on climate and environment-related risk management for supervisory authorities and on scenario-based climate risk analysis.

On the regulatory front, supervisors can support the work of financial intermediaries in agreeing on a robust taxonomy of « green » and « brown » assets and in specifying how and when supervisory frameworks will integrate climate-related risks. In that perspective it is a watershed that the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors recently joined the NGFS as observers. They will have the opportunity to take part in the work of the NGFS and to ensure the consistency of the regulatory effort at a global scale. Indeed, climate change as a global challenge requires a global and coordinated response. ●

Philip Owen

Head of Unit, DG Climate Action, European Commission

A 2050 climate neutral EU economy: a key role for sustainable finance

The Commission’s Communication “a clean planet for all – a European strategic long-term vision for a prosperous, modern, competitive and climate neutral economy” sets a direction of travel for the next 30 years. Already, since 1990, the EU has successfully decoupled greenhouse gas emissions from economic growth. New industries and jobs have been created, technological innovation has taken place and costs driven down. Between 1990 and 2016 energy use was reduced 2%; greenhouse gas emissions by 22% while GDP grew by 54%. The renewable energy revolution is the best example of this change: renewable energy in final energy consumption has increased from 9% in 2005 to 17% in 2018.

The EU is broadly on track to meet its 2020 greenhouse gas, renewable energy and energy efficiency targets. The 2030, 40% economy-wide reduction in greenhouse gas emissions has passed into legislation. The flanking, renewable energy (32%) and energy efficiency (32.5%) targets have also been enshrined in law. If these goals are fully achieved total greenhouse gas emission reductions are estimated to reach around 45% in 2030. While these current policies will continue to generate impacts after 2030, they will only achieve an estimated 60% reduction in emissions by 2050. This is insufficient for the EU to meet the Paris Agreement’s goals.

In the transition to a climate-neutral EU, energy plays a central role as it is today responsible for more than 75% of the EU’s greenhouse gas emissions. Ensuring maximum energy efficiency and a secure and sustainable energy supply that integrates electricity, gas, heating/cooling and mobility systems and markets with smart networks, placing citizens at its center, is key to delivering this goal.

While industrial processes will have, via technological improvement, to become more efficient, the greatest improvement in efficiency needs to be achieved in buildings >>>

>>> that currently account for 40% of energy consumption. Given that most of the 2050 building stock exists today, higher renovation rates, fuel switching, use of the most efficient products and appliances, smart management systems and improved insulation methods will be needed. To achieve these changes new and appropriate financing methods and instruments will be required to permit consumers to make these investments in a rational and economic way.

"Reorienting capital flows and fostering long-termism is thus key."

- PHILIP OWEN

Today, the major part of the EU energy system is fossil fuel based. Achieving climate neutrality implies that the energy system becomes renewable for both consumers and industry. Europe depends on imported fossil fuels that will reduce by 2050 releasing billions of euro, currently spent on imports, for domestic investment. By 2050 more than 80% of electricity will come from renewable sources (mainly off-shore wind) with nuclear power accounting for some 15%. While several sources of renewable energy, such as ocean energy, are still to be harnessed, the EU industry already employs 1.5 million people and 6 of the 25 largest renewable energy companies are European. Furthermore, the deployment of renewable electricity permits the decarbonisation of other sectors such as transport and industry and the production of e-fuels that can be stored and used in multiple ways. This transition will require a smarter and more flexible system with greater consumer involvement.

The transition will not be without cost. Some 2% of EU GDP is currently invested in the energy system. This would have to increase to 2.8% (some €520-575 billion annually) to achieve a climate neutral economy. Public budgets alone cannot meet this sum. Public finance may act as a catalyst or even guarantee private investment in cases of market failure but the private sector will have to fund the vast majority of this investment.

Reorienting capital flows and fostering long-termism is thus key. Fully integrating climate risks into financial risk models, at both a macro and micro level, is necessary to address the longer-term impacts of climate change. The recommendations of the High-Level Expert Group on sustainable finance and the subsequent Sustainable Finance Action Plan show the way forward. Making the financial system sustainable, avoiding carbon lock-in as well as stranded assets, will greatly assist in creating a climate neutral EU in 2050. ●

Benoit Lallemand

Secretary General, Finance Watch

Environmental crisis: mission or risk for the financial system?

Recent reports by the IPCC and IPBES leave little doubt: the combination of climate change and the depletion of biodiversity and ecosystems puts our societies on the path to environmental collapse.

Young people are calling for immediate action by governments. And rightly so: without additional resources, world leaders can start steering the economy out of fossil fuels and nature-depleting activities. Public subsidies to energy, agriculture, fisheries and other sectors and all public expenditures should be aligned with environmental objectives. Environmental and economic regulation, accounting rules, reporting requirements should be reviewed and enforced to match the scale and urgency of the problem. Such clear political ambition is the prerequisite to any substantial contribution by the private sector. Markets won't be on a mission if public authorities do not show the way.

How does finance come in the picture? In two ways. First: transforming our systems of production and consumption will require massive investments. Second: the environmental crisis presents a threat to financial stability. Given the predominantly prudential character of the financial reform agenda sealed at the Pittsburgh >>>

>>> Summit in September 2009, the risk approach is naturally where most of the action is taking place. And with impressive ambition. As the NGFS puts it: "...climate change presents significant financial risks that can only be mitigated through early and orderly transition". This is a strong call not only for the political ambition we just described, but also for financial regulators to press the financial sector to start identifying, disclosing and managing risk now. An optimistic reading of the quote could even be: "because the only way to avoid a major threat to financial stability is an early and orderly transition, it would be within central banks' mandate to contribute to initiate this transition by constraining financial institutions to move away from fossil fuel and nature-depleting investments". The micro- and macro-prudential toolboxes, not to mention monetary policy, certainly offer interesting options. In any case, it seems like mandatory, harmonized climate-risk disclosure should be implemented without delay – including methodological work around non-climate environmental risk (natural capital valuation and risk assessment techniques are a great basis to start from).

"A group of central banks on a mission is great news. Combine it with a plan to bail-out nature."

- BENOIT LALLEMAND

Now we come to how finance needs to contribute positively to support transitioning the economy. Here there are two complementary ways: steering private finance towards a long-term mission and increasing the role and share of inherently mission-oriented financial institutions (public and development banks, ethical banks, impact investing, etc.). The first part requires to address the root-causes of short-termism, including the "cult of liquidity" and the absence of a clear political signal of where the economy is going. The second requires to design what can only be called a "bail-out of nature", mobilizing resources of and coordinating efforts from all sources of public finance. This plan would have the additional benefits of leveraging private finance and, because it would trigger an "early and orderly" transition, reducing financial risk across the system. ●

Daniel Hanna

Global Head, Sustainable Finance,
Standard Chartered Bank

Can we bank on a low-carbon transition where it matters most?

Climate change will impact those who have least benefited from the industrialisation and globalisation that have led to its creation. In tackling it, we must strike the right balance between transitioning to a low-carbon future and continuing to lift millions out of poverty; connecting them to power, water and other necessary social goods; and supporting rising living standards.

How can we accelerate the flow of capital to those areas where the biggest risks and opportunities are to ensure climate resilience, mitigation and adaptation? How can we ensure that we are focused on where it matters the most in determining the pathway to limiting global warming to significantly less than 2 degrees?

"Climate change requires a multifaceted response based on science, technology, economics, and policy."

- DANIEL HANNA

There is no single solution. Climate change requires a multifaceted response based on science, technology, economics, and policy. Like all transitions, an optimal outcome is one that is measured and orderly; a gradual and linear rate, like the 7% per annum assumed in the EU's Climate Benchmarks proposal.

However, more global collective action is required to achieve this in all regions. This is especially true across Asia, Africa and the Middle East, were investment is required to leapfrog now to low-carbon alternatives and ensure that per capita emissions do not reach the levels of high-income countries.

We believe that science-based targets can play a critical role in allowing companies across all sectors, including the financial sector, to set long-run decarbonisation goals consistent with the Paris Agreement.

Standard Chartered is proud to have set such targets for our own financing activities across Asia, Africa and the Middle East, and to be at the forefront of work on how such targets can be set for lending portfolios, as outlined in our recent Emissions White Paper (www.sc.com/emissions).

We are supporting our clients in their transition to low-carbon energy sources as costs continue to fall. We took the decision to stop financing new coal power projects and are taking a leading role in financing investment into renewables across our markets. We are connecting investors with platforms such as Ayanna in India, and we are financing the largest single concentrated solar power project in the world in Dubai. We are also innovating new products to catalyse capital flows into the countries and sectors most affected.

Regulators are playing an important role, as shown by the rapid growth of the Central Banks and Supervisors Network for Greening the Financial System. Further work is needed to take scenarios designed for policymakers and translate them into tools for capital allocation. In particular, further analysis on physical risk is needed by both public and private sector bodies. Regulatory focus helps to illustrate the realities of a disruptive transition and support action to deliver a smoother path.

Financial institutions are already supporting regulatory initiatives such as TCFD reporting in ways that often go beyond current government policies. An individual financial institution might prove to be 'Paris aligned' but the financial system and underlying economy will not be unless there is coordinated industrial strategy and financial policy. Collectively, these efforts will ensure the transition to a low-carbon economy where it matters most. ●

Eugenie Molyneux

Chief Risk Officer of Commercial Insurance,
Zurich Insurance Group

Decarbonisation and mitigation of climate related risks: regulatory tools and insurers' contributions

Insurers are playing a major role in taking into account transitional, physical and climate-related risks into their operations and investments.

Climate change and other ESG issues will have an impact on insurers, both as investors, and as underwriters. Zurich Insurance proactively ensures its businesses accompany the transition to a low-carbon economy and contribute to the mitigation of emerging climate related risks by optimally using both sides of their balance sheet (asset/liabilities), having appropriate governance and ensuring the data necessary for investment and underwriting decisions becomes accessible.

The FSB Task Force on Climate-related Financial Disclosures (TCFD) recommendations form a useful framework to respond to climate change-related risks, embed sustainability in governance structure, corporate strategy and risk management across organisations. This is a first step toward a global regulatory harmonisation.

Data transparency and trust are essential for institutional investors and a driver of change. To this end, the proposed EU Regulation on disclosures and the development of a sustainable investments taxonomy will help generate a common understanding of what is deemed sustainable and scale-up these investments. They will allow parts of the financial industry least accustomed to investing in ESG to rapidly build the necessary capacity.

It is vital that the taxonomy is flexible to reflect technological changes, new insights and the different pathways to achieving science-based targets (SBT). It is key that methodologies are built over time, comprehensive (especially taking into potential conflicts between E and S goals) and leave space for innovation. Their use should not be mandatory before both regulations are finalized and verified to avoid unintended consequences.

The taxonomy should not be considered a prudential tool to identify assets that have a higher/lower exposure to risks but a sustainability classification of economic activities.

The prudential framework for insurers is fit for purpose

The current Solvency II risk framework allows sustainability risks to be captured without needing to add their explicit specification.

Prudential regulation should not be used as an economic tool to the detriment of financial stability. Therefore, Zurich does not support a penalising 'brown factor' nor the idea of stimulating 'green investment' by building incentives in Solvency II in the form of lower capital requirements. Capital requirements should remain risk-based and are not the right tool to support the pricing in of environmental externalities. Other market mechanisms should be preferred: transparent disclosure of ESG data, cost transparency and polluter pays principles, standards to measures ESG impacts, and ESG-integrated underwriting practices.

In that context, modelling is becoming a major tool to assess climate-change related risks and hence price and underwrite accordingly. The timeframe of the modelling has to be carefully calibrated so we believe it is too early to impose detailed and prescriptive requirements on scenario planning.

Challenges remain

A lack of adequate sustainable investments opportunities with the appropriate risk-returns is visible, rather than a lack of committed capital. Institutional investors want to fund sustainable investments but cannot put all the capital to work.

Other challenges remain: defining what is sustainable is a priority, assessing the profitability when investing in ESGs, establishing a common and adequate methodology. ●

Stephanie Maier

Director, Responsible Investment,
HSBC Global Asset Management

Decarbonising the economy: regulatory tools for real economy impact

The European Commission (EC)'s strategic long-term vision aims for a climate neutral economy by 2050. This transition will require sizable investment and finance. To meet this ambitious goal, we need to consider policy and regulatory tools focused not just on the financial sector but on bridging between finance and the wider economy.

The EC Action Plan on Sustainable Finance set out meaningful and far-reaching proposals, which have already catalysed and accelerated action across the industry. The proposed Taxonomy is central to a number of the actions – including the EU Green Bond Standard and additional labelling for investment products. The Taxonomy Technical Report issued in June 2019, has sought to outline a common language for economic activities making >>>

>>> a substantial contribution to climate change mitigation or adaptation, to be used by investors, issuers, lenders, policymakers and regulators. While there is a clear roadmap to evolve, it currently describes only a narrow set of activities.

For low-carbon investments to become mainstream, clear, long-term policy signals are also required to support the efficient deployment of capital to the wider economy. The current focus on financial regulation will not be sufficient. A policy and regulatory framework drawing together the financial and real economy sectors will be critical for investors to assess and manage climate-related risks, to support innovation, and to invest in low-carbon and climate-resilient opportunities.

A holistic decarbonisation strategy, with a common objective to reduce emissions in all industrial sectors to net zero (or near zero) by 2050, requires a broader set of policy and regulatory measures such as a meaningful EU carbon price, ambitious targets for renewables and energy efficiency, robust vehicle emissions standards and progressive measures for the energy performance of buildings.

Ensuring a 'just transition' will require greater consideration of how to appropriately support workers and communities in industries most affected. Further steps to fully implement the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) would be welcome as a key tool to bridge investment and decarbonisation objectives.

More economies, including the UK, France, Norway, Finland and Chile have committed to net zero carbon emissions creating significant investment opportunities within Europe and beyond with all the associated economic, social and environmental benefits. With an effective and comprehensive decarbonisation strategy, Europe will generate the necessary investment in low-carbon and climate-resilient technologies, markets and business models – demonstrating real leadership at this crucial moment in our history.

Without it, investors face growing and systemic climate-related risks across all economic sectors and geographies, more potential for stranded assets (assets that have suffered from unanticipated or premature write-downs) and more disrupted industries. This is a test Europe must not fail. ●

Dimitris Zafeiris

Head of Risks & Financial Stability Department, European Insurance and Occupational Pensions Authority (EIOPA)

Decarbonisation of the economy and understanding climate risks: the role of regulation

Considering what financial regulators can do to support the decarbonisation of the economy means understanding the risks and transmission channels through which the supervised financial entities themselves would support - or stand in the way of - this process.

In that context, the starting point is usually that financial companies often are large asset managers. Insurers, accounting for more than 10 trillion euro in investments in the European Economic Area (EEA) is a key example. Insurers can have an impact on the decarbonisation of the economy either by channelling capital towards sustainable investments, or through active ownership, making active use of voting rights in the companies they are investing in. The most important channel through which regulation can have an impact is the financial strength of the sector, which in turn safeguards capital flows into the real economy.

A risk-based supervisory framework does not simply dictate any investment policies to achieve a particular political or environmental goal. The focus should be on actively engaging and highlighting risks, best practices and opportunities in the investment universe. Furthermore, legislation or other forces should not incentivise companies unnecessarily to invest with undue short-term objectives, but rather support long-term planning and horizons.

"A risk-based supervisory framework does not simply dictate any investment policies to achieve a particular political or environmental goal."

\- DIMITRIS ZAFEIRIS

In practice, regarding the capital flows, achieving a 'common language' is essential. Therefore, a taxonomy or a common framework for assessing what type of sectors and activities aggravate or mitigate climate change is key. In addition, relevant data needs to support the assessments. That is why disclosure - also for real-economy firms, when it comes to climate impact - is necessary. Finally, models that translates climate-relevant exposures to financial risks need to be further developed. Once these necessary conditions are in place, regulators and supervisors are in a good position to include climate risks in their assessment and monitoring tools in particular in sensitivity analysis and stress tests.

At the European Insurance and Occupational Pensions Authority (EIOPA), we are already taking first steps into that direction. Through the dialogue with market participants and with national competent authorities, we are able to discover risk channels and to document real risk exposures, which eventually could become subject of a supervisory discussion directly with affected undertakings.

Currently, one of the main challenges is the lack of a commonly agreed scenario generation framework. For example, how to assess the impact of an increase in natural catastrophes - not only in one defined period (e.g. a year) but also combined with an increase in the probability of increased extreme weather events every year from now on - is still a question.

How will this factor impact pricing, profitability of non-life insurers – and are there risks that will become simply un-insurable? Moreover, >>>

>>> a regards the transition risk on the asset side, a better understanding of the likely transmission mechanisms and price effects of a combination of political changes, legal changes and public opinion is required.

Regulators, including EIOPA and the financial entities themselves are actively working on these issues. In the coming years, relevant tools such as stress testing and scenario analysis will dramatically change. In return, this change will stimulate the debate and improve the understanding of the risks stemming from the climate change. With these risks clearly defined, the role of the supervisors and regulators to support the decarbonisation of the economy will become more important. ●

Mario Nava

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

The decarbonisation strategy and sustainable finance tactics of the EU

In the Art of War, Sun Tsu, a Chinese general, military strategist, writer and philosopher from the sixth century BC, stated: "Strategy without tactics is the slowest route to victory. Tactics without strategy is the noise before defeat." By strategy, he meant an over-arching plan to dominate the battlefield, exploiting the enemy's weaknesses; by tactics, the specific actions aimed at implementing the plan, such as deciding where and when to attack.

Man-driven climate change is regarded as serious as the threat of war. Indeed, for more than a decade now, the United Nations has warned us that the danger posed by war to humanity and our planet is matched by global warming. Moreover, climate change itself, with the resulting upheavals from droughts, loss of arable land and inundated coastal areas, is a driver of war and conflict.

In order to mitigate climate change and the risks it poses to life on Earth, the European Union (EU) has adopted an ambitious strategy: the 2030 Climate and Energy Framework and a long-term vision on a climate-neutral Europe by 2050. The former consists of targets and policy objectives for the period 2021-2030, such as cutting greenhouse gas emissions by 40% from 1990 levels; the latter shows how climate neutrality can be achieved in the next 31 years through technological innovation, citizen empowerment and policy coherence, while ensuring social fairness during the transition.

"The EU is determined to mobilise private finance to reach climate neutrality by 2050."

\- MARIO NAVA

To actualize such vision, however, around EUR 175-290 billion of additional investments will be needed each year until 2050, underscoring that these will have to be financed mainly through private capital, since public money won't be sufficient. With its EUR 100 trillion of assets, the EU financial sector has a key role to play in filling such investment gap. To that end, in March 2018 the EU's tactics were revealed, consisting of an action plan on financing sustainable growth, centred on three policy goals:

1. Managing financial risks stemming from climate change, resource depletion, environmental degradation and social issues.
2. Reorienting capital flows towards sustainable investments in order to achieve sustainable and inclusive growth.
3. Fostering transparency and long-termism in financial and economic activity.

As part of such action plan, the European Commission (EC) has already established a unified EU classification system (or taxonomy) of sustainable economic activities, determined sustainability disclosure requirements by financial markets participants and financial advisers toward end-investors, and created two new categories of low-carbon benchmarks. Further initiatives presented in the plan include: (i) developing standards and labels for sustainable financial products; (ii) strengthening companies' disclosures of climate-related information; (iii) incorporating sustainability in prudential requirements; and (iv) proposing to include environmental, social and governance factors in the mandates of European supervisory authorities.

Finally, since the EU is responsible for only 11% of global greenhouse gas emissions, it's paramount to join forces with other jurisdictions, working together to build a global approach to mobilize private capital towards sustainable investments. To that end, in September the EU will launch an International Platform on Sustainable Finance, which will facilitate the exchange of information and best practices on sustainable finance among countries. ●

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Tackling long-term investment disincentives

Harald Waiglein

Director General for Economic Policy and Financial Markets, Federal Ministry of Finance, Austria & Member of the Board of Directors, European Stability Mechanism (ESM)

Long-term investment – how to proceed in a changing economic landscape

It is common sense in economics that investing is not an activity one should stay idle on for a long time. In the absence of a proper capital stock, technological progress is hindered and will pass by without creating positive spill-overs. Moreover, convergence and rebalancing in a monetary union are stalled when efforts to modernize economies and to pursue structural reforms are lowered. Unfortunately, public and private investment contracted in several EU Member States and the Euro Area as a whole during the crisis and still display low levels.

As a reaction, Ministers of Finance agreed on common principles to promote investments in 2017. Accordingly, efforts and reforms should focus on (i) facilitating efficient resource allocation, (ii) high quality public investments and (iii) market-based sources of financing. Furthermore, investments in general gained importance in EU economic governance. This year's country specific recommendations contain respective elements addressed to every single EU member state.

> *"A high level of human capital triggers investments in other intangibles and physical capital."*
>
> \- HARALD WAIGLEIN

In short, we are aware of the importance and developments of investments as well as how reforms goals should be set. However, what about the long-term perspective and the interplay between public and private investment? How should incentives be set?

It is clear that challenges such as climate change, digitalisation, ageing societies or migration need to be addressed right now to avoid staying behind the curve. It is also clear that private and public sector efforts need to be aligned to do the job. While a business environment without bottlenecks and unjustified regulatory barriers is a prerequisite for successful private engagement, high quality and sustainability of public finances are decisive as well. Whenever public funds are overly spent on debt service, outdated technologies or inefficient structures, they do not create much value added. >>>

>>> Projects and priorities have to be carefully selected and stay within the available fiscal scope. Comparing current general government net debt levels and capital stocks reveals that many Euro Area members still incur debt for other purposes than investment.

Spending Reviews can help in this context in two major ways. Firstly, a holistic application of these instruments on all budget items can help to create the required fiscal space for investment, even in an uncertain economic environment. Secondly, spending reviews can play a role in identifying opportunities for high quality public investment, ensuring that the allocation of funds is efficient and that investment multipliers are maximized.

Various economists point to education and skills as important factors to boost private investment. A high level of human capital triggers investments in other intangibles and physical capital. Other areas of eminent relevance at the current stage and carrying a potential "double dividend" are resource efficiency, green tech and R&D&I in general. This is exactly where especially economies at the technological frontier should go as they need to create new comparative advantages. Of course, all efforts need to be based on a sound structural basis as it is not wise to pour water into a leaking tank.

Taking a deeper look at incentives to invest, it is obvious to talk about costs and availability. Completing major projects such as the Capital Markets Union and keeping up EU-wide investment programs, but also clear-cut rules for alternative financing and currencies could support access to funds. On the other hand, internalising external costs would increase the payoff of investments in resource efficiency. Both aspects - policies focused on the demand and supply side - need to be part of our tool kit.

Summing up, it is essential at the current juncture to keep creating enabling environments and carefully selecting those areas for investment that are forward and not backward looking. This especially holds true for education and skills. However, in the end public efforts need to be backed up by a sustainable financial position. ●

Märten Ross

Deputy Secretary General for Financial Policy and External Relations, Ministry of Finance, Estonia

Regulation of risk taking by households and the problem of overprotection

Are existing regulations reinforcing the risk/long-term investment of households?

To start with, one could wonder if there is a basic issue of undersaving by households in the EU? Probably not, although differences persist. Therefore, prime question is rather about the structure of asset allocation that we seem not to be satisfied.

There is some reason to believe that one reason for this misallocation lies with regulatory approach. Partly and paradoxically, some part of the problem lies in that existing regulatory environment tries to overprotect retail investor from the risk. Maybe to the extent they themselves do not even desire.

This includes unnecessary liquidity requirements and risk coverage requirements for equity investments. Commensurate cost of regulation is at the end excessive and thereby tends to limit such risk taking unnecessarily.

Furthermore, it is not just savings' supply side that is problematic, but also the way how demand side functions. Large junks of economy continue to rely too much on financing structure that does not support active public participation in risk taking. If the supply side remains unwelcoming it constrains more risk taking by the households in the financial markets.

All in all, the situation in the single market remains uneven.

"Cost of regulation is at the end excessive and tends to limit risk taking unnecessarily."

\- MÄRTEN ROSS

What should be changed regarding consumer protection concerning long-term investment?

There is some mix-up in discussion between knowledgeable long-term >>>

>>> investments by households and their intentions to invest (preferably) into liquid assets that might include also long-term underlying instruments. The problems are mostly with the first one and regulatory work should support primarily incentives to allocate some savings into less liquid proportions of the market.

New technologies and other innovations of financial intermediation could help there and should be wisely treated. It is true that in many cases the innovations are merely a circumvention of the regulation and in that sense rather old-fashioned animals in substance.

However, in many cases the innovations are also a sign that readiness of public at large to engage into more aggressive risk taking is somewhat bigger than consumer protection paradigm admits.

How to transform savers' stable resources into long-term investment without imposing excessive constraints?

If the underlying problem is not saving rate as such, but the sub-optimal composition of the assets the savings are allocated, primarily into "low-efficiency" banking deposits, both push and pull factors need to be addressed.

Explicit or implicit regulatory cost advantages that support asset allocation into more liquid and so called safe assets, including state debt, could be constrained.

Finally, one should recall that it is not just strictly financial sector regulation that influences household asset allocation. Tax and other incentives to overinvest, eg into housing market, matter as much as a details of the financial market regulation. ●

Patrice Morot

Partner, PwC France

Prudential and accounting standards may trigger a further decline in the long-term investment in equities by insurers

It is often argued that insurers should finance the economy by buying long-term assets (like listed and private equities, infrastructure investments, and securitization). However, Solvency II and IFRS standards, which are based on mark-to-market values and a short-term risk horizon, may prevent insurers from playing this role more fully.

Three main obstacles stop insurers from investing with a long-term outlook.

The first one relates to the duration of their liabilities and asset-liability management. In France, most insurers liabilities come from life insurance products composed mainly of saving contracts of which 80% are participating and 20% are unit-linked. The average duration is 12 years, but policyholders have the right to surrender their contract at any time at carrying value, without any penalty except a loss of tax incentives. Because of low, if not negative, interest rates, even a 0% minimum guarantee on participating contracts could be "in the money" in the current economic environment. In the event of a financial crisis and a rise in interest rates, life insurers would be exposed to liquidity risks and financial losses, making them cautious regarding their long-term investment strategy. To enable insurers to invest more in long-term assets, we believe actions should be considered that would increase and provide better predictability of the duration of their liabilities.

The second factor relates to solvency rules. Under the Solvency II framework, assets are measured at fair value and stresses are calibrated in accordance with a VAR at 99.5% over one year. Thus, the shocks applied on equities are relatively high (39%-49%). One can easily see how a fair value measurement basis and one-year time horizon are not consistent with making longer-term investment decisions. Updates to the Delegated Acts published this year introduce a new class of Long-Term Equity Investment benefiting from a reduced shock at 22%. Even if this change would normally act as an incentive, the eight eligibility criteria of LTEI appear very restrictive, which could prevent a reversal of the current trend, despite the best intentions of the European Commission.

Last year, the French Treasury Department and the Dutch Ministry of Finance proposed more robust incentives in favor of equity investments to the European Commission. A study undertaken by PwC at the request of the "Institut des Actuaires" in France estimated that the proposed scheme might result in an increase to equity investments estimated to be worth between 50 and 100€ bn across Europe. In 2020, the Solvency 2 Directive will be revised, and this opportunity should be seized to review the criteria of LTEI and allow further investment in equities.

The third factor relates to IFRS accounting principles. The new IFRS9 standard, which will be effective at the same time as IFRS17 for the majority of insurers, ie January 1, 2022 is likely to increase volatility in the P&L:

- IFRS 9 will cause insurers to classify most of their equities at Fair Value through P&L (FVPL) since classifying equities in FV through OCI will not allow them to recycle the realized gains and losses through the P&L;
- the only measurement applicable to mutual funds will be FVPL, and insurers hold most of their equities through these types of funds.

IFRS17 will partially address this concern for assets that are used to back insurance contracts that are substantially investment-related and where the insurer promises an investment return based on the performance of these underlying assets (i.e. insurance contracts with direct participation features). However, for equity and mutual fund investments that are used to back all other types of insurance contracts or indeed the insurers' own funds, the IFRS9 measurement model remains an issue.

The resulting increase in volatility through the P&L will not be conducive to long-term investment by insurers.

These three factors combined with the low interest rate environment could lead insurers to carry on divesting from equities unless something is done to change the situation. It is urgent that actions are taken now to enable insurers to continue playing their important role in ensuring long-term sustainable growth across Europe. ●

Cyril Roux

Group Chief Financial Officer, Groupama

To finance the European economy, normalize its framework

European finance vexes multitudinous desires to drive its behavior. German public figures decry the nil return offered to German savers on risk free assets. French politicians wish to increase the equity allocation of insurers, public companies and asset managers in domestic ventures. Irish commentariat laments the mortgage rates required by domestic banks in a market which suffers from high delinquency and low repossession. In other countries private equity firms, merchant or high street banks, markets and "vulture" funds are variously condemned for failing to pursue the public interest. And in more rarefied settings one long-standing criticism leveled at these institutions is their insufficient provision of long-term capital to the financing of the European economy.

It has long been observed however that spot pricing (so called "market consistent valuations") drives European retail investors away from assets with volatile market prices. Americans seem more inured to the fluctuations of their 401(k) account statements. By importing the "fair value" IFRS standard into the accounting of heretofore patient institutional investors, Europe has made the fateful choice of driving them away as well from listed securities. The vaunted benefits of this choice, transparency and comparability, have failed to materialize, but the European economy suffers from the all too real economic disincentives at play. The upcoming application of IFRS 9 to European insurers will aggravate these disincentives unless the EU ceases to kowtow to the IFRS board and make good on its ambition to be a global rule maker rather than a rule taker.

The EU has decided to base its prudential regulation on IFRS accounting, and its ever-increasing reliance on volatile market prices. By so doing, the EU has built in procyclicality into the reaction functions of its banks and insurers. To reduce it, it has then added countercyclical buffers, volatility adjusters and dampeners. But these mitigating measures cannot undo the core procyclicality it has decided upon. When regulatory ratios decline and get closer to thresholds for regulatory intervention, the major adjustment lever available to European financial institutions is to divest; when financial markets decline, this feeds a vicious sell off circle. Current European financial regulation has been designed with the prevention of a 2008 replay in mind. It is yet to be tested, but it has certainly failed to take sufficient account of its effect on the financing of European economy.

The extraordinary interest rate environment under which European banks and insurers operate today combines with the aforementioned accounting and regulatory disincentives to further distort the allocation of capital and provision of credit. Here also, the merits of an unprecedented monetary policy are debatable whereas the costs and risks associated are building up. In such an environment, it is pointless to flog financial institutions into acting as if financial markets, accounting and regulation were otherwise. One would be better advised to normalize monetary policy and devise an appropriate accounting and regulatory framework for the European economy. ●

Markus Ferber

MEP, Committee on Economic and Monetary Affairs, European Parliament

Boosting long-term investments in the EU

Investments are the lifeblood of an economy since they pave the way for long-term success. Today's long-term investments lay the groundwork for tomorrow's economic growth and tomorrow's overall welfare. Therefore, it is more than worthwhile to pay close attention to how the European economy is faring when it comes to channelling capital into the right areas.

If we want to achieve our policy goals - such as making Europe fit for the digital age, transitioning towards a carbon-neutral economy and improving the EU's long-term competitiveness - we need investments in the trillions. With public purses being strained and government debt levels at all-time highs, it is clear that a very substantial part of the investments needed have to come from the private sector.

In general, there are two areas we have to look at. On the one side, we have to think how to unlock the considerable amounts of money held by institutional investors such as insurance companies. Insurers with their long-time horizons are the perfect long-term investors, e.g. for infrastructure or green transition projects. However, despite this helpful match in terms of characteristics, we see too little actual long-term investment by insurers. Part of the problem is that that the capital requirements laid out in Solvency II are sometimes too conservative, particularly when it comes to equity investments and long-term investments. With the review of Solvency II that is due this term, we have to tackle this issue.

The other side of the medal is making investments into capital markets

more attractive to private investors. This is even more relevant as traditional European pay-as-you-go pension systems are under increasing pressure and private retirement arrangements will become increasingly important. One element of this is certainly long-term since it is cultural. In Europe, we are lacking the same risk-taking >>>

>>> attitude as for example in the United States. This is why many Europeans prefer to put their savings into low-yielding savings accounts - despite the record low interest rate levels. However, such a cultural change will only be possible in the very long run and can probably only be achieved if financial education gets a much bigger role in our education system.

However, while those long-term improvements are certainly important, we also have to think hard about what can we do in the short term to make accessing capital markets more attractive. One part of the equation is to offer retail consumers attractive and easy-to-understand products that can be easily invested in. In this regard, the UCITS framework was certainly a successful example of how an attractive product category could look like. To make such investments attractive and overcome investors' fears, it is essential that retail clients understand what they are getting into, which makes information to clients a key issue. Unfortunately, today's disclosure regime with similar, but not identical requirements in UCITS, PRIIPs, MIFID II and IDD does not inspire the retail investor's confidence. A horizontal approach that aligns the requirements and also focusses on the key metrics an investor needs to understand before investing will therefore be a key project in the new term. ●

Alexander Batchvarov

Head of International Structured Finance Research, Bank of America Merrill Lynch

EU regulatory framework: enabler or barrier to securitisation in CMU?

The EU securitisation law came into force on 1 January 2019 without the full set of enabling regulations ready. This led to an initial delay and subsequent crowding of deal supply, which in turn led to pricing distortions. Some of the key RTSs (e.g. data templates) are unlikely to be implemented before year end, i.e. one year after the law came into force. The extra-territorial reach of the regulation impaired the global investment reach and returns of EU regulated investors. The inadequate grandfathering and limited transition period did not help either.

STS deal flow picked up in 2Q19 and the STS securitisation sector is gradually building up. Over time we believe STS will become an established market and, some suggest, a global benchmark. The non-STS sector will tag along, as has done so far successfully. STS was meant to address some borrowed-from-the-US reputational issues of the EU securitisation market, whose credit and rating performance since EU market's inception has been excellent, in line with initial expectations. However, STS alone is not enough to restore EU securitisation market.

To reach the full potential of securitisation to foster long-term investments in the EU financial sector a number of barriers need to be overcome. Some of the barriers are associated with the interpretation of the securitisation regulation, such as the lack of differentiation between public widely-distributed deals and private bi-lateral deals between sophisticated counterparties, several operational issues, extra-territoriality of investor due diligence, etc. Other barriers arise from biases embedded in the prudential regulations, related to capital charges, reporting, liquidity, etc., which in turn distort issuer and investor behaviour. The SRT discussion is already raising concerns.

Overall, a quick look at the capital charges for financial institutions suggests that insurers are dis-incentivised from taking securitisation longer-term mezzanine risk, which they are otherwise uniquely qualified to do. Insurers are incentivised to take illiquid loan and residential mortgages exposure directly rather than through securitisation bonds; the cliff between STS and non-STS capital charges cannot be justified, in our view. Banks are incentivised to buy each other's covered bonds, often collateralised by the same mortgage exposures they hold on their own balance sheets; this is further enhanced by the unjustified gap in LCR treatment of covered bonds and STS securitisation. In public debate the systemic risks created by covered bond and loan holdings are glossed over, while the risks of securitisation exposures are overstated. The unjustifiable gaps in cost of different funding instruments (rating, reporting, verification, penalties, enforcement, etc.) biases issuers' choice: banks prefer covered bonds, fincos - securitisation. ESN, if introduced, will distort banks' motivation further.

STS securitisation volume is picking up, but the recovery of the securitisation market is far from assured. In order to advance the CMU and foster a long-term positive economic effect of securitisation in the EU the above distortions must be addressed, the capital and liquidity cliffs eliminated or reduced, the capital markets' playing field levelled. ●

Lauri Saraste

Director, ALM & Solvency, LocalTapiola Life

Long-term insurance business model faces challenges today

Long-term perspective in the insurance business model has been highly important for insurers to both offer products that suit the customer needs but also to invest so that returns and customer benefits are created. The products insurers provides for citizens and corporates plays crucial part when it comes to risks they might need to face by their >>>

>>> own without these solutions. The same applies on savings and pension plans, as different guarantees and customer options towards the insurer or the ways of providing liquidity brings a long-term safe, customized and stable way to save for the future. By fact, the number of insurers ending into liquidation, remains to be really low in EU. By that, it has helped to ensure the functionality and stability for both the European insurance- and finance industry and the societies.

Mutual insurers, which are insurance undertakings collectively owned by its members who are at the same time its clients (policyholders), cannot make decisions based to short-term optimization. This is because the congruence of ownership and control and being same time customers of the very same undertaking. This makes it necessary to establish a balance between maximizing profits and delivering optimal high-quality services and benefits. By this, decisions can be based on stable and long-term measures, which are highly needed for providing stability for the financial sector and societies. AMICE, the Association of Mutual Insurers and Insurance Cooperatives in Europe, aims to ensure that this perspective is brought out in the best possible way.

The long-term business model, especially among mutual insurers, can survive if the European regulatory environment allows both long-term commitments towards the insurance customers, but also investment strategies that gives possibility for a broad diversification into different asset classes. And this can provide benefits for the societies and improve welfare in many ways, aging population and the increased need for savings for individuals to name a few. This is particularly stressed now, as even though we have good and holistic regulatory framework in place, there is reviews going on at the same time when the economies are facing different challenges. To best survive this, will call for a regulatory framework that rather enables than disables the different ways keeping the long-term perspective, and allows the use of market based stabilizing mechanisms and robust valuation principles. Similarly, insurers need to crystallize the measures behind the long-term perspective, which should more and more be centered on the customers.

Sustainability, and especially actions to slow down climate needs to be part of any long-term investment strategy and insurance offering. But this requires a common ground for understanding and defining the concept across Europe. We in LocalTapiola mutual Insurance group (Finland) have had ESG measures a part of our investment process a long time, and closely think where to invest, when to take actions as a shareholder and whether to exclude something. Yet the information available and the lack of real data makes the actions difficult. The increasing awareness of climate change is helpful but not making it easy to take fast, forward-looking and brave actions. As one solution, we in LocalTapiola, see that the possibility to diversify highly over different asset classes, on both public and private markets, creates a number of benefits in terms of influence, awareness, risk and returns and even on stewardship. Moreover, we see that offering the same investment opportunities for our customer owners via different saving possibilities, helps them to access the very same benefits. ●

Sébastien Raspiller

Assistant Secretary, French Treasury, Ministry of Economy and Finance, France

Renewing the EU narrative toward long-term investments to strengthen our economy

Since 2015, the Capital Markets Union (CMU) have made progress towards a more resilient and consistent framework for financial services in Europe. However, despite having furthered the logics initiated in the aftermath of the financial crisis, the CMU remains a largely "theoretical" endeavor whose end-benefits were not clearly explained. Now, we need a renewed narrative, notably on the competitiveness and growth prospects of European economies, which require other financing capacities than bank financing, especially for long-term investments.

For the World Economic Forum, long-term investment can be defined as "investing with the expectation of holding an asset for an indefinite period of time by an investor with the capability to do so". Indeed, the main specificity of long-term investors is that they do not intend to capture short-term variations of value or immediate liquidity. They focus on economic fundamentals and are deeply involved in the management of their investments. Thus, they have a role to play as capital stabilizers and contracyclical forces which need to be acknowledged by public authorities. Moreover, as co-legislators, we need to lift the barriers to the financing of the economy, especially in equity which allows for more risk taking and innovation while bringing new products and diversification to investors.

However, the time horizon of our prudential and regulatory framework has been shortened over the last years. While enhancing the transparency of financial statements and the European harmonization of supervision, the focus on fair value and the calibration of prudential treatments have had negative effects on long-term investments: for instance, investments in infrastructure in Europe are 20% below pre-crisis level while we are net exporter of investments since 2015.

In particular, the Solvency 2 framework relies on the assumption that insurers should resist in the next year to shocks that statistically happen every two hundred years. This 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 cope with its liabilities. But it creates a strong disincentive for insurers to invest in equities, even when they can prove those equities would not be sold in such situations. This is all the more detrimental that insurers are, due to their specific business model, well suited for long-term investment. In parallel, EFRAG is currently assessing the impact of the new accounting standard IFRS 9 on long-term investments in equities. We will need to take stock of its conclusions.

Thus, we need to adapt our regulations to the fact that - as Jacques de Larosière expressed it - "the long-term is not more risky, but has a different risk profile". We owe it to the financing of our economies, notably for climate transition which will indeed require long-term thinking by investors to enable projects such as resilient infrastructure or the mainstreaming of renewables. Long-term investing is now a top priority of the Commission action plan for financing sustainable growth, notably with a focus on non-financial corporate disclosure, which will help investors make better informed decisions regarding the way they create long-term value. ●

Revising Solvency II: main policy priorities

Patrick Montagner

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

Long-term measure: maintain heading and don't get swamped in complexification

While primarily leading to a major shift in the way insurers' solvency is assessed, Solvency II framework was also designed to take into account the specific features of long-term business such as life, pensions, or some specific non-life activities. For this purpose, Omnibus II directive superimposed a package of long-term guarantee (LTG) measures on the initial prudential framework, whose main objective was twofold: first to reduce the effect of short-term volatility of the markets and promote market value, and second to consider long-term financing needs of insurers. Today, LTG measures have proven their efficiency in practice, but simultaneously turned out to be quite heterogeneous in their use, impact and status. Therefore, they must be fine-tuned to rebalance prudential considerations, long-term business specifics, while avoiding the pitfall of complexification.

Equity measures, which were specifically developed to avoid penalizing long-term equity investment, are now too many and too varied, when sometimes not even used. They endeavor to bring an appropriate answer to each specific case, such as the DBER (duration-based equity risk sub-module) and the recent long-term equity investment portfolio (LTEIP), but since each asset class comes up with different criteria and specific rates, they lead to more complexity. Once more, when trying to accommodate all potential situations, we contributed to build a many-headed creature. Let's rationalize and have a wise move by rather focusing on the most relevant and sensible measures.

Regarding the volatility adjustment (VA), which efficiently corrects the volatility of own funds due to credit spreads changes, the focus should again be on the simplification and improvement of the existing options, rather than significantly changing its nature. While recognized as relevant and useful, the VA is currently on the table for discussion at European Insurance and Occupational Pensions Authority (EIOPA). However, it is unlikely that revamping significantly its design would increase its efficiency and robustness. For instance, adding the valuation of illiquid liabilities as an additional objective of the VA might go beyond the initial aim of this measure. We should rather make sure that its initial objectives are fulfilled, for instance ensuring that the VA country reflects more systematically and less abruptly national spreads.

The accounting framework and the implementation of IFRS are also major considerations to be taken, while we are still in a transition period. The future implementation of IFRS 17 is expected to provide a more accurate picture of the contractual obligations resulting >>>

>>> from long-term coverages. Indeed, discounting future cash flows and recognizing the expected profit margin over the coverage period is the way firms are monitoring the value of their business. However, the extreme complexity of the standard, including several models and various options, could lead to some difficulties for both preparers and investors. Moreover, from the point of view of the insurance supervisory authority, accounting must remain neutral and must not influence the way in which the insurer selects and prices its risks. We fear that the application of IFRS 17 as it currently stands could lead insurers to stop pooling certain risks or to design reassurance products, solely for accounting presentation purposes.

Finally, even if the actual framework meets most of its objectives, there is definitely room for improvement for both prudential and accounting regulations. While being ambitious and determined, we also need to be extremely careful in the context of the 2020 Solvency II review : what has been well conceived clearly needs to remain and that the initiatives to address the specifics of long-term business must be driven by simplification. Let's give priority to simplification and avoid the pitfall of complexification as this does not add value, but rather make things less accessible. ●

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Dr. Frank Grund

Chief Executive Director of Insurance and Pension Funds Supervision, Federal Financial Supervisory Authority, Germany (BaFin)

Low interest rates are no reason to change the Solvency II regime

You do not have to be clairvoyant to see that insurers and supervisors will have to face the challenges posed by extremely low interest rates for a long time yet. Calls to change the supervisory regime in response to these challenges are getting louder, with suggestions that the ongoing Solvency II review process be used to introduce appropriate simplifications. My view is more differentiated. A one-size-fits-all approach is not the right solution here.

Our supervisory activities must not be dictated by financial circumstances, and we must guard against making imprudent and short-term changes to the supervisory regime according the prevailing economic situation – however much of a burden this situation may place on the industry. Insurers must hold sufficient own funds to cover all of the risks they are exposed to, regardless of any external conditions. This also includes the risks arising from an economic environment such as we have never seen before. It is the duty of supervisors to critically examine whether the regime is generally fit for purpose, even under these conditions. Any blind spots that are uncovered as part of this examination must be appropriately addressed.

One blind spot up to now has involved the consideration of negative interest rates in the standard formula: Solvency II does not currently allow for this. EIOPA has recognised this shortcoming and, within the scope of the SCR review, has put forward an appropriate proposal for remedying it. This proposal is still being fine-tuned by EIOPA and is yet to be implemented.

I see a considerable need for improvement as regards the appropriate treatment of life insurers' core business; this relates to the possibility, in future as in the past, of offering long-term guarantees to policyholders and beneficiaries in insurance contracts. The discussion here is too negative for my taste. I believe there is too little focus on the positive aspects for companies associated with obligations that need only be fulfilled at a much later point in time.

We therefore need mechanisms that are able to appropriately take account of the differences in risks between short and long-term investments of insurers. The keyword for me here is "appropriately". It is not the task of supervisors to promote economic development! We are responsible for clearly identifying how investment risks differ depending on their maturity. In my view, therefore, it is indispensable that the tools already included in the regime be analysed from this perspective – tools such as the volatility adjustment, which, in its current form, is well-intentioned but not very well executed. It combines elements that are intended to take account of the long-term nature of insurance undertakings' investments with elements that are intended to facilitate supervisory reactions in adverse market scenarios. Here we must draw a clear distinction. This is the subject of lively discussion within EIOPA. I am certain we will reach a good solution in the end. ●

Mireille Aubry

Head of Prudential Regulation Foresight and Standards, Covéa

The combination of key characteristics that underpin long-term investment

The "long-term" nature of insurance is shaped by cumulative characteristics. The first one is the duration of the commitments in the contracts binding the insurer to the insured and beneficiaries. This duration is, however, only one component of the total duration of the business. It is, secondly, necessary to take into account the ability to renew the in-force commitments, as well as the ability to maintain a relevant insurance offer (new business). Thirdly, the robustness or solvency of the insurer is an important element of long-term scoring because it initiates, strengthens, invalidates or depreciates the ability to sustain a long-term future. These long-term characteristics of insurance are the necessary starting point for long-term investment, but they are not sufficient.

Indeed, long-term investment has characteristics that give it a particular risk profile that is not sufficiently well understood by prudential and accounting regulations.

As regards prudential rules, long-term investment is a concern in Solvency 2 and its revisions.

It has quickly become apparent that provisions adopted in the name of financial stability, transparency and market confidence tended to favor short-term behavior and penalize long-term investments. In response, targeted measures have been adopted to correct what were perceived as undesirable effects of these reforms. However, in the end, these "patches" only have a limited scope. This needs to be addressed.

What is prudentially sound about a long-term investment policy? It is based on an assessment of long-term returns and risks and corresponds to a horizon that goes beyond an economic cycle to allow long-term investment to be counter-cyclical. The ability to manage in the long term is demonstrated by not having to sell or buy in contradiction with the performance objectives and appetite criteria expressed in the strategy. It should be noted that these characteristics allow several types of long-term strategies to be undertaken: passive "buy and hold" strategies, but also active ones. The latter are based on extremely thorough continuous monitoring of the micro and macroeconomic environment, as well as of market conditions and investees prospects to allow portfolio rebalancing.

Long-term management must be based on robust governance consistent with the long-term objectives set. The strategic framework validated by the AMSB must focus on this long-term objective and be based on sound risk management, effective control procedures and appropriate routine, as well as preventive and corrective management actions.

"As regards prudential rules, long-term investment is a concern in Solvency 2 and its revisions".

\- MIREILLE AUBRY

Long-term investment can be defined by the process by which the investor seeks optimized profitability over a long period of time. To use the OECD definition, long-term investment is a productive, patient and responsible investment. It is an investment that captures risk and illiquidity premiums where they are located and optimizes the diversification effects between asset classes and over time.

To sum up, prudential reporting must measure risks inclusive of the management and mitigation actions. As regards the accounting framework, it must allocate fairly the valuations between the result and the balance sheet. ●

Fausto Parente

Executive Director,
European Insurance and Occupational Pensions Authority (EIOPA)

Investing for the future: investing the right way

Insurers are used to playing the long game. Life insurance and pensions in particular demand a long-term perspective and it is this perspective that enables insurers to invest in assets for a long period. This brings benefits for governments, economies and citizens.

Solvency II has, without doubt, resulted in a stronger insurance industry and one in which capital is better aligned to the risk it runs. But, could more be done to better accommodate the long-term nature of the assets that have for so long been the mainstay of life insurance and pensions funds? The 2020 Solvency II review will look at the characteristics of insurance liabilities, investments of insurers, long-term guarantee measures, and market valuation of insurance liabilities.

The market is evolving and the European Insurance and Occupational Pensions Authority (EIOPA) will remain attentive to these developments, in particular regarding changes in business models, especially in life insurance, with a move towards contracts with lower >>>

>>> and more flexible guarantees and, in some countries, the significant increase of pure unit-linked products.

"Long-term investments are essential to foster economic growth, develop infrastructure and boost jobs".

\- FAUSTO PARENTE

While this is a natural management reaction to ensure long-term sustainability of the insurers commitments and optimise capital, it also increases the transfer of risks to policyholders, putting more pressure on conduct risks.

In this context, EIOPA is analysing the available evidence on the characteristics and risks of different long-term life insurance products, especially concerning the illiquidity characteristics of the liabilities and the ability of insurers to mitigate short-term volatility by holding assets throughout the duration of the commitments, even in times of market stress. This work will feed into the 2020 Solvency II review.

EIOPA already reports on a yearly basis on the use of the long-term guarantee measures that were introduced to ensure an appropriate treatment of insurance products that include long-term guarantees and the evidence collected from these exercises will also feed into the review.

Insurance plays an important role in Europe's economy and the insurance industry and consumers have both benefited from the risk-based regime that is Solvency II. It is right to review the regime so that it remains fit for purpose. However, the review will be an evolution rather than a revolution and the fundamentals of Solvency II will remain.

Long-term investments are essential to foster economic growth, develop infrastructure and boost jobs. Insurers should not be discouraged from investing in long-term assets or illiquid liabilities. However, any changes to Solvency II, no matter how minor, cannot be at the cost of the consumer.

Ensuring a resilient insurance industry is a priority for EIOPA and the 2020 Solvency II review is fundamental to achieving this objective. EIOPA's Opinion submitted to the European Commission, to be published in June 2020 will reinforce Solvency II as an effective tool to support a strong and stable insurance sector. ●

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VI. DIGITALISATION AND FINTECH

Issues at stake

Technology offers new opportunities that could lead to 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, the use of sophisticated data analysis and AI 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, raise ethical issues with regard to the use of data and create fair competition issues. 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.

Content

Implications of digitalisation for the EU financial sector

Levin Holle

Director General, Financial Markets Policy,
Federal Ministry of Finance, Germany

Digitalisation of financial markets – a key priority

Digitalisation can be a driving force for prosperity in Europe. It strengthens the European financial sector through helping to create a digital single market for financial services and supporting the capital markets union – all with the goal of creating a European digital single market.

Digitalisation creates innovation, reduces costs for customers and firms, and can promote greater competitiveness and choice for businesses and households. An example of this is the area of payments. As e-commerce is growing customers increasingly buy and sell goods and services online. And more e-retail payments are made using mobile phones.

Online and mobile payments can accelerate the speed of transactions, boost transparency and reduce costs. Europe has laid the groundwork for supporting innovations in retail e-payments through fully harmonised payment regulation, including the payment services directive PSD2 and the single euro market area (SEPA) regulation. This helps to provide customers across Europe with access to payments that are safe, efficient and easy to use. However, promoting a sustainable and competitive EU payments market requires a strategic approach towards a pan-European payment scheme. Instant payments as a new payment infrastructure within the Single Euro Payments Area (SEPA) can play a major role here. In my view, the Commission, the ECB and co-legislators should get together and develop a genuinely European approach.

Beyond payments finance is being transformed throughout by the availability of ever more data and new technologies, such as blockchain or artificial intelligence. These trends create new dynamics in the provision of finance and bring new players into the financial services landscape. Technology firms can reach vast user networks at scale in an instant. For European companies to be able to leverage these developments they have be able to offer their digital products across borders and gain access to the single market as a whole rapidly.

Last year, the Commission took an important first step in addressing the challenges this presents for policy makers through its FinTech Action Plan. It set out steps towards a more innovative and competitive financial industry in three key areas. The first seeks to encourage innovative business models through aligning regulatory standards and supervisory practices. The Fintech Lab convening supervisors, technology providers and financial institutions as well as the European Network of Innovation Facilitators are just two examples of ongoing efforts in this space. The second is to ensure greater uptake of new technologies through promoting trust in the ability of regulatory authorities >>>

>>> to preserve financial stability and protect customers. Global initiatives such as Facebook's Libra coin demonstrate the need for a renewed commitment to developing common European and international approaches to regulating innovation. Finally, while digitalisation provides enormous benefits to customers and businesses it also poses new risks. Promoting operational resilience and dealing with cybercrime therefore form a key part of Europe's policy agenda. Regulators and policy makers will have to ensure we remain at the forefront of combatting threats.

The FinTech Action Plan provides a stepping stone in our efforts to create a strong and safe pan-European financial services industry that is competitive in the world and creates prosperity for Europe's citizens. The new legislative cycle should be used to take decisive steps towards the goal of creating a fully-fledged Digital Financial Market Union (DFMU). Beyond payments and AI we should focus on developing our approach to crypto assets and building a comprehensive digital ecosystem that will allow customers and businesses to benefit from the highest quality products and services everywhere in Europe. ●

Claire Bury

Deputy Director-General, DG Communications Networks, Content and Technology, European Commission

EU leadership in digital technologies. Can blockchain and FinTech be the EU's game changers?

Banks, other traditional financial market participants and FinTech startups are all facing an uncertain, and perhaps, turbulent political and economic landscape, with many uncertainties on the horizon. However, there are several developments of which we can be sure. Firstly, that digital technologies are gaining an ever stronger foothold in finance, and in the economy as a whole. Blockchain applications are particularly promising, especially when thinking about their use in connection with other digital technologies like artificial intelligence (AI), Big Data and Internet of Things (IOT).

Blockchain (or more broadly Distributed Ledger Technologies) will become one of the key drivers of the internet of the future with the potential of decentralising digital applications and the management of data in the interests of citizens and consumers. New economic opportunities will emerge for startups in the field of decentralised finance but also for traditional financial sector firms that aim to innovate.

The second certainty is that 'Big Tech' is entering into finance and payments. Long expected and discussed, the recent announcement of Libra shows that blockchain technology is moving into another stage in its development and a further order of magnitude. This will unquestionably be a great challenge for European and international banks, as well as for FinTech and decentralised finance startups in Europe and beyond.

What does this mean for the European and international financial sector? Firstly, that the European Commission will be vigilant in ensuring respect for Single Market and Digital Single Market (DSM) rules. Since the publication of the FinTech Action Plan in March 2018, the Commission has been looking closely at the issues raised by crypto-assets, including crypto-currencies. Furthermore, Commission services are also monitoring broader legal aspects of blockchains in general, including tokenisation and non-financial instrument (utility) tokens and have commissioned a study on it. Both sets of assessments should soon be ready to prepare the ground for action by the next Commission. >>>

>>> Secondly, the positive agenda is one of EU Digital Leadership and your sector is very welcome to get involved. The European Commission President, Ursula von der Leyen, stated in her political guidelines "To lead the way on next-generation hyperscalers, we will invest in blockchain, high-performance computing, quantum computing, algorithms and tools to allow data sharing and data usage. We will jointly define standards for this new generation of technologies that will become the global norm." Several aspects of the EU's Blockchain strategy deserve emphasis because they demonstrate how a dynamic innovation ecosystem can benefit both financial sector incumbents and startups:

- The European Blockchain Services Infrastructure is uniting 29 European countries (from the EU and European Economic Area) in rolling out cross-border public services on blockchain - a global first! - and is to be further supported by the new Digital Europe Programme. In its declaration The European Blockchain Partnership forsees public private partnership possibilities.
- The International Association of Trusted Blockchain Applications, a global stakeholders association for the governance of blockchain, was founded and is based in Brussels. It offers developers and users of DLT a global forum to interact with regulators and policy makers and bring blockchain technology to the next stage. If your institution has not yet joined, now is the time to do so. The Convergence Global Blockchain Congress in Malaga 11-13 November will feature regulatory dialogues between INATBA membership and financial and data regulators. It will be an essential event for blockchain in finance and decentralised finance, underlining the future links to AI, IoT and Big Data.

Pål Erik Sjåtil

Managing Partner, Europe, McKinsey & Company

Digital innovation in Europe: narrowing the gap

Innovation is essential for Europe's prosperity, given the continent's relatively high wage costs and low reliance on natural resources, and for decades, Europe has been an important driver of worldwide innovation. European companies still account for one-quarter of the global total of industrial R&D. Yet Europe's embrace of the digital technology revolution—one of the largest change factors in the world over the past 15 years and most likely also the next 15—is less forceful than it could be. Today, the continent is increasingly challenged by the new generation of disruptive technologies, including artificial intelligence (AI), where it risks falling behind both the United States and China.

Already in 2016, research by the McKinsey Global Institute found that European countries were capturing only 12 percent of their full digital potential (defined as weighted deployment of digital assets, labor, and practices across all sectors, compared with the most digitized sector). That was just two-thirds of the captured potential in the United States, which itself has considerable room to grow.

Large Western European companies are continuing to expand their use of early digital technologies. In banking and financial services, for example, European customers are among the most digitally connected in the world, in terms of mobile banking adoption and mobile banking usage. Nordic banks in particular are leading the way in moving to a cashless society. And the "open banking" movement started in the United Kingdom, under which third-party developers are able to build applications and services around a financial institution, is now copied across the globe.

At an aggregate level across all sectors, however, the share of fully digitized companies in Europe increased by less than 10 percent a year between 2010 and 2016. Moreover, in a digital-first world, in which new "superstar" companies are coming to the fore, Europe lacks the global platform companies that have propelled Chinese and American firms to dominance.

Europe's disadvantage in digital diffusion seems likely to spill over into AI. Early digital companies have been the first to develop strong positions in AI, yet only two European companies are in the worldwide digital top 30, and Europe is home to only 10 percent of the world's digital unicorns. Less than half of European firms have adopted one AI technology, with a majority of those still in the pilot stage.

Europe is taking some good steps

Europe can still narrow the digital and AI gap. It has a wealth of talent, with close to six million software developers—over one million more than in the United States. Its public-sector research >>>

>>> remains a powerhouse. The number of AI startups has tripled in the past three years and is now relatively comparable to the figure for the United States on a per GDP basis. Early-stage startups are better financed than ever before. Investment in European tech is at a record high, with $23 billion invested last year, a five-year increase of 360 percent and an increase of 21 percent compared to 2017.

Investments need to increase—everywhere

To sustain its growth model over the long term, Europe will need to switch into a higher digital gear. Europe invests less than the United States in intangibles like software and databases, intellectual property, and economic competencies like organizational capital and training, which represent major factors for innovation capacity. It also must contend with a fragmentation challenge: Europe's ability to innovate is widely distributed among its member states. In the past decade, EU countries performing at lower levels and those performing at higher levels have not converged; innovation performance has even decreased in 10 out of the 28 EU members.

If Europe is able to develop and diffuse AI according to its current assets and digital position relative to the world, we have estimated that it could add some €2.7 trillion, or 20 percent, to its economic output, resulting in 1.4 percent compound annual growth through 2030. Such an impact would be roughly double that of other general-purpose technologies adopted by developed countries in the past.

To address the digital challenge and reap the potential benefits, Europe will need to focus on six priorities:

- Scale up. Overcoming fragmentation is only part of the scaling challenge. Europe will need to put an emphasis on finding and supporting managers able to take exciting potential and scale it up to world-beating business;
- Continue developing a vibrant ecosystem of deep tech and AI startup firms that will use AI to create new business models;
- Raise the pace on the digital transformations within companies, which will need to embrace AI innovation;
- Accelerate progress on the Digital Single Market, which remains incomplete;
- Build the right talent and skills that will be needed to capture the opportunity presented by digital and frontier technologies, including with a renewed focus on education and mid-career training;
- Think boldly about how to guide societies through the potential disruption to work that will likely accompany AI and other frontier technologies, including a fresh look at impediments to worker mobility and adapting welfare systems to the digital age.

Europe has risen to challenges in the past and there is no reason why it cannot do so again in this era of technological ferment. But it will not happen on its own: policy makers and business leaders have critical roles to play in creating the right conditions, ensuring scale, and leading the charge. ●

Leena Mörttinen

Director General, Financial Markets Department, Ministry of Finance, Finland

New technology and trust

New technology will potentially have huge consequences for the financial industry. It may improve our everyday lives by creating trust between unknown parties, enabling payments with no time delays and with minimal transaction fees, allowing us to access financing from multiple sources and enabling us to lend to peers when we have excess funds to invest. The list seems endless and benefits are potentially huge.

The issue may however not be that simple. The potentially large change in financial services will come at a cost. Mostly we think of this cost in the form of losing control over our data and privacy. In the real time economy the discussion on our right to our data seems already a familiar one. All the answers may not be there but at least we are beginning to know the questions. However, the impact may be more complicated than this. For example, we can only speculate about the effect of the changing financial services on our economic and social structures.

The changes may hit Europe particularly hard since we rely heavily on traditional banks in payments as well as overall financing of the economy. Although in the light of the previous and past financial crises we can disagree on the stability and hence successfulness of the bank-based system, nonetheless banks are part of the critical infrastructure that we rely on and still mostly trust. Unfortunately, the slow reaction of European banks to cleaning their balance sheets has rendered them vulnerable. They are hit by new technology, low interest rates and tough competition from both big tech and financial institutions from third countries.

It is often argued that existing laws and regulations prevent banks from improving their business models and getting ahead of the competition. However, irrespective of how fast technology advances it will not replace the need for regulation to create trust in the society nor to ensure a level playing field. The latest financial crisis and big-tech scandals point to the same conclusion: markets, if left unchecked, will not be able to compete fairly nor take into account systemic externalities or security needs of countries and individuals.

Consequently, when seeking the right balance between the financial service benefits that new technology brings with it and the needs of stable societies, there is list of issues that need to be covered. These include improving the stability of money creation and finance, promoting healthy competition while ensuring consumer protection, preventing terrorist financing and money laundering, and preventing cybercrime and enhancing national security. This may not be a fully exhaustive list but it includes the "must-haves" for any stable nation.

Any technological improvement or new business model providing crucial financial services has to be analyzed from these perspectives. Creating trust through technology is not enough. In a developed society, trust requires accountability of government officials and democratically elected decision makers. It cannot be outsourced to multinational companies. ●

Santiago Fernández de Lis

Head of Regulation, Banco Bilbao Vizcaya Argentaria (BBVA)

How to maintain European regulatory leadership for digital financial services

The digital era is one of opportunities. New technologies have created entirely new possibilities spanning across all sectors of the economy. In finance, this transformation enables a more efficient provision of better priced, more convenient financial products and services to EU citizens, irrespective of their location within the region. Besides contributing to make the Single Market a reality, new technologies enable the banking sector to live up to the task of financing an economy that is undergoing the capital-intensive process of embracing digitisation and transitioning towards a low carbon economy.

However, these new possibilities have brought the challenge of maximizing innovation while containing new sources of risks in the financial sector or for society in general, such as those related with market concentration, data protection or AI ethics. Digitisation also makes more evident the deficiencies of the Single Market absent a truly harmonized regulation and supervision across the EU.

An EU response is therefore needed to ensure that growth-enhancing digitisation is promoted and that it rests on the foundations of our rights and values. Fortunately, EU authorities and lawmakers have already made significant advances: PSD2 has significantly enhanced security and contributed to foster competition in European payments, while the framework on use, access and protection of data - of which GDPR is cornerstone - has reinforced privacy as an individual right. Following the European Commission Action Plan on Fintech significant work has also been undertaken to mitigate regulatory obstacles to the use of cloud computing, to introduce some harmonization in regulatory sandboxes and to foster collaboration in the fight against cybersecurity.

However, more work is needed to ensure European leadership for digital financial services. For instance, by creating a comprehensive framework to enable effective cross-sector user data sharing, data-driven innovation can be catalysed and EU competitiveness and growth boosted. On the other hand, as new business models emerge and the traditional notion of sectors becomes obsolete, European authorities should reflect on how to evolve from an entity- to an activity- and risk-based financial regulatory framework, to protect financial stability and guarantee an effective and equal competition in the benefit of final consumers and the development of the economy. The latter becomes increasingly important at a time in which incumbents from other sectors - for instance, large, established technology companies that have created successful digital ecosystems - appear willing to expand their activities in the financial sphere. If these companies are able to leverage the competitive advantage that comes from a large user and data base, it could lead to an increased concentration in the provision of critical inputs or by the appearance of new systemic financial service providers or infrastructures.

Against this background, authorities could prove to be ill-equipped with tools unable to tackle risks outside the traditional prudential framework. Therefore, only by ensuring risk-based regulation and supervision can we be certain that EU citizens are able to fully reap the benefits of innovation by all players while ensuring that the risks inherent to financial services are captured regardless the provider. There is no time for complacency, as the pace of change is fast: we must embark in this work with urgency and ambition. ●

Ksenia Duxfield-Karyakina, PhD

Government Affairs & Public Policy Manager, Google Cloud, EMEA

A path to trust and innovation

The use of cloud services has become mainstream for financial institutions of every type and size across the globe. Cost savings, enhanced collaboration, business agility, artificial intelligence (AI) and advanced data analytics are key benefits that can be realized through cloud adoption. Organizations can also take advantage of the first-in-class security capabilities of hyperscale providers like Google.

Given the complexity of the regulatory landscape, financial organizations were initially slow to migrate to the public cloud. Recently though, financial institutions and regulators have better understood the benefits of making the shift. Their initial concerns have been eased by cloud service providers' (CSPs) strong compliance posture.

As the global regulatory and compliance landscape evolves, organizations have turned to cloud service providers for risk mitigation. CSPs' infrastructure also provides higher availability and better security along with data integrity, portability and confidentiality. For their part, >>>

>>> financial supervisors deepened their understanding of the cloud. Regulators such as the European Banking Authority have issued guidance on outsourcing.

Adoption of cloud technology in finance requires thorough risk assessment and dialogue between financial institutions, CSPs and regulatory authorities. We believe that these factors should be part of that discussion:

- **Trust and addressing skills gap.** Further efforts are required to educate industry leaders and decision makers to increase trust and enhance cloud uptake. A common misconception is that cloud solutions are less secure. Actually, the security capabilities of cloud platforms have surpassed those available on prem;
- **Openness of the ecosystem.** Open cloud, relying on open source, open APIs, and common standards, promotes interoperability and innovation. Google is committed to an open ecosystem and supporting customer choice;
- **Multi-cloud and hybrid-cloud** to address concerns over concentration risk and vendor lock-in. As an example, Anthos[1] enables Google Cloud customers to build and manage modern hybrid applications on-prem or in different public cloud environments;
- **Portability.** The migration and portability solutions available should be an essential criteria in choosing a CSP, as they are fundamental building blocks of any multi- and hybrid-cloud strategy;
- **Environmental sustainability** must be a key concern. It certainly is for Google - we were the first organization of our size to achieve 100% renewable energy two years running since 2017;
- **Shared responsibility.** In the cloud environment, customers and service providers operate on the basis of shared responsibility. Regulatory and policy guidance need to cater for it;
- **A value-based assessment of potential solutions** based on tools to monitor cost savings and other non price-based gains.

The regulatory and compliance approach to cloud outsourcing must develop and evolve. In an era of rapid change, one-size-fits-all solutions are unlikely to work. Instead, it is important to focus on a specific problem and seek well-tailored solutions, assessing the benefits and the potential unintended side-effects. We are committed to continuing that conversation with financial services institutions and regulators over the years to come. ●

1. https://cloud.google.com/anthos/

Ulku Rowe

Technical Director,
Google Cloud

Five habits of highly effective capital markets firms who run in the cloud

Every time I meet with our customers in the capital markets, they share new ways they are reinventing their businesses. Recently, I met with a CIO from a large investment bank looking to take the next step in the bank's cloud adoption journey and create a culture of innovation. What would it take to achieve this evolutionary transformation?

IT leaders in capital markets are asking the same question. Google Cloud recently contracted Aite Group to survey 19 capital markets firms on their public cloud adoption journeys. Here are insights into what these firms do to bring metamorphic change:

1. They learn from the tech industry

Technology is becoming more and more vital to non-tech companies, but innovation can stall if you don't fundamentally change how you build software. Successful capital markets firms have taken cues from traditional tech companies, adopting their software operations methodologies. Most importantly, innovative capital markets firms adopt a "lifelong learning" attitude, emphasizing "training first" to respond in a fast-changing capital markets environment. They recognize that every employee can be a cloud worker, connected 24/7; security and workplace policies support this reality.

2. They foster a front-office culture of "everyone is a programmer" and bring AI to the middle and back office

By democratizing the ability to build solutions across the business rather than isolating those capabilities in innovation labs, firms can build better products for their clients. The front office may finally be less wedded to management via spreadsheet, if the tools are more fit for purpose. In the middle and back office, machine learning (ML) and artificial intelligence (AI) may bring much needed relief in areas such as trade surveillance, where sophisticated malicious attacks make identifying breaches increasingly challenging.

3. They use data openly with strong controls and security

One CIO at a tier-1 global bank predicts that in the future, regulations will require data access to be granted by the end client. Storing data in a manner where access can be granted or revoked by users easily across service providers will be essential to retaining business. Cloud-based services that incorporate tools for data loss prevention, obfuscation, tokenization, encryption and logging can help firms meet security, privacy and data lineage requirements.

4. They adopt production ML systems

There's more to ML than implementing an algorithm. Production ML systems equipped for multiple functions enable firms to improve monitoring, prediction scaling, error diagnosis, reporting and other tasks that support trading operations. For example, a proprietary trading firm in Singapore uses TensorFlow, an open-source ML library for numerical computation, with the Google Cloud Bigtable NoSQL database service, to "listen" to live market data and make trading decisions.

5. They commit to open-source code with serverless applications

Using open-source code rather than starting all software projects from scratch also speeds up innovation, provides tighter security and offers freedom from vendor lock-in. Numerous capital markets firms have begun to champion open-source development and participate in related industry groups, such as the Fintech Open Source Foundation (FINOS). ●

New technologies: opportunities and challenges

Anneli Tuominen

Director General, Finnish Financial Supervisory Authority (FIN-FSA)

Digitalisation brings better financial services, but also new risks

We have seen significant shifts in the digitalisation of retail financial services in recent years. Incumbent firms are developing their own digital services and are aiming for cost savings through digitalisation and automation. Fintech companies are applying for licences and also seeking partnerships with incumbents. We have also seen big tech companies applying for and being granted EU licences for payment services. All these developments may make the sector more efficient and increase access to these services. But they also introduce new types of risk.

The accelerating pace of digitalisation is beneficial for those consumers who have good digital skills. These users will have a wider variety of retail financial services to choose from and they will be able to access these services at almost any time and place – also across borders. Operating in an online environment also makes it easier to switch between service providers, assuming that terms of contract do not raise unnecessary barriers. On the other hand, fraudulent actors may take advantage of the accelerating pace of change in the market and establish services which look like authorised ones, but which have been set up only for fraudulent purposes. More effort is needed to educate consumers about the detection of fraud and the identification of licensed and authorised service providers.

> *"The consumer segment unable to use digital financial services cannot be neglected."*
>
> \- ANNELI TUOMINEN

According to the latest Digital Economy and Society Index (DESI), 17% of the EU population had no digital skills and 35% of the EU labour force did not have the basic digital skills needed in most jobs. As the pace of digitalisation of retail financial services accelerates, the consumer segment unable to use digital financial services cannot be neglected. We must ensure that the regulatory framework contains the tools required to ensure consumers' access to financial services. More tools may be needed to ensure access to cash services in sparsely populated areas, for example. >>>

>>> Supervisors are closely watching the use of data and AI in retail financial services. Broader use of data enables more tailored services and may reduce service providers' risks by making available more accurate data on particular consumers. Use of AI is also driven by cost savings, for example by reassigning simple claims management or credit scoring by AI.

This raises two important questions from the supervisors' point of view: Are data handled in compliance with data protection rules? And how can the decisions made by AI be explained to consumers and also to supervisors? A good example of efforts in this field is the work of the High-Level Expert Group on AI appointed by the European Commission. The expert group has developed draft Ethics Guidelines for AI, which put forward key requirements that AI systems should meet. These requirements are now in the piloting process. I am happy to see that some financial services companies are also developing and committing to their own principles for ethical AI.

The progress of digitalisation does not necessarily introduce new cyber threats, but it increases the significance of existing threats. The increasing use of cloud services in providing digital services highlights risks such as data confidentiality in cloud platforms and service continuity in subcontracting chains. Protective measures against cyber threats must be taken into account at all stages of the digital service lifecycle. Internal and external security testing in service development, deployment and production are indispensable. A recent example of an initiative to improve testing is TIBER-EU, a framework to test and improve the cyber resilience of entities by carrying out a controlled cyberattack.

Finally, the possible entry of big tech companies into the retail financial services market brings an additional, new element to the discussion, namely big techs' access to data from their existing platforms. The potential entry of big tech companies into the financial sector requires a balance to be struck between financial stability, competition and data protection, as mentioned in the BIS annual report. ●

Mark Wetjen

Managing Director, Head of Global Public Policy,
The Depository Trust & Clearing Corporation (DTCC)
& Chairman of the Board, Deriv/SERV LLC.

In with the new: rules for implementing new technologies for market infrastructure

Any discussion pertaining to the implementation of new technologies in the case of financial market infrastructures (FMIs) must focus on the question of what is the underlying purpose of deploying a new technology tool. An incorrect answer to this question will set any implementation project off onto the wrong course. The correct answer will result from carefully considering the needs of customers and key stakeholders, which for FMIs, also includes regulatory supervisors and policymakers. There must be a rational basis behind the use of the technology, which will be informed by a keen focus on delivering on clients' and stakeholders' expectations.

Once a sound decision to implement a client solution using a new tool is made, in the case of FMIs, there are several key considerations to keep in mind. >>>

>>> FMIs arguably are held to the highest of regulatory standards; therefore, the first consideration is that a measured, incremental approach must be followed. A narrow use case first must be identified and pursued, with client and stakeholder needs driving the assessment, and implementation should move forward only if the initial stage is successful. There are trade-offs to this approach, but from a safety-and-soundness perspective, an FMI must accept the conditions and proceed accordingly if it is to manage its responsibilities successfully. For example, one trade-off is that the implementation timeline will likely be longer than it might be for other firms with fewer regulatory responsibilities.

The second consideration is that collaboration with key stakeholders must drive the process. Successful implementation of new technology by FMIs requires key industry players, including policymakers, to understand how new technology implementations meet not just the needs of clients, but the interests of the overall industry and, indeed, the public. One method to achieve this is reaching a mutual understanding of how existing public policies and their implementing regulations will be met. Another is to agree on how to adjust regulations if necessary, in the cases where existing regulations may not squarely apply to a new technology implementation.

With this in mind, regulators and policymakers are consulting at a global level, through standard-setting bodies (SSBs) such as the Financial Stability Board (FSB) and IOSCO to gain a greater understanding of how new technologies such as DLT, robotic process automation, machine learning and big data can improve the functioning of financial markets without risking their safety.

> *"FMIs must focus on the underlying purpose of new tech deployment to ensure successful implementation."*
>
> \- MARK WETJEN

Best practice guidelines are useful tools to guide the collaboration process, and cloud technology is a good example. Due to the new levels of robustness and sophistication of cloud technology, FMIs – such as DTCC – continue to expand use of the cloud across external services and applications, and point to and follow best practices in the implementation process, as well as in discussions with stakeholders.

Finally, it is important to acknowledge that while many different types of technology tools are frequently categorized as emerging technologies, the fact is that some are more mature than others, and today, some of the newest and least-tested of these tools will likely struggle in the short term to deliver on the requirements that FMIs face.

Meanwhile, the industry must address challenges now. While today's financial infrastructure is highly resilient, the future beckons, and pressures on clients remain. These conditions demand that FMIs begin the journey today to tomorrow's infrastructure, which inevitably will leverage innovative technology.

New technologies are transforming parts of financial services and continue to change the way in which certain areas of post trade infrastructure operate. Over the past decade, FMIs have successfully achieved increased levels of efficiency, speed and cost reduction using technology. It is our view that in ten years' time, FMIs will have been further transformed by new technologies, driven by a combination of established and newer technologies. While this development should be encouraged, it is critical that in the case of FMIs these technologies are implemented following a strict framework of prudence, collaboration with policymakers, best practice guidelines and at the appropriate time of their maturation.

Klaus Löber

Head of Oversight,
European Central Bank (ECB)

Distributed ledger technology: slow and steady wins the race

Many market players and central banks, including the ECB, are exploring the potential of new technologies. Decentralisation and tokenisation offer significant potential as well as challenges that must be addressed. At the international level, standard-setting bodies such as the CPMI have developed analytical tools for this purpose. Similarly, they are guiding public authorities' thinking on the risks and opportunities posed by new ledger technologies and services based on decentralised cryptographic arrangements to hold and transfer assets and cash in tokenised form.

The key feature of distributed ledger technology (DLT) lies in the possibility of making multilateral arrangements involving multiple participants to propose, validate and record state changes consistently without the need to rely on a central and trusted third party. By replacing central account providers and custodians with a distributed ledger consensus mechanism, DLT also enables the "tokenisation" of assets. Efforts to create digital settlement assets, often called digital coins or tokens, particularly in the wholesale sector, come with promises to enhance settlement efficiency. These initiatives are often presented as alternatives to traditional settlements in central bank or commercial bank money.

In theory, they could lead to greater transparency in and accessibility to financial markets, as well as simplify reconciliation among contractual parties, facilitate authorities' access to traceable and manipulation-proof data, and increase operational resilience and process automation.

> *"Regulatory measures should support innovation without compromising security and integrity."*
>
> \- KLAUS LÖBER

However, from a legal and regulatory point of view, DLT and digital tokens raise a series of questions relating to legal status, governance, finality, interoperability and operational risk management, to cite just a few. From a technological standpoint, studies have shown that use cases in finance and banking can be conceptually and technically designed in a DLT environment. At the current stage of development, however, DLT is not mature enough to meet the safety and efficiency requirements demanded by the financial industry and the authorities.

Although we see continued progress in the technical solutions considered, firms will have to proceed with caution as they contemplate implementing new solutions.

To maximise the benefits of new technologies for the financial industry, adoption should not be pursued to the detriment of integration. Time to market cannot be innovators' sole focus. Without addressing interoperability concerns, there will be siloes and fragmentation, duplicated efforts leading to unnecessary costs and a lack of efficiency. Harmonised rules and technical standards must be defined >>>

>>> to help new technologies fulfil their promise and support integration, particularly in the financial domain.

Regulators and central banks play an active role in this process. Amongst others, the Basel Committee, CPMI, IOSCO and the FSB provide analysis and recommendations on the implications of digital innovations for their constituencies. At EU level, through its Fintech action plan the European Commission is driving research on regulatory measures that may 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 innovation in the financial services' regulatory framework. This work is complemented by sectoral activities conducted by European supervisory authorities and the Eurosystem. The combined result should allow for the provision of a technology neutral and risk sensitive regulatory environment to foster and support innovation based on new technologies. ●

Dr. Christopher P. Buttigieg

Chief Officer Strategy, Policy and Innovation, Malta Financial Services Authority (MFSA)

An overview of the Maltese framework for the Regulation of Crypto-Assets and the need for international standards of best practice for the sector

Malta's initiatives in the Blockchain sphere started with the government's publication of a Consultation Paper on the establishment of the Malta Digital Innovation Authority; the Framework for the Certification of Distributed Ledger Technology Platforms and Related Service Providers; and a Virtual Currency Act[1]. This ultimately led to the enactment of three legislative acts; the Virtual Financial Assets Act[2]; the Malta Digital Innovation Authority Act[3] and the Innovative Technology Arrangements and Services Act[4]; which together provide a holistic regulatory framework catering for regulation both from a technology and financial services perspective. Whilst the MDIA Act and the ITAS Act cater for the establishment of the Malta Digital Innovation Authority and the certification of innovative technology arrangements and services, the VFA Act provides a regulatory framework for virtual financial assets as a separate asset class for investment purposes.

Malta does not regulate the crypto-assets themselves, but rather the persons issuing such assets and, or providing services in relation thereto in or from within Malta. In a nutshell, the VFA Act provides a regulatory framework for [i] the offer of Virtual Financial Assets to the Public and the admission of VFAs to trading on a DLT Exchange; and [ii] persons providing services in relation to virtual financial assets as well as a new functionary termed the VFA Agent. Whilst the regulated activity is analogous to that under the traditional framework, it is the asset in relation to which the service is being conducted (or which is being issued or admitted to trading) which is different, given that it does not qualify as a traditional financial instrument. In this light, it is evident that the applicability of the VFA framework is highly dependent on >>>

>>> the classification of the DLT Asset in question as a VFA. The Act defines a VFA as a DLT Asset by way of exclusion – a DLT Asset which is not: [i] a virtual token; [ii] electronic money; or [iii] a financial instrument. In this respect, in order to provide further clarity, the Authority has issued a Financial Instrument Test which, through a set questions, provides the end user with a determination as to whether a particular DLT Asset qualifies as a VFA or otherwise.

At international level, with the exception of the Financial Action Task Force's AMLCFT standards, there is no common approach towards the regulation of crypto-assets - whilst some jurisdictions have integrated the regulation of crypto-assets into existing legislation others have opted to enact bespoke regimes to address regulatory gaps. That being stated, it is clear that various jurisdictions are striving to provide legal certainty in a field which was, until recently, unregulated. In this light, it may be argued that the diverging approaches being undertaken are a direct result of the absence of international standards on best practices for the sector and that therefore such standards may be necessitated. The promulgation of such international standards would not only ensure harmonisation; but would also foster mutual trust and understanding between financial supervisors and facilitate collaboration with respect to cross-border business. ●

1. Government of Malta Consultation Paper in relation to the establishment of Malta Digital Innovation Authority (MDIA) and the framework for the certification of Distributed Ledger Technology Platforms and related service providers, 16 February 2018, available online at: https://meae.gov.mt/en/Public_Consultations/OPM/Pages/Consultations/ConsultationPaperinrelationtotheestablishmentofMaltaDigitalInnovationAuthorityMDIA.aspx
2. Laws of Malta, Chapter 590, Virtual Financial Assets Act ('VFA Act'), available online at: http://www.justiceservices.gov.mt/DownloadDocument.aspx?app=lom&itemid=12872&l=1
3. Laws of Malta, Chapter 591, Malta Digital Innovation Authority Act ('MDIA Act'), available online at: http://www.justiceservices.gov.mt/DownloadDocument.aspx?app=lom&itemid=12873&l=1
4. Laws of Malta, Chapter 593, Innovative Technology Arrangements and Services Act ('ITAS Act'), available online at: http://www.justiceservices.gov.mt/DownloadDocument.aspx?app=lom&itemid=12874&l=1

EU electronic payment strategy

Burkhard Balz

Member of the Executive Board,
Deutsche Bundesbank

What does digital transformation mean for European payments?

The European payments industry is undergoing profound and substantial change. Its main driver is the wide-ranging digitalisation of almost all areas of business and everyday life. The increasing digitalisation will affect European payments along various dimensions:

- As ever more business moves to the digital space, payment solutions will need to adjust to the evolving needs of users, who are increasingly expecting instant execution of payment and seamless integration into digitalised business processes and end-user applications. In some EU countries, this development has contributed to a marked decline in the use of cash;
- The unprecedented availability of data, coupled with fast-evolving AI and ML techniques, has enabled new business models driven by data analytics. As payment data are inherently valuable, the payments industry has become increasingly attractive to non-traditional data-savvy firms whose business models rely on the monetisation of data rather than on fees;
- Technological innovations, such as cloud computing and new API-focused IT infrastructures, combined with regulatory reforms, have significantly lowered entry barriers to retail payment markets. As a result, new players, such as young FinTech start-ups and large global tech firms, are now competing – as well as cooperating – with traditional payment service providers (PSPs);
- In an interconnected world that offers virtually unlimited opportunities to obtain information and do business, online platforms that efficiently match demand and supply play a key role. This crucial role is further accentuated by strong network effects and significant economies of scale. For platform providers acting as intermediaries between supply and demand, integrating the payment process into their product range is a natural step.

While these developments have the potential to enhance efficiency and user experience in European payments, they may also pose a number of serious challenges.

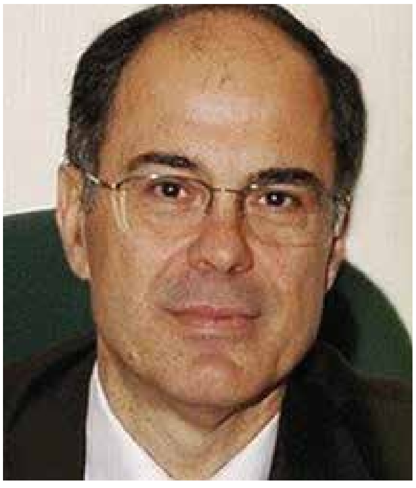
Cyber resilience of electronic payment services is bound to gain ever greater importance. The market entry of large tech firms that rely heavily on data-based business models may not only fundamentally challenge the current economics of payments but also raise significant privacy issues. Key players in the digital economy, such as online platform providers or smartphone producers, may act as gatekeepers to digital payment services and use their market power to the detriment of payment service users. >>>

>>> Moreover, even five years after the completion of SEPA, the European payment market re-mains fragmented along national borders. To date, intra-EU cross-border retail payments at the POS and in the increasingly important area of e-commerce rely heavily on non-EU providers. As well-positioned foreign tech companies leverage their large user bases and offer their services throughout and beyond Europe to exploit network effects and economies of scale, they may become increasingly become a factor in domestic payments as well.

The political implications of this dependence of the EU retail payments market need to be investigated more closely. However the trend towards open banking might further boost com-petition and innovation in the European payments landscape. In addition, new solutions based on instant payments could support the independence and sovereignty of European payments.

The EU payments market is on the verge of a sea change. For European PSPs it is crucial to now plot the right course in order to deliver safe, efficient and user-centred pan-European payment solutions and remain relevant now and in future. While, now that SEPA Instant Payments has been developed, the necessary basic infrastructure is already in place, it is now up to European PSPs to develop such pan-European solutions.

Importantly, these private sector endeavours have to be supported by a regulatory framework that ensures that the openness and competitiveness which characterise the EU payments market will allow pan-European players and solutions to thrive and not unduly favour large, global companies with wide networks. ●



Paolo Marullo Reedtz

Head of the Directorate General for Markets and Payment Systems, Banca d'Italia

Will new POS payment solutions replace cash? The Italian perspective

App-based payments, contactless transactions, e-money wallets and payment initiation services: the payment ecosystem is changing rapidly. While innovations are spreading far and wide, divergences in the use of cash or electronic instruments persist among European countries. Although Italy remains a cash-based country, promising developments have emerged recently, spurred by technological innovation and the new legal framework supporting security, efficiency and transparency in digital payments.

The growth rate for electronic transactions is in double figures, at 11 per cent in 2018 with respect to 2017. Payment cards remain the most widely used instrument, experiencing 16 per cent growth in 2018. The Italian debit card scheme is launching a new project, Bancomat Pay: tokenized debit cards will be used to pay via a smartphone; the same app will allow transfers between individuals, whose their accounts will immediately be debited/credited. We expect a further increase in the volume of proximity payments (especially for contactless applications) and through Remote POS.

The growth of payment cards has been favoured by both the diffusion of c-less technology and the implementation of the IFR regulation. The latter, according to estimates carried out at Banca d'Italia[1], appears to have contributed between 30 to 40 per cent to the increase in merchant acceptance observed over the last years[2], spurred by a reduction of merchant fees. Studies on the impact of the IFR on cardholder fees are in progress: anecdotal >>>

>>> evidence seems to indicate an increase in fees for consumers to compensate the reduction in the interchange fee. Other studies have remarked[3] that the pass-through between interchange and cardholder fees is not perfect, given that consumers can change payment service provider more easily than merchants can. In any case, the IFR has increased transparency and competition, fostering more balanced pricing models.

Further boosts for developing POS electronic payments in Italy can come from the operation of limited circuits. According to PSD2, merchants may issue instruments to pay within limited circuits: there are no supervision requirements but there are reporting obligations to competent authorities when transactions exceed €1 million. So far in our country, 86 companies (i.e. big retailers, vending machines) have sent reports. The total value of transactions within limited circuits in Italy is around €15 billion on an annual basis, accounting for over 6 per cent of the total value of card transactions. Data confirm customers' readiness to pay with electronic instruments if they are easy to use, convenient and well promoted.

Although the use of POS instant payments (i.e. SCT Inst) is still in a start-up phase, we expect new developments in the near future if the industry adopts more appropriate business models (the service cost is currently an issue) and implements additional value added services (i.e. payment guarantee mechanisms in the event of error and fraud).

Finally, innovation in security is a key driver for all new developments. The widespread use of new security features has resulted in a decrease in fraud rates over the last few years in Italy and Europe[4]. Confidence in digital money is indeed crucial to replace cash. ●

1. Source: Bank of Italy, banking statistics.
2. Source: Bank of Italy, banking statistics.
3. European Commission (2006), Sector Inquiry on retail banking – Interim Report I Payment Cards, Brussels.
4. See ECB 2018 (Fifth Report on Card Fraud).

Kari Kemppainen

Senior Adviser, Bank of Finland

European payment landscape in a change

Digitalisation is shaping almost every sector of the economy enabling new ways of doing things by digitising old, often manual, processes. Payment services also belong to this category: in recent years numerous new digital payment applications have emerged in retail payment markets but the underlying payment infrastructures have remained almost unchanged. Nevertheless, technological advances combined with increasing competition enhanced by regulatory changes will shape retail payment markets in the coming years.

Regarding the European payment markets, three forces are likely to shape the market in the future: i) new service providers, ii) new products, and iii) new regulation. First, we have already witnessed steps taken by new service providers (i.a. BigTech and FinTech firms) to enter into the European payment markets. Second, we have also seen a multitude of new payment products, mainly new payment applications, being offered by both newcomers and, to a certain extent, also by incumbents. Third, this development has been enhanced by the updated Payment Services Directive (PSD2) aiming at increasing competition in the payment markets.

It is very likely that the effects of these three forces will further materialize after the complete adoption of the PSD2. This evolving new environment will set up new requirements and competences to authorities for safeguarding the security, reliability and efficiency of payments. It is important to bear in mind that payment business is heavily based on people's trust that their payments are executed and delivered in a reliable and secure manner no matter who is the service provider.

Therefore, it is crucial that all payment service providers and systems are properly supervised and overseen by the relevant authorities also in this new environment.

At the same time, it must be ensured that there remains a level playing on supervisory and oversight requirements imposed on service providers so >>>

>>> that the competition landscape is not distorted. As more and more service providers seem to come outside of the traditional financial sector, it could be advisable to move on towards activity-based regulation over the entity-based regulation. This would prevent the emergence of competitive distortions in the payment markets. When building the future regulatory framework for payments, we should make sure that it accounts for the inherent network economic characteristics of these markets. These characteristics lay ground for a "competition–cooperation" prevailing in these markets. On the one hand, competition among payment service providers and systems is needed in order to have contestable markets. On the other hand, a certain degree of cooperation is required in solving the chicken-and-egg problem and achieving user critical mass for new payment products.

Recognising these network characteristics is essential to ensure that "socially efficient payments" are available and usable throughout the whole society also in the future. To this end, an adequate dialogue among payment service users, providers and authorities must be possible. Therefore, multi-stakeholder bodies, like the Euro Retail Payments Board (ERPB) and national payment councils, will play an important role in the future digital payment world. ●

Klaus Löber

Head of Oversight,
European Central Bank (ECB)

New providers, new products and new technologies call for a new approach to oversight

Technological innovation in financial services – often referred to as fintech innovation – has led to the introduction of new financial products and services by both incumbents and new market entrants, especially in the field of payments. Regulatory, and in some instances legal reforms have helped to open the market to new payment service providers able to compete with their established peers. While new technologies, such as distributed ledger technology, are still at an early stage of development, they offer many opportunities while challenging some of the basic concepts of the current regulatory approach.

Change has so far been incremental, and existing regulatory, supervisory, and oversight approaches have served their purpose well. Complacency should nevertheless be avoided, and authorities must be prepared for more disruptive developments going forward. Developments taking place in the field of crypto tokens serve as a good example of this guiding principle. Ten years after the arrival of Bitcoin's open source software, this year's release of the Libra white paper and its open source software could be seen as a watershed moment. Originally envisioned as an accessible and borderless way to pay, first-generation crypto assets have generally suffered from severe price volatility and limited capacity to process transactions compared with existing arrangements.

Consequently, they function primarily as risky investments or a niche payment instrument, and have not achieved a scale that could entail a material imprint on the payments and financial system. New types of settlement tokens labelled "stablecoins", such as the aforementioned Libra, seek to reduce volatility by anchoring the "coin" to a reference asset (e.g. a sovereign currency) or a basket of assets. While the issuance and usage of stablecoins to date have been limited, a number of new stablecoin initiatives backed by large technology companies or financial institutions could have the potential for widespread adoption, both for retail and wholesale payments.

A global stablecoin for retail purposes could in theory pave the way for faster and cheaper remittances, spur competition in payment services and thus lower costs, and support greater financial inclusion. In this regard, stablecoin initiatives highlight the need to step up ongoing public and private efforts to upgrade existing payment systems.

As a fairly nascent product, stablecoins are largely untested at scale in a real-world environment. Moreover, they give rise to a number of serious risks relating to public policy priorities, particularly anti-money laundering and counter terrorist financing, as well as consumer and data protection, cyber resilience, fair competition and tax compliance. They may also raise issues relating to monetary policy transmission, financial stability and the smooth functioning of and public trust in the global payment system. As large technology or financial firms would be able to leverage vast existing customer bases to rapidly achieve a global footprint, authorities must be vigilant in assessing the risks and implications of stablecoins for the global financial system.

Given their potential impact, authorities are following these developments closely. A G7 working group is currently assessing stablecoins in coordination with the relevant standard-setting bodies, the G20 and the Financial Stability Board. As regards digital innovations from a broader perspective, the Committee on Payments and Market Infrastructures has established a dedicated working group on this topic. The Eurosystem is taking a leading role in this international work. As a result of these trends, it has taken steps to review its oversight policy approach and to start developing a new framework for the oversight of payment instruments, schemes, and arrangements (PISA oversight framework).

Upon finalisation, the PISA framework will replace the current oversight framework for payment instruments and will complement the oversight of individual payment systems and/or the micro-prudential supervision of payment service providers with aspects that are relevant from a payment scheme and arrangement perspective.

This new holistic, agile and future-proof framework is designed to apply to traditional and new payment products, providers and technologies alike, and contribute to the safety and efficiency of the overall payment system. ●

Sujata Bhatia

Senior Vice President & General Manager for Global Merchant Services Europe, American Express

Towards a pro-competition & outcome-oriented EU payments strategy

It is an exciting time for payments in Europe. With a backdrop of rapid developments in everything from instant payments, to open banking and e-commerce, the European Union has the opportunity to lead the world in regulation that promotes innovation and truly serves consumers. But to be most effective, and unlike some of its antecedents, new regulations should be genuinely pro-competition and outcome-orientated, focusing on achieving specific objectives (e.g., fraud rates to stay below a certain level or expanding the single market for non-bank payment services) without mandating any one particular solution (e.g., two factor authentication) or business model (e.g. restricting the ability of payment institutions to passport payment services involving the extension of credit).

The payments industry shares that outcome-oriented ambition, and over the last decade has driven increasingly frictionless payment and more effective, unobtrusive, security to European consumers. There have, however, been a number of recent examples where policy-makers could have taken a more strategic approach, taking into account the complex interdependencies in the payments eco-system and the potential for innovative technology to provide a solution to existing problems, rather than locking in old tech or shutting out smaller, innovative market players.

One particularly potent live example is Strong Customer Authentication (SCA), where from mid-September new rules will come into play). Here, those complex interdependencies in the payment's ecosystem have caused significant problems, not least since Payment Service Providers cannot control the entire payment process and must rely on merchants to implement many of the necessary updates. While the objectives of SCA are one standard industry solution, an outcome-orientated approach, allowing market participants greater flexibility in finding solutions, could have achieved the same objective without the disruption that many merchants are currently facing to implement SCA rules.

> *"The European Union has the opportunity to lead the world in regulation that promotes innovation and truly serves consumers."*
>
> \- SUJATA BHATIA

The review of the Interchange Fee Regulation (IFR) provides another opportunity to foster electronic payments in the E.U. But for that to happen, the European Commission needs to take a different approach in comparison with previous years. While the IFR created many opportunities, arguably it did not achieve many of its core objectives in terms of increasing competition, innovation and choice in the cards market. Price regulation is a blunt tool, and should not be seen as the way forward, nor should big-tech be excluded from bringing innovation into payments. Rather, introducing for example new mechanisms that would improve the transparency of merchant fees would help competition by allowing merchants, especially smaller ones, to compare the full cost of accepting cards. Similarly, from the consumers' perspective, adopting a full ban on surcharging across the E.U. could be beneficial and would also tackle fragmented rules in the single market.

As we have seen with Open Banking, where regulation is both pro-competition and takes a flexible outcome-orientated approach, the European Union can be a leader in global payments innovation and regulation. ●

Bobby Chadha

Head of Fin-Tech Labs, Banco Santander

Towards the future of fair and competitive digital payments

As the debate intensifies over rules of the game for digital payment services in a digital age, a thorough reset of the financial services regulatory and policy environment is required. As a guiding principle to foster a prosperous and inclusive society, rules for the digital economy should lay the foundations for fair competition that encourages a diverse economy and avoids excessive concentration of economic power.

Consumers and businesses demand instant payment solutions that provide a good customer experience with global reach. The EU should foster a solution with these features:

- Availability (365x24x7) and Speed (instant settlement for low-medium value payments, commitment for "same day" for the rest). Payments below a certain value between countries deemed to have equivalent compliance standards, should benefit from proportionality.
- Reachability. Instant connectivity also for payments originating outside of Europe, including direct connectivity for non-European participants, which may need to comply with collateral requirements.
- Addressability. Provide secure address systems throughout Europe >>>

>>> to reduce fraud and other risks based or linked to a personal identifier that is independent of the bank account number. This will facilitate switching.

- Single European Register. Europe needs a pan-European repository where instant payment services can match an email address or phone number to a bank account.
- Interoperability. Real time transactions, traceable end-to end.
- Fees. Transparent, predictable fee structure with no hidden fees.

"As a guiding principle, rules for the digital economy should lay the foundation for fair competition."

\- BOBBY CHADHA

As payments are the most frequent interaction with customers in digital finance, the regulatory framework should also be holistic. Key areas to be addressed now are:

- All payments providers should be subject to the same standard of accountability and responsibility in anti-money laundering, security, privacy and consumer protection.
- Banks' payments units that do not take deposits should be treated like those of non-bank payments providers. Activity-based rules should be put in place and the additional layer of prudential regulation be eliminated.
- Just as they do in the context of PSD2, users should be empowered to share their transactional data with companies across different sectors to ensure fair competition, increase choices for users and opportunities for businesses. Combining payments and non-payments raw data such as online searches, purchases or travel, banks and other players can provide better, safer, more targeted products and services, including more lending to SMEs, enhancing competition and consumer choice.
- Any payments platform that becomes a systemically important financial markets infrastructure should be regulated and supervised as such to safeguard financial and economic stability. Given the propensity of platforms to dominate in their respective spaces, we risk creating a too-big-too-fail payments provider without too-big-too-fail regulations and backstops.

Banco Santander offers competitive, safe and efficient payment systems wherever we operate, to foster financial inclusion as part of our responsible banking commitments. We are accelerating the development of our retail peer-to-peer payments services, ensuring our 144 million customers can pay easily in a simple, personal and fair way. We believe all these initiatives will ultimately help people and businesses prosper. ●

Tim Keane

Chief Operating Officer,
Western Union Payment
Services Ireland

Financial inclusion in a digital world

Financial inclusion is close to my heart and that of Western Union. The company was founded in 1851, when the New York and Mississippi Valley Printing Telegraph Company was formed to build a telegraph line from Buffalo, N.Y., to St. Louis, Mo. Overcoming geography was the foundation of our business. Today, Western Union offers fast, safe and secure payments in all but a few countries and territories in the world, including in regions where there is conflict, natural disaster or no traditional banking or other financial services network.

Western Union operates within many cultural contexts, following our customers as they move to where they find employment and ensure they can support their families and communities back home. Increasingly we also support small and medium size businesses in their aspirations to expand globally. This helps integrate many individuals and companies into the wider global economy, brings opportunities for greater inclusion and fosters social mobility.

Technology is becoming an increasingly important part of our lives. What does this mean for Western Union and financial inclusion? Technology, such as the wide availability of mobile phones, makes it easier for people to connect. Technology therefore plays an important role in fostering financial inclusion. It is of course important that the access to these technologies is not restricted but made widely available.

"Technology therefore plays an important role in fostering financial inclusion."

\- TIM KEANE

Western Union has adapted to this new reality by offering mobile and online remittance services. The proportion of remittances sent via such services is continuously growing. Nonetheless cash remittances still remain very important. Technology also helps us to improve our services, be it around fraud detection, the know your customer requirements or meeting our reporting requirements. All of these are important cost drivers in our industry and any efficiency gains will have a positive impact on our service delivery.

Technology also has its challenges. It brings choice to our customers and fosters competition. It can open the door to new channels of fraud or introduce new ways of circumventing detection. EU regulation needs to keep up with these challenges. Allow me to make a number of concrete suggestions.

The EU should:

- ensure regulation is technology neutral and designed to encourage investment in new technologies;
- enable the use of eID for cross-border transactions;
- adopt an activity based approach to regulation meaning new providers should be subject to the same rules thus ensuring a level playing field;
- ensure that core functions, such as anti-money laundering requirements, cannot be outsourced without a clear allocation of responsibilities. ●

Pia Sorvillo

Director of European Affairs, Visa

Partnerships will define the next generation of retail payments in Europe

The payments market in Europe is unique for its combination of technology, consumer trends and regulation. Whilst fragmentation between markets remains, as in many sectors, digitalisation is helping to erode the traditional barriers to commerce and allow goods and services flow more freely across national borders. In doing so digital payments have evolved from a convenient and secure way to pay, to open payment networks providing new opportunities for growth and have attracted interest from FinTech and BigTech players. These players may in turn adopt data driven business models which poses new challenges and considerations for regulators.

Irrespective of the direction of travel for payment networks, the true driver of industry trends remains consumers. Commercial partnerships have been a staple part of the digital payments landscape for some time to offer new services, and target new customer bases, around the world. As an example, Visa partners with European banks and innovative FinTech firms to offer payment solutions which leverage our best-in-class fraud detection capabilities and cyber resilient network. These partnerships keep European consumers up to date with some of the safest and most innovative retail payment technologies.

Innovation brings challenges as well as opportunities, particularly where the pace of technological change is both fast and novel. Digital payments are one such area. There are a number of buzzwords which, whilst not new ideas, are increasingly cropping up in conversations about the future of retail payments. "Crypto assets", "digital fiat currencies" and "real time payments" to name but a few are entering the conversation alongside the traditional card payment experience. These are welcome additions to the payments landscape but do not yet offer the same level of consumer protection.

These new areas are evolving fast, and in all regions of the world, which is why a different type of partnership is encouraged. One between policymaker, regulator and innovator to make sure that this global landscape is understood – both in terms of risks and opportunities – and can thrive in Europe.

> *"Growth in Europe will require partnership between industry and policymakers."*
>
> \- PIA SORVILLO

Partnerships are a feature of the digital economy but to truly promote growth and innovation in Europe partnerships must involve more than commercial relationships, and include dialogue between industry and policymakers. The cycles of evolution in these emerging digital payment networks is rapid, and a new approach to policy is needed to keep retail payments competitive and able to expand. Policymakers should react to the emerging trends of digitalisation and take a holistic, and principle based, view to regulation which sets clear rules but provides flexibility to innovate. ●

The Eurofi Financial Forum

Helsinki September 2019

Data challenges associated with AI

Kostas Botopoulos

Advisor to the Governor,
DPO, Bank of Greece

Artificial Intelligence and data: a steep two-way road

The link between artificial intelligence (AI) and the use of data is obvious: AI is about empowering machines to "think" as humans on the basis of huge amounts of data "fed" to those machines. The matter is not theoretical.

AI is already used or tested in the financial sector, especially by banks, which may see, according to studies, up to 50% improvement of their capabilities through the use of AI. Such use concerns most frequently trading (algorithmic trading), combatting anti-money-laundering (AML) and financial fraud (by identifying and preventing complex criminal behavior), enhancing consumer service (by mimicking human interaction and giving tailor-made answers), facilitating risk-management (by improved analysis and prediction) and even helping in compliance (by sorting out and giving solutions to the great complexities of the regulatory requests).

> *"The existing regulatory framework is not adapted and has not taken into consideration the emergence of AI."*
>
> \- KOSTAS BOTOPOULOS

"The existing regulatory framework is not adapted and has not taken into consideration the emergence of AI."

The basic attribute of "machine learning" is that it is able to detect patterns -of action, behavior, prediction- and thus make data "talk" –be more salient-and even "decide"– make choices and give advice- in a way that enhances financial capabilities. One could thus say that AI is both an opportunity and a danger, especially when viewed from a regulatory perspective: the main problem is that the existing regulatory framework is not adapted and has not taken into consideration the emergence of AI.

On the data front, the regulatory cornerstone in the EU, the GDPR, in principle prohibits, in the name of data protection, automated processing, which is the

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basis of machine learning. In other words, although AI is not exempted from the regulatory perimeter of the GDPR, it does not fit into such perimeter either. The issues of supervision of data (who feeds what into the machines), organization (who decides what is or becomes relevant) and protection (who knows and who can oppose use of data) are both relevant and difficult to solve. New regulatory approaches are needed in order not to "tame" AI but to profit from its potential in the financial sector.

Olaf Sleijpen

Director Insurance Supervision, De Nederlandsche Bank

Explainable AI for regulators

Artificial intelligence (AI) is becoming more commonplace in the financial sector. Consequently, various legislators and supervisory authorities, including the European Commission and the European Supervisory Authorities, are considering the development of AI-specific policies and/or regulations.

Explainability seems to be at the heart of the current debate on responsible AI. When financial firms start to deploy advanced data analytics, such as deep neural networks, in their business processes, the need we feel to understand what is going on "under the hood", naturally, becomes stronger. After all, while deep learning is able to achieve extremely high levels of accuracy, it is also at the root of the "black box" problem. A systemically important financial institution that deploys an unexplainable black box to determine its capital requirements is clearly undesirable.

The obvious answer to this problem? Simply demand that AI applications used by financial firms should at all times be completely explainable. Indeed, many reports advocate a regulatory response along these lines. Taking our responsibility of safeguarding a sound financial system seriously, however, I would like to caution against such a regulatory reflex.

When considering the application of AI to their business processes, financial firms inevitably are faced with fundamental trade-offs. Should the application be as accurate as possible, or does our need to understand how the model works warrant a few extra wrong outcomes here and there? Should type I errors ('false positives') be minimized, or are type II errors ('false negatives') more detrimental? Is process fairness (to prevent disparate treatment) more important for a certain customer-oriented application, or is outcome fairness (to prevent disparate impact) of primary concern? There simply is no single right answer to these questions. What the most sensible trade-off is in any given situation depends, amongst others, on the activity for which a firm wants to deploy AI, the role the application plays in the decision-making process, and the materiality of the application for the firm's business continuity and/or its customers.

"The challenge we face is to assess what level of explainability is warranted in different situations."

\- OLAF SLEIJPEN

To give an example: money laundering transactions are notoriously hard to identify using traditional (often rule-based) approaches. Globally, we do not even intercept 1% of all suspicious transactions. If someone were to develop a deep neural network that somehow increases performance by a factor 10, is rejecting this system for not being fully explainable really the right regulatory response? And how about the use of AI to automatically analyse legal contracts? Would it be sensible to favour a simple model that only gets it right 70% of the time over a – perhaps not fully understood – model that manages an accuracy of 99.99%? Probably not.

The challenge we face, both as regulators and as financial firms, is to understand the risks we are dealing with and to conscientiously assess what level (and what kind) of explainability is warranted in different situations. While this certainly is no easy task, it is part and parcel of what constitutes responsible AI in the financial sector.

Garrett O'Neill

Assistant Commissioner, Data Protection Commission, Ireland

Key GDPR essentials for AI processing of personal data

Imagine that you just become the proud owner of a fully automated driverless car. You would expect the following before you took a journey in it:

That the car:

- had been fully programmed with the rules of the road, such as which side of the road to drive on;
- was able to distinguish the relevant speed limits;
- was able to adjust to bad weather conditions.

If the car has, none of these primary programmable features then your first journey in it will probably be your last.

Similarly, for Digitisation and Artificial Intelligence (AI), you require that certain features are running in the background to ensure that regulatory rules are being complied with.

From a data protection perspective this means that any collection and processing of personal data of an individual, needs to be done in a transparent and accountable manner that is consistent with the General Data Protection Regulation (GDPR).

How can this be done? Answer: - Data Protection Impact Assessment (DPIA).

The Article 35 DPIA, is a means to collate, analyse and implement measures to ensure that the eventual outcome of a project can have appropriate safeguards applied.

A DPIA should not be a "paint by the numbers", exercise. It must demonstrate the proportionality and necessity of the data being processed and how it could affect individuals and their rights. There is no point to a DPIA if it just highlights in bright colours the different level of risk as being either red, yellow or green. Instead, the DPIA should be exploring the whole purpose of the project and what the overall outcome of a project will be. It is therefore an objective, living document that will change, as the project progresses with the ultimate aim to give an evidential analysis of all the potential issues and problems that could affect the outcome of the project and what can be done to mitigate or reduce these problems by introducing appropriate and relevant safeguards.

What are relevant safeguards? Answer: Data Protection by Design & Default.

The safeguards can be a number of things but when it comes to A.I., it should incorporate Privacy by Design and Default features as set out in Article 25. This could be done by implementing and embedding regulatory EU/ National legislation, into algorithms, which have to be designed to be transparent and accountable. A core safeguard feature is that the processing of personal data is viewed from the perspective of a law-abiding citizen who expects that his /her personal data be treated with respect and confidentiality.

As A.I. is primarily a bunch of algorithms then there should be a built-in protocol algorithm that monitors and reports on non-compliant issues. Similarly, other financial and insurance laws could be built into a "regulatory algorithm", to ensure that the A.I. is within the regulatory obligations of AML rules or other requirements.

In conclusion, there must be protocols and limits, as to how any A.I. can operate and what is proportionate and necessary to achieve a beneficial outcome, for everyone. Potentially the best way to do this is to purpose build, a regulatory algorithm into the A.I. to ensure that the process is done in accordance with existing regulatory rules. ●

Ermir Qeli

Head Stargate Services, Swiss Re

Are there regulatory obstacles to innovation in insurance?

The rapid growth of new technologies is bringing a significant change to the (re)insurance value chain. Technologies such as Big Data and AI are expected to improve significantly underwriting, risk assessment, costing and pricing and claims management. The ability to predict risks and accurately quantify losses allows a better understanding of risk, enabling thus more attractive insurance products for existing risks as well as for risks that were previously excluded.

Wearables and lifestyle tracking technologies may lead to more rational and bespoke insurance solutions covering actual needs rather than subjectively perceived risks. At the same time, completely new types of insurable risks, such as cyber, are starting to emerge for which Big Data and AI might provide the means of assessing these risks properly.

"Some examples reveal that changes to regulation are needed to support financial innovation."

\- ERMIR QELI

Technology also opens up new opportunities for "parametric" insurance products where claims pay-outs are not determined based on manual assessments

of resulting damage, but on the occurrence of predefined triggers, usually based on data, such as for example drought >>>

>>> insurance where the pay-out is linked to measures of lack of rainfall.

With new technologies come new risks, and the (re)insurance industry will be more relevant than ever as a financial shock absorber for unforeseen losses for individuals and institutions alike. (Re) insurers are adjusting their products and services to address new risks created by technologies in the most efficient way and to narrow the huge protection gaps worldwide. At the same time, regulators and policymakers will have a huge influence over whether the industry is able to develop new products and services that are relevant to customers' evolving needs.

Some concrete examples are already emerging where regulators and policymakers could make changes to the regulatory framework to support technological innovation in (re)insurance. For instance, under Solvency II Directive there are significant limitations on the types of products that (re)insurers can offer – it is not clear whether a reinsurer could receive a fee-based remuneration for the service it provides to the cedant where no prior reinsurance contractual relationship exists. Restrictions around business activities which are not directly linked to (re)insurance should be interpreted more liberally to allow incumbents to experiment with new business models and technology. Another example where we need regulatory action is on parametric solutions. Currently, in many markets across the EU, parametric products are not recognised by the national Codes of Insurance, and therefore, such solutions cannot be offered to consumers in these markets. Such products could eliminate all complexity of a loss investigation process and can give customers the confidence when it comes to liquidity and speed of payout in emergence situations. We need an EU-wide action by regulators and policymakers to ensure that such innovation solutions could be offered to consumers in Europe.

In the age where many companies in the (re)insurance industry are embracing new technologies, it is more important than ever for regulators and (re)insurers to engage in an open dialogue to ensure that the industry can harness technological development in the interest of consumers and society as a whole. ●

Diana Paredes

Chief Executive Officer, Suade

How do you solve a problem like AI?

If data is the new oil, artificial intelligence (AI) is the engine that turns that oil into something that can power a car. The comparison seems so obvious in terms of the benefits we extracted from moving from horses to motored engines, but the financial industry did not get the memo. Given how history repeats itself it is shocking to observe how little attention and investment is done for AI in our sector. AI is still seen as a pet project rather than a solution to real complex problems. It is often drowned in budgets for analytics rather than have a legitimate cost centre. AI has the potential to transform KYC, catch fraudulent transactions, catch a rogue trader, clean data and optimise margins for our industry. Then why is it not at the top of the agenda beyond the buzzword? There are two main reasons for this and they both come down to data.

Firstly, it is a matter of how the financial industry views its relationship with the data of its clients. There is no doubt that AI could allow the financial sector to leverage the vast amount of data it has. A bank could become as efficient as Amazon at selling products, advertisement, services to a client. But that is not something that the financial sector is used to do and would it be a popular decision with clients? Are clients ready for the invasion of their privacy in their bank accounts in the same way Google and Facebook do? The solution here is to change the relationship the industry has to client data. Let's have a good deep creative think about products and services that would truly be valued by clients in exchange of their data. Better mortgage rates, relevant savings products, a dating app, market comparisons are the first things that come to mind. The only way to commercialise client data using AI is by doing it more transparently and better than what tech giants have been doing for years instead of refusing to enter the game at all.

The second blocker for AI is that the results for the experiments conducted so far in finance are poor. This is mainly due to poor data and the misuse of data scientists. AI models are simply not delivering interesting insights proportionate to the cost of the investment. The lack of data standards in finance has perpetrated bad habits from enrichments and adjustments to proprietary, unsuitable ontologies that make data impossible to be easily reused.

"If data is the new oil, AI is the engine that turns that oil into something that can power a car."

\- DIANA PAREDES

Data is locked within legacy systems from one vendor to another which makes it hard to clean and make sense of. The importance of starting an AI project with clean data is misunderstood. 99% of the efficiency of an algorithm is dependent on that. Due to this lack of focus on clean data, the spend goes to hiring an unnecessary amount of data scientists who consequently will not be able to do much. They will cost money but given they do not come from finance they usually cannot make sense of the data without support. If our industry is serious about AI it should:

1. Clean and harmonise its data using the regulation as a way to do it;
2. Hire fewer data scientists to pair up with existing subject matter experts within their organisation. This is how you will get to the best models and insights. This is also an opportunity to upskill the financial services workforce, it is always cheaper and more efficient to leverage your existing staff. ●

VII. DEVELOPING EU CAPITAL MARKETS

Issues at stake

Developing capital markets in the EU is essential for providing businesses with additional sources of financing and offering appropriate investment opportunities to savers. Existing trading and post-trading legislation and asset management frameworks have contributed to harmonizing EU capital markets and mitigating risks. The additional policies adopted in the context of the Capital Markets Union initiative moreover aim to further develop and integrate EU capital markets.

The beginning of the new EU political cycle is the opportunity to review the progress made and assess whether the initial objectives of the CMU can be achieved with the existing action plan or if additional actions or more radical changes to the CMU initiative are necessary. Further developing retail capital markets and SME equity financing, better capitalizing on the role that banks and digitalisation can play in the development of capital markets and finding an appropriate balance between EU-level integration and the development of local ecosystems are among the issues that require further attention.

Content

CMU way forward

Steven Maijoor

Chair, European Securities and Markets Authority (ESMA)

EU needs to level up the Capital Markets Union

The overarching aim of the CMU project is to transform the EU capital markets into a fully integrated and globally competitive capital market. It is admittedly a very ambitious objective, which requires a complex combination of actions to turn it into a success.

Among the various key success factors for establishing the CMU is an optimal regulatory framework, and the CMU action plan featured a substantial overhaul in this regard. Since the announcement of the action plan in September 2015, a large number of legislative changes have been proposed by the European Commission, and a majority of them have been agreed politically.

Despite the progress made, and the overall fairly high level of capital market integration in Europe in areas like asset management, trading, and post-trading, I believe we need to do more to successfully achieve the CMU. Especially the modest progress on equity markets and low levels of household participation in capital markets are sources of concern.

As a matter of fact, European companies continue to receive a significant share of their funding from bank loans rather than from capital markets, which negatively affects the stability of the financial system and the economic growth in the EU. A banking oriented financial system tends to favour debt, while an increased role of equity would reduce risks to the financial system and would better support innovative economic activity.

It is vital to make progress and extend our CMU efforts, and further improve the relevant conditions and regulatory framework. Some of the key improvements are outside the area of financial regulation, like the treatment of equity in tax systems. However, improvements are also needed regarding financial regulation.

Firstly, we need to develop a larger and deeper European retail investor base. Today, European households own substantial financial assets which have steadily increased in the last decade. However, their participation in capital markets is overall low, especially when compared to the US. To provide households with adequate incentives to place their money in capital markets, one key challenge is finding the right balance between offering attractive investment opportunities and ensuring that retail investors are sufficiently protected. Retail investors should have access to transparent, efficient, and low-cost fund products. We could achieve this by, inter alia, improving the availability of simple products and provide clear, comprehensible and comparable information as well as addressing product distribution, by ending conflicts of interests in the distribution chain. Additional measures should focus on increasing the demand for capital market products, e.g. through pension reforms to support households in meeting their retirement savings.

Secondly, we need to look at sources of funding for SMEs and their access to equity markets. There is already a fairly well-integrated EU capital market for large listed issuers. However, most SMEs, in addition to relying on bank finance, tend to privilege local markets due to easier access and lower information asymmetries for investors. The number of IPOs

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>>> is currently very low. Despite some targeted actions under the CMU Action Plan, including the creation of the SME Growth Markets and changes to the Prospectus Regulation, this area needs more attention. Available options could include the strengthening of specific market segments for SMEs that – based on the proportionality criterion – would be subject to reduced regulation, also by looking at which type of investor should have access to this SME segment. Other measures to look at concern the standardisation of information on SMEs to reduce information asymmetries, especially cross-border.

To sum up, I would like to underline that Brexit only reinforces the urgency of the goal of a successful CMU. In the aftermath of Brexit, capital markets should play a more important role in the EU's financial system and should compete effectively vis-a-vis other major financial centres outside the EU. This can only be achieved if the EU capital markets are more sizable and further integrated, through a range of measures that should increase retail participation in capital markets and access to equity markets for SMEs. ESMA will continue to support these goals and will remain actively involved to facilitate implementation of next steps. ●

Srobona Mitra

Senior Economist, International Monetary Fund (IMF)

Anke Weber

Senior Economist, International Monetary Fund (IMF)

Europe needs capital market integration

Europe lacks an integrated capital market. Not only are firms relatively highly dependent on bank loans, but European capital markets are also sharply segmented along national lines. Almost half of EU insurers' and pension funds' equity investments are in their home jurisdictions. This is especially so in the largest countries, notably, Germany, France, and Spain.

Such segmentation is costly. First, firms face sharply divergent financing costs based purely on national domicile; our analysis shows that firms in, say, Greece, pay 250 basis points more on debt, on average, than comparable firms in the same industry in, say. France. Second, innovation and growth potential suffer; our analysis shows that firms with limited collateral to offer—think of your typical start-up—grow faster in more developed capital markets where venture capital is available. Third, private cross border risk-sharing suffers; we show that domestic consumption is four times more sensitive to local shocks in the 28 EU countries than in, say, the 50 U.S. states. >>>

>>> Our survey of European capital market players—national regulators and fund managers—highlights important obstacles to integration. Deficiencies in national insolvency frameworks, regulatory quality, disclosure and listing requirements, audit quality, and withholding tax refund procedures come out as important barriers to larger intra-EU capital flows. The United Kingdom scores higher in most areas than euro area or the EU? 27 countries.

Guided by the survey results, our empirical analysis finds that lowering such barriers offers the prospect of powerful macroeconomic benefits, including a reduction in firms' funding costs, an increase in intra-EU portfolio capital flows, and higher risk-sharing across countries. If Italy, for example, were able to improve its insolvency practices to best-in-class standards, it would reduce its firms' average debt funding cost by some 25 basis points—this is not small change. If Portugal were able to raise its insolvency standards and regulatory quality to those of the United Kingdom and Belgium, respectively, those two countries' portfolio asset claims on Portugal would double. Resilience to local shocks would increase accordingly.

We propose that policy efforts focus on three targeted sets of initiatives at the EU level to help achieve greater capital market integration:

- to enhance transparency, we propose instituting centralized, standardized, and compulsory electronic reporting for all issuers, irrespective of size, on an ongoing basis. This would be a major change to the European reporting framework. Furthermore, digital technologies could be used to improve the efficiency of cross border withholding tax reclaims;

- to improve regulatory quality, we favor strengthening ESMA's supervisory convergence role; bringing systemic entities such as CCPs and large investment firms under centralized oversight; lowering the regulatory ceiling on administrative costs associated with the Pan-European Personal Pension product; and maximum regulatory cooperation with all third countries, recognizing the global nature of capital markets;

- to improve insolvency regimes, we see a role for the European Commission, first, in carefully collecting data in an area where the existing information is unreliable; second, in developing a code of good standards for core features of corporate insolvency and debt enforcement processes; and, third, in systematically following up on member states' progress toward observing such standards—in essence, we propose a "name and shame" approach modeled on the Basel Core Principles process. We are aware that progress here will take time. ●

Leonique van Houwelingen

Chief Executive Officer, The Bank of New York Mellon SA/NV

Delivering CMU – using a mission-orientated approach

The story so far of the CMU project is very largely a story of frustration. There is little sign that the CMU project has had a material effect on the development of capital markets in Europe. This is disappointing as the CMU project - by facilitating the collection and channelling of savings into productive investments – is a necessary pre-condition for broader policy efforts to tackle fundamental social and environmental challenges in Europe. And because Europe, with its resources, skills, and diversity, has the capabilities to tackle these challenges, if only it succeeds in organising itself. >>>

>>> The CMU project is complex, and has a large number of very diverse stakeholders, including retail investors, SMEs, intermediaries, securities regulators and Member States. We need to find ways to bundle the forces of these stakeholders, and to reinvigorate the CMU project.

One important source of ideas is the work of Professor Mariana Mazzucato, who currently holds the Chair in the Economic of Innovation and Public Value at University College London. In 2018, she wrote for the European Commission a report entitled “Mission-Orientated Research & Innovation in the European Union”. This report describes the interaction of actors involved in research and innovation in ways which are similar to the description of capital market eco-systems; it sets out an explicit objective of increasing investment and of creating opportunities for investment-led growth, and it sets out specific suggestions as to how research and innovation policy can be successful, and can help deliver solutions to broad societal problems. One key idea of the report is that innovation and research policy need an explicit mechanism that connects a broad societal challenge (a “Grand Challenge”) with the portfolio of individual projects and bottom-up experimentation, which is the day-to-day reality of innovation and research.

Such a connecting mechanism is a “mission”. A “mission” is a tool to focus research, innovation and investment on critical problems, bring together and encourage collaboration between different actors and sectors, and create positive spill-overs.

“We should use key elements from the Mazzucato Report for the CMU project."

- LEONIQUE VAN HOUWELINGEN

In June 2019, the Centre for European Policy Studies (CEPS) published a report entitled “Rebranding Capital Markets Union: a Market Finance Action Plan”. The report contains a valuable description of a capital market as a complex system with diverse actors, from both the private and public sectors. It contains recommendations with respect to bond and equity markets, the promotion of retail participation in capital markets, and the introduction of a set of indicators to measure progress towards more market-based finance.

The report also stresses the need for political support at the highest level if CMU is to achieve its objectives. One of the major problems of the CMU project is that each individual proposal has been viewed, and discussed, in isolation. What this means is that each initiative (Pan-European Personal Pensions, withholding tax, insolvency, post-trade, etc.) is faced with a daunting set of obstacles, and with scepticism that it can actually deliver material change.

We should use key elements from the Mazzucato Report for the CMU project, including the ideas that (i) the definition of a mission should include a clear, targeted policy outcome; (ii) a mission should engage the public, and should have clear societal relevance; (iii) a mission should involve actors from both the private and public sectors (possibly in a “co-creation” framework); and (iv) the trajectory of a mission to reach an outcome must be based on a bottom-up approach of multiple solutions. Many of the core elements of capital markets (resources, information, communication and trust) are very similar to the core elements of the research and innovation process.

We should also use the CEPS Report, as it provides a framework for specific action with relation to improving the functioning of capital markets.

The CMU project, and sustainable finance more generally, are necessary elements in our efforts to deal with the “Grand Challenge” of climate change adaptation and mitigation, or what could be called a “European Green Deal”. ●

Robert Ophèle

Chairman, Autorité des Marchés Financiers (AMF)

Making CMU work: without of a strong political will, CMU will be a long journey

Europe enters a new legislature in a unique context in several respects: politically, with a fresh impetus to find amongst Member States and a novel balance of powers in the Parliament after the recent elections; institutionally, with the challenge to tackle the exit of the UK and to rethink the role and position of the EU on the global scene. In that context, the completion of the CMU, while necessary, remains uncertain since it will encounter the same hurdles that have derailed or slackened the project during the recent mandate.

The CMU project was launched in 2015 in order to establish the building blocks of an integrated capital market in the EU by 2019. The 2015 action plan was updated in June 2017, one year after the UK referendum, by strengthening existing actions and introducing new measures. What was seen as useful at a time when the EU had a dominant financial center, which, to a large extent, alleviated the fragmentation of its capital markets, should be considered as necessary with the exit of the UK since this will leave the EU27 with several competing middle-sized financial centers. And everybody supported (and still supports) the general ambition: creating more opportunities for investors, connecting financing to the real economy, fostering a stronger and more resilient financial system, deepening financial integration and increasing competition.

Nevertheless, little has been achieved; to some extent, this should not come as a surprise. For issues that do not fall within the EU's exclusive competence, and unlike monetary policy for the Members States whose currency is the euro, capital market issues are under shared competence. The principle of subsidiarity applies and rules out EU intervention when an issue can be dealt with effectively by Member States. The EU is only legitimate to act when the latter are unable to satisfactorily achieve the objectives pursued, and if value can be added by EU level action. Actually, the CMU is not perceived as an absolute necessity and very few countries are ready to abandon part of their sovereignty to build a convincing CMU. The subsidiarity principle is not leading to a fully-fledged CMU.

How can we overcome these difficulties? While the cards are obviously in the hands of the European co-legislators, it is our responsibility, as national regulators, to document how detrimental it is for the EU globally, but also for every Member State individually, to have fragmented and unattractive internal financial markets. And why it is not desirable to depend in the long run on third countries for the management of EU savings, for the funding of our large investment projects and for the development of European corporations abroad.

The CMU is therefore a legitimate objective. What could be the priorities? Let me mention three:

- we need similar bankruptcy and collateral collection rules; similarity is key for issuing debt on a Union wide basis and for the securitization of debt, especially if you intend to pool debt issued under different jurisdictions. Chapter 11 is one of the key US integration factors;
- we need to remove the Giovannini barriers as updated by the EPTF with the harmonization of segregation requirements of client assets, of operational registration procedures and shareholder identification procedures, and of processing of corporate actions;
- we also need strong supervisory convergence. Both the ESA review and EMIR 2.2 have sent clear signals from Member States, refusing to increase the direct powers

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>>> of ESMA and to strengthen its governance. These regulations have nevertheless reinforced the supervisory convergence tools and we should make full use of them. The relevance of many EU financial institutions and market infrastructures goes far beyond the national perimeter; they deserve a common EU supervisory treatment. The passport, which is at the core of the CMU and is widely used in asset management, cannot be sustained in the medium run without a strong supervisory convergence.

I do believe that we will have the opportunity to make decisive progress towards the CMU. Many key regulations (MIFID/MIFIR, AIFMD, PRIIPS, CSDR ...) will be reviewed; new financial domains, which will shape our capital markets' future, are still to be covered by European regulations: digital finance and sustainable finance. We should not miss these opportunities. ●

Christian Staub

Managing Director Europe, Fidelity International

Weighing the opportunity cost of low retail investor participation

With around 30% of EU household savings languishing in deposits or currency, and public pension systems under pressure, the opportunity cost to EU's ageing population of not investing in market-based instruments is too high to ignore.

This is not to say that market exposure should be a priority for all households; many must prioritise paying down debt and putting cash aside to cover contingencies. And many more are already invested via workplace pensions.

But we think it should be a higher priority for policymakers in their capacity as agents of gradual but paradigmatic change. So, our first recommendation for the CMU over the next 5 years is that the project reconnects with its founding objective of stimulating market exposure for EU households.

"Policymakers should leverage PSD2's competitive logic to direct household savings into market products."

- CHRISTIAN STAUB

Under the pan-European Personal Pension Product (PEPP), for example, we welcome the inclusion of a fund-based default option. However, we maintain that a better alternative to the 1% fee cap would have been a higher threshold encouraging providers into the market and the PEPP to build scale, with policymakers lowering the threshold later on. Leaving advice costs outside the cap could give the PEPP a better chance of take-off, as could allowing alternatives to full-strength MiFID advice for what is already a highly prescribed product.

PEPP policymaking seems to have had its original market-facing instincts blunted in other areas. For example, its preference for capital guarantees counters prevailing wisdom that such guarantees subtract more in cost than they add in certainty. This is a lesson that policymakers are coming to terms with in DC markets, yet debate remains over including the cost of guarantee within the same PEPP fee cap. Not doing so clearly misleads >>>

>>> potential investors about the PEPP's value-for-money; while our preference is Target Date Funds which offer near-perfect capital guarantee at a fraction of the cost.

Our second recommendation is that the CMU is given a clearer objective to strengthen competition between retail investment options - a natural safety-net to policy designed to stimulate retail participation in capital markets. We encourage policymakers to pay closer attention to the product disclosure policy that ultimately drives retail consumer decision-making.

In terms of existing data, the ESAs February 2019 reports on the relative cost and performance of the EU's investment products were worrying in the lack of useable data they discovered. Retail-friendly fund data was readily available but somewhat patchy, while data on bank- and insurance-based products was almost entirely absent. This clearly hinders investor choice between products. In terms of future choice-data we must solve PRIIPS. The technical problems with disclosure methodologies are known. Here we advocate that policy should allow product-specific disclosure standards to pivot away from an original ethos of comparability towards a new ethos of understandability.

We also encourage policymakers to refresh their view of where customers make choices about investment products and exposure in the first place. EU investors no longer buy funds on a stand-alone basis but rather buy into broader investment services, either in the form of a portfolio or wrapper or via investment advice. To be effective, investor choice ('value for money') policy must be relocated to the intermediary closest to the end customer. It is here that policy must empower customers to make effective choices.

Our final recommendation is that CMU policymakers greater consider the transformative potential that Open Banking may have on saving patterns. Policymakers should look to appropriate but extend the competitive logic of PSD2 and view it as means of drawing household savings out of cash deposits and into investment products. Where PEPP uses tax efficiency to encourage this shift, PSD2 will allow retail investment platforms to leverage technology to nudge customers in the same direction.

Fidelity has already launched a pilot enabling users of our UK platform to view their deposit savings alongside their investment holdings - a powerful tool for cross-comparing the relative performance of these assets. Any extension beyond this will need creative policy control. But tech-based guidance, advice and transaction tools that allow EU households to re-allocate their assets towards the market exposure their retired selves need is a key industry's challenge over the next 5 years. ●

Kevin Wall

**Chief Executive Officer,
Barclays Europe**

Unlocking the growth potential of Europe

Barclays has been supportive of Capital Markets Union (CMU) since its conception. We remain supportive today.

Important progress has been made over the past five years but CMU is not a small undertaking and the new European Commission and European Parliament terms provide an opportunity to develop fresh ideas and a renewed impetus. The core rationale for CMU remains. Addressing our over-reliance on traditional lending channels can both support long-term growth and enhance economic stability. >>>

>>> We should be clear, this does not mean replacing traditional lending channels. Rather, it is about helping markets develop to provide funding that is generally not provided through banks. It can bring together our need to find sources of patient capital and our long-term need for investment returns to meet our savings gap.

It is also about augmenting banks capacities to lend in their core areas and to help banks develop the markets where direct lending or funding is not the answer.

Let's look at these in turn.

The funding challenge for Europe's SMEs is often misunderstood. While it is clear that there is a gap for SME accessible risk finance, it is not by any means obvious that there is a gap for traditional loan finance or finance more generally for businesses with clear trading histories and reasonable expectations of repayment.

What is needed is to provide a bridge from conceptualisation of a business to the traditional capital markets, and to make equity available at the smaller levels. We call this idea the 'Pre-Capital Markets Union'.

CMU will require strong wholesale/investment banking institutions that can promote the development of capital markets through bringing users and providers of funding together efficiently. These will need to comprise of both large global but also strong local and regional institutions that are familiar with local markets and have a strong vested interest in building these markets and bringing local firms to the capital markets.

Barclays European investment banking activities have recently been consolidated under our Irish subsidiary and other global firms have been undertaking similar changes, in a variety of locations. This helps cement that vested interest to develop pan-European capital markets, leveraging our global operations and vice-versa.

Some of the regulatory changes required to support this are not particularly new or innovative but they require an understanding of the inter-linkages between policy areas and the political and supervisory will to address them.

Home-host issues are an obvious example, within the Eurozone, within the EU more widely, and internationally.

The EU's decision to require a 90% scalar for internal MREL (the highest level within the FSB's recommended range of 75%-90%) combined with host supervisors' discretion to layer on additional requirements increases costs without improving or facilitating resolution. It discourages investment in the EU financial services sector (especially in leverage-constrained businesses such as capital markets activities).

At an international level, although there is work ongoing at the FSB to address market fragmentation, it is not yet translating into policy outcomes at regional level. In the US, the consultations on the tailoring of rules for Foreign Banking Organisations do not point to an outcome that would indicate increased trust of the home country regime. In Europe, internal MREL is an example but we also have the increasingly fractious discussions around the continued ability of firms to access and use Europe's foremost financial centre.

The work on CMU should also look at potential opportunities to accelerate innovation and help develop markets for financial instruments that would be new to the EU and designed to address the specific characteristics and needs of the EU markets.

We could push further on securitisation, including doing more work on the securitisation of SME loans. We could look at new equity like instruments for private companies requiring more limited disclosure and avoiding loss of family control. We certainly need to continue to try to develop our venture capital market and, of course, develop our sustainable finance solutions as a matter of priority.

The list could go on but the pre-requisite is strong financial institutions operating in open, competitive, and efficient markets. ●

Stéphane Boujnah

Chief Executive Officer and Chairman
of the Managing Board, Euronext

Aim high and think holistic

The next European Commission mandate provides a unique opportunity to reframe the CMU around a holistic regulatory agenda. One of the weaknesses of CMU under the previous Commission mandate was that many of the issues underpinning the objectives are found in areas of EU legislation – such as MiFID II – which to date have not been explicitly the subject of the CMU agenda. This has contributed to a sense that the CMU deliverables have fallen short when compared to the ambitious objectives.

Accordingly, the CMU policy approach going forward would benefit from an integration of upcoming reviews of EU legislation. From the Euronext perspective, this translates primarily to MiFID II as this is the single most important piece of EU legislation impacting our ability to finance European economies. However, the same approach should also be taken to all other relevant EU legislation, such as the Market Abuse Regulation.

As part of this process, Euronext believes that legislative reviews, embedded within the CMU process, should encompass an approach to evaluation which delivers: (i) a clear benchmarking of regulations' market outcomes against the initial objectives; (ii) economic impact assessments which include a strong focus on the macroeconomic impact of regulations on the national and local ecosystems which support public capital markets; and (iii) a comprehensive approach covering all participants in the market ecosystem and value chain, particularly when it comes to determining end-user costs.

"The next Commission mandate provides an opportunity to reframe the CMU around a holistic agenda."

- STÉPHANE BOUJNAH

Also, CMU 2.0 should address in a holistic manner all the issues that prevent the flow of capital towards equity investment. This means that the concrete objectives of CMU 2.0 will have to include steps to be taken to unleash resources from insurance companies towards equity investment in the context of renewed a Solvency II.

Since CMU was launched, Euronext has continued to grow with the recent acquisition of Oslo Børs VPS complementing that of the Irish Stock Exchange in 2018. Today Euronext stands as a family of seven united regulated exchanges in Amsterdam, Brussels, Dublin, Lisbon, London, Oslo and Paris providing access to public capital markets across the continent.

One of the challenges for Euronext as a truly pan-European operator of regulated exchanges is how to reap the advantages of consolidating a deep and transparent European liquidity pool, whilst maintaining local market ecosystems across its jurisdictions. The EU faces the same challenge in the development of CMU. A careful balance needs to be struck between delivering harmonization to support consolidated liquidity pools and maintaining sufficient flexibility to nurture the diverse range of local market ecosystems on which the EU depends.

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>>> Strengthening capital market financing for tech SMEs clearly demonstrates the challenge of combining the benefits of integration of EU capital markets while maintaining strong domestic capital markets. Capital market financing is particularly important for these companies as their business models are not always profitable in the short-term, meaning that bank financing is often not the best financing route.

Critically, tech SMEs are often 'globally local 'meaning they have a pan-European or international profile but rely heavily on local financing ecosystems. While the CMU and Banking Union are progressed at an EU level, it is critical to nurture these local market ecosystems, particularly focusing on the role of banks, advisors and research providers. At the same time, there needs to be a greater focus on investors taking an EU perspective. Greater market integration will strengthen institutional investment and provide enhanced financing opportunities to corporate users.

Alongside institutional investors, the ability of retail investors to invest in tech SMEs in other EU jurisdictions should also be strengthened. In this context, Fintech may have a profound impact on the way that issuers engage with retail investors.

Euronext is committed to playing a key role across the European continent in facilitating the access of companies to capital to finance innovation, economic growths and jobs. We look forward to working with the EU institutions and national authorities under CMU 2.0 to take the project to the next level and deliver the public capital markets Europe needs. ●

Developing equity financing for SMEs

Sébastien Raspiller

Assistant Secretary, French Treasury,
Ministry of Economy and Finance, France

Fostering SMEs' growth should be both at the national and European level, but with distinct tools

Developing new financing capacities for small and medium-sized companies should be one of the main goals of an efficient Capital Market Union (CMU). If many milestones have already been reached since the beginning of the project in 2015, it seems that SMEs still face several hurdles while trying to diversify their financing, as the European Commission pointed out with its SME Growth Markets initiative in spring 2018.

That former initiative is typically relevant in order to review, regulation by regulation, every potential obstacle for the development of stronger companies within the European Union.

Nevertheless, **we need to distinguish two types of actions that may foster the development of SME markets in the EU.**

Firstly, a wider and more ambitious review of each regulation applicable to SMEs in the context of the new momentum we are trying to gather in the CMU initiative, through the very clear direction of alleviating the administrative burden for those companies. And everyone truly understands that that action imposes a European scale, which is of paramount importance in that dimension.

Secondly, the development of SME markets as an ecosystem of creators, researchers, financers, helpers, is primarily led at a national level. Indeed, even if it is without question a long-term objective, we must acknowledge that the very concrete impulse and dynamism in SME cycles of growth, development and financing are still concentrated at the national level, sometimes even regional level, among sponsors, banks, business angels, investing communities, etc. And that ecosystem should be fostered at a national level as we do in France with our clusters and communities we initiated and animâtes, such as the French Tech initiative.

Consequently, the CMU should largely include considerations on SME markets, bearing in mind that we must not miss the goal, which is to reduce the administrative burden each country and European regulations impose on those companies that are sometimes growing very fast. Therefore, an ecosystem-wide approach may not be relevant at the European level, no more than developing one-size-fit-all approaches or very costly >>>

>>> and non-targeted tax incentives, while European companies are still very different in sizes, financing practices and cultures within the European Union. Even if convergence remains the final goal, we cannot force it that way.

The development of SME markets is a major field of development for the CMU. Above-mentioned actions are relevant for the development of SME markets, but they are not sufficient. We may think of other options that could be useful in that dimension. First, the incentives to long-term investment could be boosted thanks to the review of Solvency 2, going further than the long-term equity investment portfolio created this year, which is a step in the right direction. Second, I expect that our work on securitization and insolvency will favor an easier way to fund business from its creation to its closing. Third, the development of capital-investment teams able to fund start-ups and scale-ups is of high relevance.

Last, the access to listing has been facilitated thanks to various initiatives, such as the SME Growth Markets initiative. However, some issues have not yet been fully addressed. For instance, financial research has been profoundly reshaped by MIFID and we observe that small and mid-cap issuers now have to fund it themselves. This may be considered as a supplementary hurdle to listing.

I expect the next Commission to look thoroughly at this subject when tackling the next CMU challenge. ●

Carmine Di Noia

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

Rethinking the funding escalator? Some thoughts from Italian experience

Corporate financing is facing interesting structural changes.

We are witnessing a declining attractiveness of stock markets (except for Asia) counterbalanced by a growing role of private equity and an increased capacity, scale and variety of private capital markets.

> *"Developing equity financing for SMEs is crucial to meet the needs of both companies and investors."*
>
> - CARMINE DI NOIA

There is more money around (mainly in the hands of professional passive investors) but chasing fewer companies: the United States has lost almost half of its publicly listed companies in the past twenty years. There has also been a downward trend in non-financial companies' use of initial public offerings (IPOs) in advanced European economies. Companies now raise lots of money privately to fund their growth, and don't go public until they are already huge and mature and worth tens of billions of dollars.

On top of that, the innovations made possible by new technologies has helped to develop alternatives to the traditional markets. The digitalisation of assets, the use of blockchain network technologies to modernize market infrastructures and to cut out the "middle >>>

>>> man", the emergence of "marketplace investing" models offering a broad range of services are all accelerating the transformations at work in the financial industry.

In Italy, we are trying to close the gap by developing a more diverse funding escalator landscape. One of the new tool is the minibond. Minibond are debt securities (bonds and commercial papers) issued by private industrial companies, with a typically low amount that could be listed or not on a stock exchange. Italian SMEs, through the issuance of minibonds, have the opportunity to engage with sophisticated investors, acquire new skills on financial markets and 'practice' in the event of possible follow-up in more complex deals, such as allowing private investors to access the share capital, or listing on a stock exchange.

The advent of the minibond industry in Italy had also the effect of creating a new segment of investors (private debt funds) specialized in minibonds and direct lending to SMEs (another growing trend in our country). Interesting developments are also stemming from crowdfunding. The 2019 Italian Budget Law allowed equity crowdfunding platforms to host, together with the equity campaigns, issuance of debt securities targeted to professional investors or "sophisticated" ones' as defined by Consob. Even though crowdfunding remains a niche phenomenon in Italy, it is anticipating some inevitable future trends. Those platforms will increasingly act as a "one-stop-shop venue" where companies, regardless of their size, could gain access to different services (private placement, capital raising, crowdlending, secondary markets) making the idea of "listing" obsolete.

On the equity side, Italy introduced an alternative way of listing, less burdensome and faster compared to a traditional IPO, by the use of a Special Purpose Acquisition Company (SPAC), company that raises cash through an IPO without having any operations or physical assets aiming to find and acquire an existing unlisted company.

Enhancing the funding tool-box may not be enough. It is also paramount to develop a focused investor base (easing the legal constraints for retail but sophisticated investor) and to educate entrepreneurs, raising awareness on the importance of thinking long term, opening up to different financing options and develop internally sound corporate governance.

To conclude, developing equity financing for SMEs is crucial but it should take into account the way in which the financial world is changing. Going public is no longer the only route. Which financing channel will eventually deliver the desired outcome in terms of stable funding is difficult to tell in advance. The answers will not come from a mere easing of regulatory constraints but will involve the development of a comprehensive vision of financing in Europe, that takes into account differences in market depth and reconciles the development needs of companies with those of market robustness to attract investors. ●

Lukasz Januszewski

Member of the Board, Markets & Investment Banking, Raiffeisen Bank International AG (RBI)

Equity financing for SMEs

For which types of companies is it most important to develop equity financing?

Contrary to the mainstream view that equity financing is mostly suitable for larger, established corporates, RBI sees strong equity financing possibilities for companies across the entire life cycle, including SMEs. RBI itself launched a EUR 25m fintech-oriented VC fund in 2018.

Sources of equity financing differ depending on the life cycle stage of a given SME (business angels / VCs / PEs / public markets). In a number of circumstances, we advise our start-up / SME clients to consider equity financing: (1) High risk-return growth projects with relatively low cash-flow visibility in the short run, yet medium-to-long term financing needs. (2) Periods of financial distress / underperformance in mature businesses to help maintain a healthy balance sheet. (3) High loan costs coupled with scarcity of financing alternatives.

How important is the objective of developing equity financing for SMEs at a time when Quantitative Easing (QE) of the European Central Bank (ECB) provides wide liquidity in the market?

Despite their critical importance in growing jobs and stimulating >>>

>>> innovation, SMEs were not able to benefit as directly from QE as their larger peers. The ECB's corporate sector purchase programme targeted specifically large corporates with a public investment grade. Put differently, QE tended to benefit SMEs through indirect channels such as the loosening of eurozone financial conditions associated with ECB policy. Additionally, ECB QE obviously in general did not provide capital, but rather a supportive liquidity backdrop. In this respect, the argument for SMEs to consider equity financing remains as strong as ever: to improve their resilience to economic cycles.

Should there be more focus on leveraging the role played by banks in capital markets in the CMU? How could this be done and how could this benefit SME markets?

While there is a need from SMEs to enter and raise capital on public markets (i.e. supply of equity) and ultimately potential demand from investors, there are currently considerable market inefficiencies where banks can play a significant role.

Let's take the CEE region where SMEs are relatively small in EUR terms and their financing needs are accordingly limited. Given institutional investor portfolio concentration restrictions (i.e. can only hold a relatively small share of a given issue), this creates a cost hurdle for SME financing deals to overcome.

Banks could address this market gap via innovation with, for instance, introducing a standard reporting approach for SMEs they have relationships with. Bank participation in blockchain initiatives also has scope to support SMEs, not only through trade finance but also through more efficient collateral usage and reducing information asymmetries (which implies potentially lower deal costs).

One could also think of a Tier 2 capital type of solution leveraging the mechanism of a perpetual subordinated debt.

In this field, there are challenges to overcome, but it is also clearly an innovation opportunity for banks and markets to be won. The only question will be, who will be first? ●

Antonio J. Zoido Martínez

Chairman, Bolsas y Mercados Españoles (BME)

CMU and SMEs: focusing on the full development of the European capital market

A Capital Market Union (CMU) will take much longer to be completed than (politically) expected. That is relevant for SMEs.

The incomplete fulfilment of the expectations of the CMU Project have opened the way to question how to reset, or rebrand or, in fact, how to restructure the Project.

Should the construction of the CMU be the result of national market's efforts flowing, at the end, into an integrated market? Or should the building of a European Capital Market be the result of a concerted European Union effort from the beginning, at all necessary levels and areas required?

Both alternatives should accept a reality that, probably, has been consistently overlooked: patience is needed.

A look at the list of issues to be faced and solved, (the preferential treatment of debt over equity, harmonisation of securities and tax laws and harmonisation of reporting and supervision across jurisdictions…) show what a monumental task lies ahead.

Obviously, the reality of a CMU able to resist a certain comparison with the US market will take much longer than anticipated by politicians at the inception of the CMU Project.

An SMEs Market can only flourish as part of a sufficiently developed capital market of reference.

The shortcomings of SMEs as sources of homogeneous and potentially liquid assets for investment, highlight the need of their markets for additional support, such as tax incentives, ad hoc corporate structures and regulations…

The SMEs markets can only exist as part of the same ecosystem as capital markets. So, let's work for a developed competitive European Capital Market and SMEs will naturally find a way to satisfy their financing needs in that system, through specific markets or other means.

However, no work has to be interrupted until the perfect construction of a European Capital Market is declared concluded. Of course, not. Work has to continue even with imperfections.

One way to move forward in the area of SMEs would be to look at all the financing needs of those companies, not only at equity and classical debt. The balance sheet of many of these companies rely often in working capital needs that are met through the issuance of receivables or equivalent instruments.

Let's pay attention to this part of their balance sheet, which is full of suggestions, too, for promoting market-based finance.

One final observation. Vice-President Valdis Dombrovskis encouraged efforts to increase the number of Small and Medium Sized Companies listed on European stock exchanges from its current 3,000. That increase for SMEs is at the heart, he said, of the CMU Project.

That could be a good step forward. But let's mention here that in the USA a similar concern is ignored or, at least, away from the relevant public interest. In fact, there is no specific market for SMEs in the USA that compares to what we have in Europe. Why are they needed here and not there?

In the end, the number of SMEs listed could be more or less significant, as could be the existence of specific regulations for those companies. The important thing is to work for a more developed European Capital Market that would, and could, encompass easily our SMEs, or their specific markets, or market, providing them with the financing they need to flourish. ●

Niels Lemmers

Director, European Investors' Association

The pursuit of equity investment by retail investors in SMEs

Relevant stakeholders in the EU have for longtime been trying to get SME-equity listed. They have inexhaustibly exchanged views and presented initiatives on rebalancing companies' financial dependence from banks to capital markets. As this imbalance is part of Europe's finance culture, shifting this will take generations. Fortunately, a positive trend is noticeable. In the European Union, according to the 2018 SAFE results, SMEs reported that the most important sources of financing are credit lines (52%), leasing (47%) and bank loans (47%). Equity financing is relevant for 12% of the SMEs. In 2009 this was even as low as 1.6%. Despite all effort, the imbalance persists. Do we have to worry about that?

European Investors believes that EU citizens and SMEs should contribute to and benefit from well-functioning equity markets and gain of the associated economic growth. However, when it comes to SME financing through equity markets, wariness arises, especially if retail investors are approached. If bank financing or private financing isn't available for SMEs, one might consider that market financing is an option. This ignores that there are valid economic reasons why banks or private capital do not provide loans or investment arrangements. There might be significant risks attached to any prospect, numbers might be flawed and not all SMEs are Business Angels. Moreover, it is also critical that SMEs understand the mechanics and dynamics of capital markets to be able to navigate and leverage them. There is no such thing as a free lunch.

> *"Equity investment in SMEs requires a sustainable eco-system and a domestic approach."*
>
> \- NIELS LEMMERS

Consequently, the fact that SMEs are still overwhelmingly financed by credit and bank loans may be part of the well-functioning of equity markets. However, if we jointly decide to pursue shifting the balance, there are two key factors to discuss: sustainable eco-system and domestic approach.

Sustainable eco-system

Many regulatory initiatives have brought benefits to equity markets for SMEs, such as MiFID II and the Prospectus Regulation. These initiatives purported to balance market access, administrative burdens and investor protection. More should be done to build visibility amongst investors. Equity research, a key element of this visibility, is undermined by the transformation of research funding models. Exchanges, in their capacity as market places, and brokers are the central points for SMEs and investors to meet. They should promote equity listing by SMEs and foster interest from investors to weigh SMEs' investment proposals. Regulators and legislators have to participate as well by facilitating an efficient but thorough listing process. It is crucial to have a sustainable eco-system for SMEs and investors.

Domestic approach

Retail investors tend to have a domestic preference when investing in companies, especially SMEs. They feel more involved with companies in their own environment or companies from which they own products or purchase services. Linking this preference with regulatory or exchanges driven initiatives is key. An investment proposition has to be introduced properly, with all relevant information disclosed and investor protection assured. Essential liquidity has to be arranged and continuous transparency on trading is a condition. Then shifting the balance may have success. ●

Michael McGrath

Assistant Secretary, Department of Finance, Ireland

CMU - recognising existing complexities, what needs to happen?

The benefits of more integrated and deeper capital markets are known. Developing an EU Capital Markets Union (CMU) complements our efforts to strengthen the resilience of the banking system. However, greater clarity on what needs to done and who needs to take action would help our delivery.

Firstly, we must acknowledge the significant improvements made so far. We have delivered a range of legislative and non-legislative proposals – we all know these files. We have also delivered significant reform of the European Supervisory Authorities. Some may have wished for more centralisation, others placed greater emphasis on targeted and appropriate measures designed to strengthen the ESAs, while recognising the important knowledge base of national supervisors. We got a good and balanced package, which now needs to be implemented.

Secondly, CMU must be understood for what it is, and what it is not. In my view, CMU is first and foremost a multi-annual structural reform project. We seek to change lifetime habits of individual and institutional actors, so as to encourage deeper capital >>>

>>> markets that will provide new financing options for our enterprises. Moving the dial from the traditional bank financing model towards a much broader investment culture, with wider societal participation, should be a positive outcome. However, CMU must not become the "banner" from which we hang more tangential proposals and initiatives. Focusing on core and necessary policies that deepen CMU and provide funding for entrepreneurs is key.

Thirdly, in a more multi-polar and complex environment, of which Brexit brings additional complexity, clarity on what our new CMU priorities should be is vital. In that context, a greater appreciation is needed that not all of the financial market expertise and activities is now, or will ever be, within the EU. If we are to develop truly cross-border and deeper capital markets within the EU, we must remain open to cross-border activities both from within the EU, as well as from outside. Of course, in so doing, national and European policy makers and our Regulators have ever increasing responsibilities. Their role is key in ensuring a sustainable, safe and appropriate system to serve our economic needs.

"Focusing on core and necessary policies that deepen CMU and provide funding for entrepreneurs is key."

\- MICHAEL MCGRATH

Fourthly, our response to "disrupters" of long-standing market practices and the regulatory environment needs to be developed. Other important policy goals such as developing the ESG and the Sustainable Finance agendas are important considerations when shaping our CMU priorities. Regulatory consistency within the EU and the ever-growing importance of transparency in all aspects of the financial markets must remain an important consideration as well.

Finally, we have yet to reap the full benefits of the steps taken so far. Appreciating this, and fully internalising it into our thinking, should provide greater clarity as we renew our collective effort to deliver a fit for purpose CMU for all of the EU over the coming few years. ●

Mario Nava

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

SME equity financing in the EU needs a boost

Although the EU already invests a lot of money and efforts into helping SMEs grow, they often remain unable to expand past the critical mass needed to compete globally. Funding support is crucial at the early stages, but many companies end up listing or being bought up by large corporates outside Europe, reducing the EU's competitiveness while other economies benefit from the EU's innovation potential.

"SME IPOs sharply declined in the aftermath of the crisis and have not picked up since."

\- MARIO NAVA

The main challenges in the primary and secondary markets are still numerous despite all the measures introduced to date. The number of IPOs remains at a much lower level than the pre-2008 crisis, while the new listings are mainly concentrated on the largest exchanges and involve large and mature firms.

The number of SME IPOs sharply declined in the aftermath of the crisis and have not picked up since, leaving the European funding escalator broken. This limits high-growth companies' abilities to expand, innovate and create jobs, not only when they reach the sufficient size to go public, but also at earlier development stages. Indeed, without sufficient investors ready to invest in innovative companies' first listings, venture capitalists will also have less exit opportunities for their investments, thus weighing on their willingness to invest.

Regarding the secondary markets, the transaction costs are higher in smaller markets, trading activity is mainly concentrated on domestic shares and there is a limited retail investment participation in European markets.

Through the CMU Action Plan, the Commission has put forward several legislative and non-legislative measures which aim at addressing this market gap: proposal for the development of the SME Growth Markets, review of EuVECA, proposal on crowdfunding, assessment of the drivers of equity investments by insurance companies and pension funds, as well as contracted a study on the assessment of the impact of MiFID II research unbundling rules.

Insufficient investor demand increases the cost of capital raising for SMEs considering a new listing, therefore weighing on the pipeline of companies willing to access public markets. This leads to a vicious circle: as there are too few SMEs listed on exchanges, SME research remains largely bespoke (i.e., not mainstream), driving up its cost. On the other hand, the unavailability of SME research makes it more difficult for institutional investors to choose SMEs to invest in, regrettably leading to even less SME issuances in the first place. These negative, self-perpetuating dynamics are very difficult for the market to solve on its own, therefore justifying some form of public intervention to support investment into SME shares.

As set out in the political guidelines of the President-elect Ursula von der Leyen, the priority is to put forward a dedicated SME strategy to ensure further reduction of red tape and improving access to the market of the SMEs, as well as creating a private-public fund specialising in SME IPOs with a view of boosting new listings. Moreover, for the entire ecosystem to be adapted to capital markets and needs of SMEs, the challenges of further addressing the barriers of non-bank insolvency, supervisory convergence and addressing barriers to cross-border trade due to withholding tax still remain. ●

Increasing retail engagement in capital markets

Verena Ross

Executive Director, European Securities and Markets Authority (ESMA)

The recipe for a successful CMU project

The CMU Action Plan has progressed significantly since it was launched in 2015. Indeed, a large number of legislative changes has been proposed by the European Commission, and a majority of them has been subsequently agreed in the political process.

Despite this progress, however, some further steps will be needed to make the CMU project a complete success. One important point of attention of policy-makers should be on developing a larger European retail investor base.

As a matter of fact, the participation of European households in capital markets activities is overall quite low. This is problematic not only for the development of the CMU as such, but also in a wider economic context, in particular to increase returns of capital for an ageing population and improve diversification of funding channels and risk sharing.

In order for retail investors to place their savings in capital markets, one key challenge is finding the right balance between offering attractive investment opportunities and ensuring that investors can be sufficiently aware of risks, thereby increasing trust and market confidence.

> *"Attention of policy-makers should be on developing a larger European retail investor base."*
>
> - VERENA ROSS

In order to overcome this challenge, we should firstly work on improving standardisation of products and provide clear, comprehensible and comparable information. In this context recent regulatory interventions, such as PRIIPs, have improved standardisation of disclosure for retail financial products at the EU level. However, there is a further need for more standardised, simple, cost efficient and safe investment products to facilitate retail investors. In addition, more could be done to reduce intra-EU market fragmentation especially when it comes to addressing tax disparities for common retail products. Finally, the data on actual distribution costs should be easily available. Looking at the particular area of investments in mutual funds, ESMA established that charges on UCITS funds impact their gross returns by one quarter on average, thus representing a significant drain on fund performance.

>>>

>>> Furthermore, we should address concerns around product distribution, by further reducing conflicts of interests across the distribution chain. With MiFID II, measures have been taken to try and tackle these conflicts of interest through the introduction of independent advice and the tightening of requirements around inducements. Another MiFID II provision worth mentioning is the unbundling of research and execution costs when managing clients' portfolios. Despite the entry into force of MiFID II in January 2018, there is still more to do to ensure a wider and clearer choice for retail investors across the Union.

In addition, it would be worth considering certain pension reforms, and so increase retirement savings. We observed in a number of EU Member States that pension systems that rely on the second and third pillar stimulate retail investor appetite for capital market participation. Therefore, in countries where the pension system's second and third pillar are still underdeveloped, steps could be taken in this direction. At the same time, we should acknowledge that the recent adopted PEPP should create a large scale, portable long-term pension product, which is likely to be helpful in removing cross-border barriers to the creation of an integrated market for personal pension products and drive further participation in the EU capital markets.

Finally, we should be mindful that investors cannot be truly confident in financial markets if they do not understand at least their very basics. Hence, efforts to promote financial education may also contribute to a successful CMU. ●

Paul-Willem van Gerwen

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

Investor protection is key to enhance retail engagement within capital markets

The need for retail investors to generate adequate returns from their investments has never been more urgent / pressing due to demographic, social and economic developments. Consumers increasingly need to provide for future financial and social provisions such as pensions, health care, and (educational) costs for children. Due to the low interest rate environment, consumers need to search for alternatives to bank deposits. As a result, the AFM has seen a significant growth of the Dutch asset management market. The EU has one of the highest saving rates in the world and EU households hold financial assets of almost 220% of gross domestic product (almost twice as much as in the US)[1]. However, 35% of those savings are placed in low-yield instruments such as cash and deposits. In the US these instruments account for only 15% of consumer assets, whereas investments in financial instruments (for example equity) is much more common. In other words, the EU market for retail investment seems underdeveloped.

The relative vulnerability of retail investors and the potential impact of investments on their financial wellbeing makes investor protection of key importance. The financial literacy of an average consumer is not comparable to that of a professional or institutional investor. Bounded rationality[2] makes complicated long-term investment products particularly hard to understand. Therefore, retail investors are generally best served by simple, safe, low cost products as well as services that are relatively easy to understand.

> *"Retail investors will only invest in capital markets if their interests are well served."*
>
> - PAUL-WILLEM VAN GERWEN

In light of the above, it is important that efforts to encourage retail engagement in the capital markets are enhanced and investor protection is strengthened along the way. Recent developed EU legislation like MiFID II, UCITS, PRIIPs and MAR provide a sound policy framework that support these efforts. MiFID II strengthens investor protection by requiring investment firms to provide more information about the costs of an investment service and about the independence of their investment >>>

>>> advice. With introduction of PRIIPs, uniform transparency requirements were introduced to a broad spectrum of competing investment products. By standardizing the information, comparison of different types of products is facilitated for retail investors. In addition, the introduction of POG (product oversight and governance) rules require producers to assess whether their offering is suitable for the targeted consumer groups. This can help to avoid products with an unsuitable risk profile being offered to consumers who do not understand the product.

Issues that require attention are the current passporting systems and Free Movement of Services. Technology has made cross border distribution much easier and so has the ease by which malignant parties could shop around for light-touch supervision. Support for the current system may erode when harmful products or services are offered (or pushed) to EU consumers. These issues will become more important with the ongoing digitalisation of financial services.

Another critical issue that Europe needs to tackle is the existence of sectoral production and distribution silos. Today, the consumer experience vary widely and is partially dependent on through which 'shop' the consumer enters the financial services sector. Investments may be sold in securities-, funds-, insurance- or banking-wrappers and/or packages, depending on the type of provider or advisor. These are often substitute products and the flexibility, cost loading and investment performance may be widely divergent. The level playing field and competition across the financial services sector must be improved, so that the start of the customer journey does not dictate the quality of the financial services and products. The AFM sees CMU initiatives – including an enhanced role for the ESAs – to play a key role in this. ●

1. Source: 'Capital Markets Union, measuring progress and planning for success, September 2018, AFME'.
2. The rationality of the investors is limited by the information they have, the cognitive limitations of their minds, and the finite amount of time they have to make a decision.

Guillaume Prache

Managing Director, Better Finance

Restoring trust: individual investors must be able to get redress when abused

Households' direct participation in capital markets has decreased significantly over the past 50 years and continues to do so. Currently, the largest share of the EU citizens' financial savings is held in complex, highly packaged life insurance and pension products. Investment funds make up only 8 % of their financial savings, low cost and simple index ETF being only a tiny portion of those. And listed stocks and bonds make up less than a fifth of their financial savings. Funding channels for SMEs come either from internal funds (68%) or from banks (13%), and less than 1.5% from equity or bond issuance. Most recently, corporate bonds have "disappeared" from the retail sector in many jurisdictions due to the PRIIPs Regulation's legal uncertainty.

As targeted by the CMU Initiative, unlocking a part of retail savings from banking and other packaged products to direct investments in capital markets would have a significantly positive impact for economic growth and jobs, not mentioning on pensions. However, individual investors are mostly sold fee-laden, highly packaged products, most of which underperform direct investments and fail to provide adequate long-term returns. The current surge of "dark" markets for equity trading does not make it easier: now less than half of European stocks are traded on individual investor friendly "lit" markets. Moreover, EU citizens are also demotivated to invest directly due to the persistent double-taxation of investment income and other obstacles to cross-border shareholder rights.

To achieve a higher participation rate in capital markets, BETTER FINANCE identified three priority issues that need to be tackled: trust, complexity, and private enforcement. Potential solutions are to better align distributors' incentives with clients' returns by minimizing conflicts of interests in distribution, ensure better access to simple investment products and provide a proper collective enforcement mechanism for investors, which is the "lion share" of investor rights.

Currently, European individual investors lack the necessary mechanisms to collectively defend their rights in court, except in the Netherlands and in Portugal. The latest example is the "Diesel Gate" scandal (VW), where US investors have already obtained compensation, while compensation for EU investors is nowhere in sight.

"A proper collective enforcement mechanism is the "lion share" for investor protection."

\- GUILLAUME PRACHE

A window of opportunity lies with the collective redress directive, but the lack of political will and protectionism of businesses remain the main obstacles for a robust and efficient cross-border enforcement mechanism. The EU must balance the scale in favour of consumers of financial services and ensure that all individual investors are covered (not discriminating direct investors by excluding them), that the mechanism includes all harmed consumers (opt-out system) and that representative organisations can actually defend consumers' rights. Of importance as well is the cross-border dimension: a Single Market for financial services cannot be achieved if individual non-professional investors are deterred or precluded from enforcing their rights.

Finally, in order to incentivise case-handling efficiency, the collective redress mechanism should be articulated with alternative dispute resolution mechanisms. ●

Simon Janin

Head of Public Affairs,
Amundi Asset Management

Creating a virtuous circle to increase retail investment in capital markets

Asset management plays a fundamental role in the EU economy by channeling retail savings towards investment, notably in capital markets instruments, essential to foster growth and jobs. Yet, retail investment in capital instruments tends to decrease in number of European countries. Therefore, it is essential to promote measures that will improve the engagement of non-professional investors in capital markets.

In this respect, the creation of a pan-European Personal Pension Product (PEPP) represents undoubtedly a progress, as it will help to channel households' savings towards long-term investments and enhance incentives for retail investors to save in capital market instruments. In particular, the inclusion of life-cycle strategies as the default option marks a real improvement for retail investors. As shown by studies, life-cycle strategies offer superior returns and lower risks compared to bonds over a long investment horizon. The success of the PEPP will of course now notably depend on sound and workable level 2 measures.

However, more has to be done to foster retail engagement in capital markets.

The very first step is to restore confidence of retail investors in the proper functioning of capital markets, and this particularly in the context of global uncertainty of a changing world. This requires developing new ways to take consumers preferences into account through products that follow specific sustainable or responsible investment strategies as well as increasing the general level of financial education. This is a major challenge, as most people lack sufficient financial and investor education to be able to make informed decisions whilst being increasingly expected to be more responsible for their own financial wellbeing in a context of ageing population and the resulting pressure on public pensions.

Fostering retail engagement in capital markets implies also to develop more employee share ownership solutions at the European level. These schemes, that align the interests of companies and of their employees, are already a real success in some EU countries but with different levels of shared benefits. Then, common rules could favor more ambitious levels of employee savings and allow for cross-border shareholding plans in pan European companies.

This can be a key driver for EU capital markets, creating a truly virtuous circle. As experience tends to show, a majority of people exposed to employee share ownership will also open brokerage accounts and buy other shares. This would also be a major step to reinforce the local base of individual investors who traditionally play a bigger role in the small and midcap markets than in the overall markets.

Last but not least, work has to be done on existing EU legislations to make sure they do not have counterproductive effect on retail investors engagement in capital markets. In this regard, the forthcoming reviews of MiFID II and PRIIPs could be the occasion to address these issues. More generally, the relevance and understandability of information disclosed should be scrutinized with a view to reduce the volume of data mandatorily shown to non-professional investors. ●

Mario Nava

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

The case for more retail investments in the EU

Fostering retail investment in capital markets has been on the agenda of the Capital Markets Union ('CMU') from its outset and featured prominently in the CMU Action Plan in 2015 and the CMU Midterm Review in 2017. European households continue to have one of the highest savings rates worldwide. However, according to the latest available figures from Eurostat, 29.7% of the total financial assets of EU-28 households (valued at EUR 35 318 billion in 2017), are held in currency and deposits, producing negative real returns. This means that roughly EUR 10.5 trillion – i.e. ~70% of the EU GDP – are unproductive and constitute an untapped potential. At the same time, many EU companies continue to rely exclusively on bank financing.

Creating conditions that are favourable for capital market investments from European households and savers can contribute to the development of funding sources alternative to bank financing, thus funnelling additional money into the real economy. This can help improve access to financing also for SMEs and benefit the economy in general by enabling companies

to invest and create jobs. At the same time, retail investments in the capital markets can help meet the challenges posed by population ageing and other future >>>

>>> liabilities by allowing investors to build or protect their wealth and to meet their needs related to health, education and retirement as such investments typically target higher rates of return. It is, however, important to ensure that retail investors are able to understand and compare different products and the corresponding risks, so they can decide for the most suitable products that fit their risk profile and offer the most adequate risk/return balance.

"Retail investments in the capital markets can help meet the challenges posed by population ageing."

\- MARIO NAVA

The CMU can bring together more companies and investors and help them match their respective financing and investment needs, domestically and cross-border, providing for deeper, more liquid markets and diversified sources of funding. Obviously, special attention has to be given to retail investors. Consumer advocates have voiced concern that often times overly complex and fee-laden products are sold to retail investors and that investment advice may be biased due to conflicts of interest of advisors. The CMU aims at creating a well-functioning market for retail investments that is transparent, competitive, and cost-effective for consumers while at the same time ensuring a high standard of investor protection. A number of previous initiatives (e.g. the regulatory frameworks applicable to Undertakings for the Collective Investment in Transferable Securities (UCITS), Packaged Retail and Insurance-based Investment Products (PRIIPS) or the Markets in Financial Instruments Directive (MiFID II) and the Insurance Distribution Directive (IDD)) have improved investor protection, introduced better safeguards against mis-selling and provided for greater transparency of the features, risk/return profile and costs of investment products. Some of these initiatives have only entered into effect rather recently and may therefore not yet have produced their full effect in the market. Going forward, the Commission may need to review the interplay of the different pieces of legislation as well as consider if the comparison of the features and costs of different retail investment products can be made easier for the benefit of retail investors. ●

Sergio Trezzi

Managing Director, Head of EMEA Retail Distribution and LatAm, Invesco Asset Management S.A.

Breaking down the silos to simplify retail investing for consumers

Improving retail participation in the capital markets is arguably the most important objective of the CMU for the next 5 years. Research shows that the presence of deep and liquid pools of capital in the form of long-term savings are a prerequisite for the development of vibrant capital markets. While there is no shortage of savings in Europe, most of these savings remain in low-interest rate bank accounts and other low-yielding products. Some of the reasons for this are down to culture, market inefficiency and tax treatment but the regulatory framework should be used to simplify the investment process for retail investors.

Today, retail investors face a patchwork of regimes when investing, depending on whether their financial advisor is subject to MiFID or IDD, or whether they will receive a UCITS KIID, a PRIIPs KID, a MiFID disclosure or, at worst, all three. Breaking down the artificial silos created by regulation can help re-focus attention on what investors really need, which is to access investment opportunities that can meet their long-term savings goals.

First, we must simplify the product landscape. UCITS is a European success story and the gold standard around the world. However, the bias towards UCITS in the regulatory regime may have contributed to more complex strategies being included in UCITS, diluting its image as a simple product. We believe that retail investors should be able to access a broader range of investment opportunities than those that are available in the UCITS wrapper if we are to help them achieve their long-term savings goals.

There is clearly an appetite for other retail options when we consider that 60% of AIFs are classed as "other", a significant proportion of which are retail products that don't fit within the UCITS framework. Developing a long-term European investment vehicle to sit alongside UCITS would allow access to more long-term investment options to retail investors while maintain the integrity of UCITS as simple investment vehicle.

"Breaking down the artificial silos created by regulation can help re-focus attention on what investors really need."

\- SERGIO TREZZI

Second, we need to reform investor disclosure in Europe. Disclosure is not an end in and of itself but a means to help investors make more informed choices. As we move to greater institutionalization of the retail market, where the focus is increasingly on providing investment solutions rather than individual products, we believe that the disclosure regime should evolve to reflect this market change.

This means moving towards a single client disclosure aggregating the risks, performance and costs of the products and services provided, as is currently the case for costs and charges under MiFID 2, and doing away with UCITS KIIDs and PRIIPs KIDs. Furthermore, regulation should be less prescriptive about the presentation of this information to allow advisors to develop their own solutions to help retail investors navigate this information, leveraging new technological innovations to do so. ●

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MiFID II state of play and remaining challenges

Natasha Cazenave

Managing Director, Head of Policy and International Affairs, Autorité des Marchés Financiers (AMF)

Time for a MiFID II refit

MiFID II stands as the cornerstone of European financial markets regulation. It governs the provision of investment services and the proper functioning of markets. This sweeping piece of legislation was designed to enhance transparency and strengthen investor protection as well as pursue efforts to foster competition introduced by MiFID I.

After a year and a half of implementation, some preliminary lessons can be drawn. While MiFID II has improved transparency, the new regime has not met all expectations, especially in relation to non-equity instruments where results are mixed.

With regard to equities, dark trading has been constrained by the share trading obligation, which mandates trading on venues or systematic internalisers (SIs) and the limitation on the use of waivers in particular with tools such as the double volume cap mechanism. However, some findings raise questions. Trading on lit venues has not increased. It stagnates around 50% of total volumes while trading on SIs, which was insignificant prior to January 2018 has surged to 25% before gradually decreasing to 20%, capturing a large share of OTC trading. Regulators are keeping a close eye. The AMF 2019 Markets and Risk Outlook provides a first analysis of this trend, underlining that transparency is quite limited and only a small portion of volume traded on SIs actually contribute to price formation. Finally, there is still a significant portion of pure OTC trades (about 30%) which needs to be better understood.

> *"MiFID II has improved transparency, but the new regime has not met all expectations."*
>
> \- NATASHA CAZENAVE

In parallel, MiFID II has extended transparency requirements to non-equity instruments, with so far mixed results. Pre-trade transparency in this area is challenging due to the RFQ systems on which these instruments trade, while post-trade transparency brings useful information. Yet, some argue that post-trade publications come too late to be fully useful and that the universe of instruments considered as liquid remains too narrow.

Data is one area where improvement is tangible. MiFID II has required regulated entities to provide an unprecedented amount of data. From the angle of market integrity, this represents a positive step forward since trading and reporting data offer regulators critical information to identify, in a timely manner, market abuses and to monitor market >>>

>>> events. For participants, trading and best execution data play a useful role to inform investment decisions. Difficulties nevertheless remain in terms of data quality and accessibility that will require further work.

While the European Commission is defining its priorities for the next 5 years, the AMF considers it would be appropriate to conduct a targeted review of MiFID II to correct the inefficiencies identified and address the challenges raised by the UK's decision to withdraw from the EU. Such an exercise should not call into question the essence of the reform but aim at ensuring MiFID II fully achieves its objectives. In that sense, we are in favour of a MIFID REFIT rather than a MIFID III.

In our June EU2024 paper[1], we sketched out a few areas that would merit reconsideration and are keen to exchange views with colleagues and stakeholders to refine and complement these avenues: transparency thresholds may require a recalibration to reflect the new perimeter of EU27 markets; the share trading obligation has proved difficult to implement and may require some streamlining. In light of experience, we may also envisage reducing the number of position limits to certain commodity derivatives, based on the type of underlying and trading volume. Such a review can be the occasion to measure the usefulness of certain provisions to analyse whether their granularity brings valuable information.

One issue to be tackled is the development of a framework to support the emergence of a European consolidated tape. Such a long-awaited tool will provide greater transparency to the market. ESMA and the EC's recent efforts to ponder the conditions of the emergence of this tape are encouraging.

More generally, it is crucial to avoid distortions of competition of the EU with the rest of the world. We could explore avenues to make sure European actors do not face an unwarranted disadvantage. ●

1. EU2024: Shaping EU27 capital markets to meet tomorrow's challenges – Focus areas and initial proposals of the French AMF.

Niels Brab

Head of Government Relations, Deutsche Börse Group

MiFID is dead. Long live MiFID!

While a number of instruments have made a critical contribution to the EU's post-crisis financial market regulation, MiFID II undoubtedly constitutes a key cornerstone with central political objectives covering a wide array, stretching from transparency, over resilience and efficiency to consumer protection. However, almost a decade after the planning around MiFID II started and about 18 months of practical application experience later, there is growing discontent that some important areas have not fully delivered on the intended political objectives.

This may not necessarily come as a surprise when considering that the final and arguably complex set of rules stretches beyond 25000 pages. But while it may retrospectively occur ironic that the Commission's 2011 announcement of the MiFID Review stated that "the main benefits of MiFID will be very tangible, but are not readily quantifiable", let us take a step back and ensure to set the right context in understanding the importance of MiFID.

With a number of indicators pointing to an overall weaker global economic performance, it is critical to understand that the EU is rather leading the race on sluggish performance with a forecasted 2019 GDP growth of only 1%. This is where the fundamental thinking around the Capital Markets Union as well as key future-oriented, accompanying initiatives, such as around the International Role of the Euro, come in.

It has been long established that the EU could benefit from a solid development of its capital markets, where key proxies illustrate that we are still far behind globally leading jurisdictions. And with Brexit on the horizon, we can safely agree that the project becomes rather more urgent and serious. >>>

>>> So how does MiFID fit into this picture? With a total of 663 registered trading venues, MiFID II has arguably resulted in a landscape that some may call competitive and others fragmented. Especially the equity trading landscape illustrates that transparency has not been increased with "lit" venues' market share being slightly reduced, accounting for only +/- 40%.

In addition, it is important to observe that well-intended safeguards do not result in the desired outcomes, such as the Double Volume Cap, which does not make a meaningful contribution to "lit" trading.

However, it is highly questionable if such market structure is desirable against the background of key political objectives. In fact, the number of companies listed on exchanges keeps decreasing, and so do the numbers of IPOs and the amount of capital being raised.

This raises the question whether the increased fragmentation, mainly result of an artificial hyper-intra-EU-competition between trading venues facing diverging regulatory requirements, has contributed to the decrease in capital markets funding.

Without doubt, transaction fees have significantly reduced – but it occurs questionable whether this results in the desired outcomes, given that end investors do not appear to see significantly reduced total execution costs while also the overall growth ecosystem seems to suffer.

As the EU's most monumental financial regulatory framework and as a key piece of the puzzle, it is critical to assume the responsibility in reviewing MiFID II to be "fit-for-purpose", notably in light of a new political and economic reality at global and EU level.

Only if we manage to collectively assume our responsibility in ensuring that capital markets are finding themselves in a consistent framework that maximises their growth contribution capacity without compromising financial stability as the cornerstone of sustainable economic growth, we will be able to lay the foundation for an appropriate contribution to critical societal challenges.

Whoever understands the bless and curse in materially contributing to shaping a future financial system that European citizens and broader society are proud to endorse, shall recognise that such endeavour is philosophically probably best understood to be a strive for unachievable perfectionism that is nevertheless worth aspiring to be approximating. MiFID is dead. Long live MiFID!

James Hilton

Head of Advanced Execution Sales EMEA, Credit Suisse

Sharpening the focus on investor outcomes

Regulators agree the greatest drag on investor returns is driven by costs. MiFID I was the EU's attempt to create a single financial market to rival the depth and dynamism of US capital markets. It reduced costs to end investors by increasing competition and breaking down monopolies. MiFID II's objectives of investor protection and a safer, more transparent and efficient market appear to have been interpreted in a way that risks increasing costs to investors.

Costs can be explicit, e.g. exchange fees or investment management charges, or implicit, such as market impact, information leakage or opportunity cost. Post MiFID I, we saw a 30% decrease in total transaction costs – a huge success for investors. Unsurprisingly, explicit costs are often driven by competition amongst providers. Around the start of MiFID II, we observed a swathe of price increases amongst primary exchanges as regulation appeared to force trading to lit venues. It is important regulators are aware that policies promoting champions will likely lead to inefficiency, lack of innovation and higher costs as competition reduces.

One-way investors minimize implicit costs is by choosing between different trading modes. Investors have long understood the trade-off between urgency and market impact and sought to find the right balance to fulfil best execution. We see no evidence these choices, and the natural balancing of these factors, have impacted market stability or efficiency over the last decade.

Under MiFID II, the industry has innovated to find solutions which meet all regulatory requirements and also provide best outcomes for end investors. Periodic auctions in particular enable investors to seek liquidity without excess price impact, whilst still maintaining pre-trade transparency. Based on ESMA's Call for Evidence, investors and brokers alike seem to be hugely supportive of this innovation.

Costs are also reduced when a fair price can be achieved. The midpoint is a fair price and is undoubtedly beneficial to end investors across a variety of trading modes. Allowing mid executions does not cause tick size wars between venues or trading modes, nor trades in fractions of a tick, but provides an equitable price without arbitrarily picking winners and losers – penalizing end investors to give the perception of a level playing field between trading modes is surely not the goal of MiFID II.

It is the end investor who bears the costs of choosing champions or prohibiting innovative trading modalities. Central Limit Order Books provide an important service to financial markets but are not always the best solution either at a collective or an individual level. A variety of trading modalities solves for different investor needs without detracting from price formation. In summary, the framework of MiFID II is broadly effective, and therefore a wholesale revision should be avoided. Some fine-tuning would make sense, however, to address some of the issues raised in this article, and we would encourage consideration of the following in particular; calibration of thresholds post-Brexit, additional transaction costs passed to investors, and the share trading obligation. As noted, such targeted amendments must avoid damaging best execution for end investors.

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written by the Eurofi Secretariat

Upcoming priorities for EU securities post-trading

Jochen Metzger

Director General, Payments and Settlement Systems,
Deutsche Bundesbank

Is EU post-trading fit for the platform age?

Rapid technological developments are reshaping many industries around the world – including more and more segments of the financial markets. The rise of exchange-traded funds is redefining how individuals and institutions invest, new providers and the spread of new technologies are changing the ways in which people make payments, and, last but not least, the emergence of potentially highly disruptive technologies based on distributed digital ledgers (DLT) may affect and eventually transform every stage of the trading-clearing-settlement value chain. And, of course, these powerful trends are also affecting the economies of the European Union.

That's why, at the moment, the European post-trade landscape is facing two major challenges. The first is the long-existing challenge to facilitate cross-border trading and securities settlement in Europe – the pivotal challenge standing in the way of finally establishing a truly integrated European capital market. Much has been achieved in this regard in recent years. On the regulatory side, CSDR, EMIR and MiFID II have strengthened the European securities markets structure considerably. On the technical side, the Eurosystem platform T2S will continue to act as a powerful driver for much-needed cross-border activities between different markets.

> *"We should apply the lessons learned from regulating stock exchanges to the platform economy."*
>
> \- JOCHEN METZGER

We are now at a point where we have a very well-balanced and efficient set-up in Europe consisting of sophisticated Eurosystem platforms and established market structures. Thus, the way forward with the most potential to further improve the European post-trading landscape is clearly the removal by the European Commission of the remaining Giovannini Barriers as identified by the European Post Trade Forum rather than the introduction of additional technical platforms.

The second challenge is the emergence of new disruptive digital technologies and the platform economy. Tokenisation and DLT promise to fundamentally challenge established solutions and infrastructures in trading and post-trading. We don't know when precisely this challenge will materialise, but we do know that these technologies and the associated platforms will play an important role sooner or later. The Australian stock >>>

>>> exchange operator ASX, for example, is in the process of developing a brand new fully-fledged post-trade system based on DLT. Working in collaboration with Deutsche Börse, the Bundesbank has successfully tested prototypes for securities settlement based on blockchain technology. Facebook and its partners are planning to launch a digital currency based on a permissioned blockchain next year.

These powerful developments – and their proper regulation – require our utmost attention. We should not be shy about applying the lessons learned from regulating stock exchanges and other financial market facilities to the platform economy. In doing so, we should enable and encourage innovation but pay close attention to potential risks to financial stability. Successfully managing this balancing act will ensure that we bring the EU post-trading system into the age of the platform economy.

Guillaume Eliet

Head of Regulatory, Compliance & Public Affairs, Euroclear S.A.

Post-trade infrastructure: the cornerstone of CMU

Even if most of post-trade legislation was adopted in the aftermath of the financial crisis and thus before the CMU was conceived, it is clear that Central Securities Depositories (CSDs) already contribute in many ways to achieve the CMU objectives. Smooth and safe settlement of securities trades is one of the conditions to ensure confidence in market trading activity, which in turn creates liquid capital markets. By implementing T2S and the CSD Regulation ("CSDR"), that have progressively built an unprecedented level of safety, harmonisation and freedom amongst EU issuers and investors, the European CSDs can already offer a deep and reliable framework for the circulation of securities across Europe.

However, substantial work still needs to be done to achieve full end-to-end access, as well as operability across the different pieces of post-trade legislation and lastly to address the remaining areas of fragmentation.

In this respect and to move forward in a constructive way, three recommendations can be made.

First, avoid rushing into a large review of the CSDR before being able to assess whether the expected benefits have been realised. Even if a review is scheduled for this year, some important pieces of this legislation will enter into force next year (for example settlement discipline regimes) and many CSDs are still in the middle of their authorisation processes. We should therefore resist to the temptation to reopen too quickly this regulation, except to correct or clarify well identified issues that currently hamper smooth post-trade services.

Second, take advantage of the implementation period to foster more convergence in the supervisory approaches across EU jurisdictions. Settlement and safekeeping of securities remain largely domestic industries, and therefore a homogeneous application and supervision of the new regime is a precondition to the development of cross-border services; services that are efficient and truly competitive.

> *"CMU 2.0 will not be achieved without a strong and explicit political message from the European Council and the Parliament."*
>
> - GUILLAUME ELIET

Lastly, tackle the well-known barriers that remain the main obstacles to the creation of a unified capital markets zone and which were already identified by the Group chaired by the late Alberto Giovannini 18 years ago. It has been obvious during the past years that certain barriers were too sensitive from a political standpoint. However, for all of the domains where harmonisation is needed, it is now up to our national governments to take the lead and to express a strong and unified political vision. CMU 2.0 will not be achieved without a strong and explicit political message from the European Council and the Parliament. This needs everyone to be convinced that deep, liquid and secure capital markets are key to the development of businesses, jobs and innovation, but also an essential protection of Europe sovereignty.

Gesa Benda

Head of Collateral Management Product, BNY Mellon

CMU and post-trade – the collateral management dimension

As Chair of the Collateral Management Harmonisation Task Force for Europe, my objective is to drive progress towards more efficient management of capital and liquidity in a pan-European financial market.

At times, it feels like an uphill marathon to arrive at a more integrated post-trade environment, but it does not have to be that way.

The Taskforce has already achieved many milestones. Our work is focused on developing an efficient and effective collateral market infrastructure, which is closely linked to Eurosystem projects that aim at improving the integration between cash and collateral.

Our goal in Phase 1 was to harmonise business processes, workflows and messaging in the areas of triparty collateral management, corporate actions for bonds, and billing processes.

We have created harmonisation standards that will enable the implementation of a single, harmonised triparty model, applicable to commercial banks and central banks across Europe. The work of the Task Force will continue, and we plan to cover not only corporate actions for equities, but also tax processes, and workflows relating to bilateral collateral management.

> *"Growth in Europe will be stifled and we will fall behind other capital markets."*
>
> \- GESA BENDA

So why is this work an up-hill marathon?

Without better alignment between operational efficiencies and necessary legislative revision, growth in Europe will be stifled and we will fall behind other capital markets.

What we need is progress towards the dismantling of the barriers identified by the European Post Trade Forum (EPTF), and in particular the public sector barriers.

It is crucial to have immediate access to collateral in case of a counterparty default. Safeguards in the collateral management ecosystem are a major contribution to the stability and integrity of the European financial market. We need progress in the harmonisation of insolvency frameworks across Europe and need to remove inconsistencies and uncertainties in securities laws, to enable harmonised rules for the liquidation of collateral.

Another severe impediment are the differences in withholding tax rules, and the absence of efficient relief-at-source systems.

Current changes in AIFMD and UCITS rules relating to the books and records of a fund depositary could – if implemented without due care to the specificities of the triparty collateral model - have the effect of preventing funds from participating in collateral management activity.

So what is the collateral management ecosystem of the future in Europe?

The transformation to a digital market infrastructure has already started. We are seeing a number of collateral tokenization or digital asset initiatives, some aimed at overcoming inefficiencies in the European post-trade settlement environment.

Global co-ordination in the development of a harmonised regulatory framework for the treatment of digital assets is required. And a Settlement Finality Directive that dates back to 1998 is clearly not able to stand up to today's market demands.

But having identified the challenges, it is within our reach, for both the public and private sector, to create a more harmonised and integrated post-trade environment. ●

Eric Derobert

Global Head of Communications & Public Affairs, CACEIS

Technology innovation driving change in asset servicing

The asset servicing industry is constantly innovating. Whether it is launching a complex global file exchange platform or just automating a mundane operational task; innovation is answering the market's calls for efficiency.

Tech-driven innovation has a big influence on our industry, offering the means to beef up responses to future challenges: increasingly integrated post-trade services, rising volumes within a fixed-cost structure, tighter productivity goals, investor cost pressures and strengthening competition - all within a low interest rate environment and with stricter capital adequacy requirements.

The beginnings of a transformation is occurring which seems to fly in the face of harmonisation trends as new platforms and asset classes emerge which demand an ever-broadening 'aggregated >>>

>>> view' across invested assets. Asset servicing companies' role here is the consolidator, offering full industry connectivity, including to Fintechs, as part of a seamless client experience across platforms, services and assets.

Besides new platforms and assets, there are various technologies that asset servicing companies are incorporating into their business which open up opportunities for further development. Many companies are actively studying Blockchain (or distributed ledger technologies) but are slowly coming to realise its limitations when attempting to replicate the functionalities of the complex internal systems asset servicing companies have developed over the years.

Robotic process automation (RPA) on the other hand, is already being applied throughout our industry to automate repetitive, low value-added tasks - essentially using computers to operate in-house systems designed for humans. Running 24/7 and flagging any issues to employees, RPA offers huge potential especially for reducing human error (operational) risk. It is effective, its applications are wide ranging and frees up staff for tasks where human intervention is essential.

"We will see asset servicing take a significant step forward to the benefit of the entire value chain."

- ERIC DEROBERT

Additionally, Big Data software, which identifies patterns in huge databases, is already more than a promise. With asset servicing positioned as data hub, centralising its own generated data, external data feeds and historical data, Big Data technology provides free-form insight on the efficacy of marketing campaigns, optimal fund launch timing, investor targeting, stress testing, sales volume prediction and management information system features, along with generating standard regulatory, tax and management reports. It is transforming our industry, and in turn, asset management.

Such innovation is central to asset servicing's future and is driven by employees, clients, regulation, strategies and new technology ideas. Asset servicing companies such as CACEIS are a trusted third party and will remain a central industry feature especially by ensuring security across new investment fields. If we can properly harness data to give granular insight on key areas, while massively streamlining processes by leveraging RPA, we will see asset servicing take a significant step forward to the benefit of the entire value chain. ●

AIFMD review

Wolf Klinz

Non-Executive Director, Union Investment Institutional GmbH

AIFMD: no major overhaul needed, but more harmonized implementation at EU level

Under the influence of the great financial crisis in 2008 the European co-legislators (European Parliament and European Council) adopted the AIFMD in June 2011.

The sector of alternative investment funds has been and still is extremely heterogeneous across basically all aspects: asset classes (hedge funds, private equity, real estate, Spezialfonds), investor types, investment and redemption strategies, legal, tax and governance structures, custody requirements, valuation and accounting practices as well as transparency. The answer was to regulate the management company and not the fund itself. Some of the above aspects were left to the NCAs, in particular concerning Alternative Investment Funds (AIFs) sold to retail investors.

The driving force behind the European Commission´s proposal was the desire to better control the hedge funds with their high willingness to take risks and the sometimes extremely highly leveraged equity funds. But rather than focusing on these two categories alone the Commission decided to address all funds that were not UCITS as AIFs in one directive.

The overall objective was to create a real European internal market for EU and non-EU alternative funds marketed in the EU by introducing a harmonized regulatory and supervisory framework. All AIFs would be subject to the same authorization and registration requirements, proper monitoring of risk and increased accountability of AIFMs holding stakes in non-listed companies.

A survey conducted by KPMG at AIF stakeholders reveals that AIFMD has indeed contributed to creating a European internal market for AIFs. However, some weaknesses remain:

- The AIFMD is not consistently applied across all member states, which can lead to rule arbitrage and an uneven playing field.
  - The reporting requirements by AIFMs to NCAs are being critisised as unnecessarily burdensome and costly. Not all the data asked for are essential, some are duplicative.
  - The information requirements to investors are also excessive, particularly with regard to investments in non-listed companies. Some valuable information like fees, total costs and charges of private equity funds is insufficient. Generally, there is a feeling that different information needs by investor category are not really being respected.
- The remuneration rules contradict some other European legislation raising the question which rules should be followed. In addition, there are also national provisions which complicate matters even further.
- Depository rules are differently interpreted between the member states, for example for the monitoring of cash duties. The one-size-fits-all approach does not accomodate different asset classes and member states.
  - The EU management passport is working well. But the understanding of what "marketing" means differs between the member states. The Commission has addressed this issue in the recently adopted file on "cross-border distribution of funds".

>>>

- AIFMD has not yet been put to a critical stress test during a major financial crisis. It does not need a major overhaul, but some parts of the directive should be modified to ensure a level playing field and increase effectiveness and efficiency.
  - The rules for reporting, depositary and marketing should be further harmonized at EU level.
  - Churches, foundations and family offices i.a. should be recognized as "semi-professional investors" seeking investment opportunities with a very high degree of sustainability and relatively low risk level.
- The focus of AIFMD on the management company of AIFs and not the underlying product should not make it impossible to introduce a low risk category (low leverage AIFs) guided by the UCITS limitations of portfolio management thus better allowing for national specificities like Spezialfonds in Germany/ Austria (€ 1,7 bill.) without negatively impacting on the European competitive situation.

Gerry Cross

Director of Financial Regulation, Policy and Risk, Central Bank of Ireland

Key areas to examine under the AIFMD review

A conference on Private Equity and Hedge Funds was hosted by the European Commission in February 2010 which marked the early stages of the consultation process on the Alternative Investment Fund Managers Directive (AIFMD). The Internal Market Commissioner at the time made an instructive remark when he said that the aim was "to extend the scope of regulatory oversight and supervision in order to ensure that all financial activities which are capable of affecting the wider market or real economy are subject to appropriate checks and balances".

At moments such as this, it is useful to reflect and take stock of the extent of change in the regulatory and legislative landscape since the financial crisis and identify areas for enhancement. While the impact of AIFMD varies across sector and Member State, it has nevertheless been fundamental for the sector as a whole. Following the introduction of AIFMD in 2013, indicative data highlights that net AIF assets have generally increased across national EU markets.

KPMG's Report on AIFMD ("the Report") identifies areas which may benefit from review. In some areas, such as the EU marketing passport, there have already been initiatives to address issues identified (through the Cross-Border Distribution of Investment Funds ("CBDF")). Nevertheless, there still may be scope for further amendments, such as the introduction of a de-notification requirement.

In other areas, the Report, makes findings and recommendations. Such as concluding that the national private placement regimes (NPPRs) which are in place in the majority of Member States surveyed add value to the EU and advocating that these should be retained.

The Report identifies general areas that warrant consideration. This includes finding that while large volumes of data are submitted by AIFMs to NCAs under the AIFMD reporting requirements, not all of this data may be essential and, in some cases could be considered duplicative. As part of the review, there is certainly scope for examining reporting requirements with a view to making focused and targeted changes. Such amendments should include making mandatory inclusion of the legal entity identifier (LEI), adjustments to the categories of AIFs available and inclusion of a method to identify sub-sets of AIFs, such as MMFs.

While finding that the use of high leverage in AIFs is rare, the Report concluded that it would be helpful to harmonize the calculation methodologies for leverage across AIFMD, the UCITS Directive and other relevant legislation. Such a review, which is desirable, should be cognisant of the current work underway at an international level on the topic.

There are also areas absent from the Report which warrant attention as part of any review. For example, ESMA has done significant work in the area of loan origination with the publication of an Opinion addressing matters such as the authorisation of loan-originating funds and their managers, eligible investors, organisational requirements and leverage. Ireland is one of the six Member States to introduce a specific regulatory framework for loan originating investment funds. We see considerable merit in developing a clear and transparent regulatory framework across the EU with respect to loan origination. The AIFMD Review provides this opportunity.

There are also a range of technical amendments, some of which >>>

>>> have been apparent since the introduction of AIFMD, which should also be progressed to improve the functioning, effectiveness and efficiency of the regime. For example, amongst others, this includes reporting requirements related to prime brokers and capital requirements for internally managed AIFs. There may also be merit in clarifying the responsibilities of the AIFM under AIFMD, particularly in light of the differing approaches taken as part of UCITS. A well-regulated alternative investment management industry plays a significant role in supporting the functioning of the financial system and wider economy. The review of AIFMD provides an important opportunity for policy makers, regulators and wider industry to ensure the framework is as effective as possible in the delivery of this objective.

Joseph Barry

Global Head of Regulatory, Industry and Government Affairs, State Street

AIFMD 2.0: small improvements, big rewards?

The European Union's legislative framework for investment funds is generally highly regarded across the globe, and the Alternative Investment Fund Managers Directive (AIFMD) is an important element of this. This is aptly demonstrated in the recent IOSCO consultation paper on leverage, which makes numerous references throughout to current provisions of the AIFMD.

The European Commission's report on the operation of the AIFMD, published earlier in the year, presents a broadly positive view with regards to whether the Directive has met its objectives; this is a view that we share. However, with fundamental changes to EU capital markets expected, precipitated by the UK's impending departure from the EU, the focus should be on what can be improved.

Firstly, the depositary requirements set out in the AIFMD have undoubtedly contributed to the establishment of a robust and secure framework. However, it is unclear whether this necessitates that the depositary is established in the home Member State of the AIF. The situation is further complicated when considering non-EU AIFs and the concept of the "Member State of reference". As we consider the next stage of the Capital Markets Union and how to further integrate European capital markets, we believe there is a case to remove such a location requirement. This will also help to ensure that AIFs have access to best-in-class service providers, regardless of their location within the EU.

Secondly, another area that could be revisited, particularly in the context of the UK leaving the EU, is the third-country regime under the AIFMD, including the unintended consequences caused by the interaction with other pieces of EU legislation. For example, under the current EU regulatory framework, the distribution of non-EU ETFs into Europe has been significantly limited, leading to a reduction in investor choice, even where the non-EU ETFs have higher liquidity and lower cost. On a related point, we believe the approach and the process relating to the granting of equivalence by the European Commission should be revisited, in order to address outstanding conflicts. One example of this is prime brokers in the US, who are subject to a different securities holding framework and are therefore unable to fully satisfy certain AIFMD reporting obligations.

Thirdly, increasing consistency regarding the application of the AIFMD could be helpful in certain areas e.g. reporting standards. While permitting flexibility across Member States can facilitate the recognition of particular market nuances and can enable competent authorities to develop the regime most relevant for their specific market, it should not result in material differences in interpretation, which could result in significant burdens on market participants and create an un-level playing field across the EU.

To conclude, we believe the EU legislative landscape for investment funds is functioning well. Nevertheless, markets are dynamic and constantly evolving, and so the regulatory framework must evolve in turn. We support the EU taking an ambitious approach to improve the AIFMD, although do not believe this requires a fundamental re-writing of the rules.

Stéphane Janin

Head of Global Regulatory Development, AXA Investment Managers

How to improve the functioning of the AIFMD?

As recognized today by many securities regulators, the European regulatory framework for funds appears largely adequate. In many cases, it has been taken as a reference in other regions or even at global level through worldwide regulatory bodies such as the International Organization of Securities Commissions (IOSCO).

Regarding the Alternative Investment Fund Managers Directive (AIFMD), it was initially aimed at tackling both the systemic risk involved in non-UCITS fund management and the lack of cross-border passport for Alternative Investment Funds (AIFs) towards professional investors across Europe.

On these two fronts, AIFMD was largely a success. Regarding systemic risk, the testing in real life of AIFMD provisions demonstrated these provisions were valid. AIF managers had to cope with major market events (the euro crisis, >>>

>>> the UK referendum on Brexit) and regular turmoils, and managed them without significant failure.

Moreover, the final adoption of a Regulation and a Directive on the cross-border distribution of funds on 20 June 2019 complemented the AIMFD provisions for facilitating the practical functioning of the Single Market for funds.

So, what is left and should be improved now?

First, we should collectively be consistent in our European overarching approach. On the one hand, policy-makers and regulators cannot ask for a permanent decrease of the level of management fees for funds – that we obviously agree on – while on the other hand asking at the same time for permanent legislative changes in provisions. European asset managers must remain competitive at global level and cannot suffer from a permanent legislative instability that their non-European competitors do not face.

Second, before proposing regulatory changes, we should wonder if existing rules are already implemented and enforced at local levels. When you look at the first ESMA's Report on "Penalties and measures imposed [by National Competent Authorities] under the UCITS Directive in 2016 and 2017", published on 4 April 2019, you have strong doubts. Over the two years 2016 and 2017, more than 50% of National Competent Authorities (NCAs) in the EEA have never delivered any single penalty or measure on UCITS on their own territory – including some large NCAs. We would be keen to see ESMA publishing a similar first Report on AIFMD in the coming years – as a pre-requisite before any decision of amending AIFMD existing provisions.

Third, it leads to the role of the European Commission itself. Under the Lamfalussy regulatory process applicable to financial services since 2001, a "Level 4" has asked the Commission to ensure the correct enforcement of EU rules by national governments. It reads: "The lack of enforcement by the Commission is seen as having been a serious obstacle to the completion of a single market for financial services". If at last, more than 10 years after its endorsement by European institutions, this Level 4 could become alive, it would a tremendous progress – to the benefit of European investors and markets.

"European asset managers must remain competitive at global level."

\- STÉPHANE JANIN

A decade ago, the AIFMD was an excellent legislative initiative to complement the EU regulatory framework for funds – let's now ensure it is applied. ●

Alexandra Richers

Managing Director, DekaBank

AIFMD review – the best is yet to come

The original objective of the Alternative Investment Funds Managers Directive (AIFMD) is to create an internal market for EU and non-EU AIFs and a harmonised and stringent regulatory and supervisory framework for AIFMs in order to ensure a common level playing field.

What does it mean in practice? The current review has revealed, that most areas of the provisions are already successfully assessed and the directive has played a major role in helping to create an internal market for AIFs. Thus, an effective legal framework for monitoring and managing the risks associated with the activities of AIFMs is provided. So far so good?

The review made also clear, that there are still difficulties and some aspects that have not (yet) contributed to the achievements of this aim. So there is still potential for optimisation.

Regarding the broad range of AIFs it would make sense to define a subset of AIFs that apply certain limits to leverage and to extend the EU passport for such AIFs to a new category of "semi-professional investors". This would also support the EU's Capital Market Union goals of enhancing cross-border distribution and facilitating capital market investments from new groups of investors.

On top of the European Commission's initiative on cross-border distribution further barriers for both AIF and UCITS marketing across the EU are expected. In terms of the pre-marketing and marketing definition asset managers should be allowed to communicate with potential investors without this being considered already as 'marketing'.

Moreover, investors should have the flexibility to set up a fund with an asset manager in a matter of days. At least, in situations where pre-marketing in the form of negotiation with professional investors has already taken place, fund managers should be allowed to notify the National Competent Authority (NCA) subsequent to the investors' subscription of fund units.

In terms of marketing communication further efforts to harmonise are needed. The EU marketing passport is suffering from the different approaches taken by NCAs. Specific national requirements create a major burden for asset managers. At minimum, asset managers should be allowed to use marketing material that complies with MiFID II requirements without the need to notify the NCA.

"The EU marketing passport is suffering from the different approaches taken by NCAs."

\- ALEXANDRA RICHERS

The AIFMD-Review identifies some areas for improvement that could be addressed by Level 3 measures and may therefore be easily to achieve. While the ESMA should not be seen as generally responsible for addressing deficiencies, it can provide valuable guidance and act as an information hub for all NCAs and market participants. We therefore see a need for further harmonisation of marketing standards for investment funds using EU passports for the cross-border marketing of their units. ●

PEPP: what needs fixing?

Gabriel Bernardino

Chairman, European Insurance and Occupational Pensions Authority (EIOPA)

The making of the PEPP: delivering on its promise to European citizens

The Regulation of the Pan-European Personal Pension Product (PEPP) is the European Union's answer to two key policy questions:

- Firstly, how to complement sensibly existing pension systems - in particular, in places where the occupational pension sector is underdeveloped - and how to provide a powerful tool for the retirement savings of a modern, mobile European citizen, working in a changing labour market?
- Secondly, how to reinforce the much needed, efficient and sustainable Capital Markets Union?

> *"To promote safe products also means implementing relevant controls and limits on product design, including through product oversight and governance measures. "*
>
> \- GABRIEL BERNARDINO

The need to save – more – privately to ensure an adequate retirement income comes at a time of a challenging economic environment. Persistently low interest rates, slow growth and the aftermath of the last financial crisis put a strain on long-term savings solutions and challenge the build-up of sufficient financial resources for European citizens' future retirement income. Though pension products benefit from a long planning and investment horizon, the effect of the persistent trends in the economic environment can be felt: the shift to Defined Contribution pension promises and the significant trend towards unit-linked products relocate the investment risks from the institutional investor to the individual saver.

The appropriate design of standardised reference points, i.e. 'quality features,' of the PEPP and initiatives to enhance the understanding of risks and rewards that are intrinsically linked and are necessary to make saving 'worthwhile', help individuals to >>>

>>> manage their financial planning in this changing – and challenging – economic environment. However, how much more challenging is it for an individual to understand the effects of inflation and the risk of outliving one's savings – the 'longevity' risk-, which are the two main exposures a pension solution has to tackle?

To overcome consumer's behavioural tendencies, such as procrastination, loss aversion or simplistic 'rules of thumb', the PEPP offers a simple approach: transparent, standardised, enforceable, default, quality features that enable comparability, set an appropriate benchmark – and most importantly – consumer trust. In addition to that, such default, standardised features bring economies of scale and efficiency gains to the PEPP providers, expected to result in cost-efficient products and sustainable investments over a considerably long-time horizon.

With the ambition to build a strong, default personal pension product comes the obligation to deliver on the inherent promise to consumers. The regulation of PEPP's high-quality features, such as standardised, relevant pre-contractual and regular information documents, the cost cap and the mandatory use of risk-mitigation techniques, requires smart and innovative approaches, to promote superior pension outcomes and to empower consumers taking good decisions. This challenging endeavour has to be undertaken with the consumers' needs in focus and the practicability for the provider to be always kept in mind.

Private pensions are often regarded as an inefficient market, where consumers' demand is not matched by adequate supply of suitable solutions. Regulation has to address agency conflicts and information asymmetry as shortcomings of an inefficient market. Conflicts of interests need to be acknowledged and the right incentives need to be put in place to facilitate optimised results for consumers. The main tools for enforcing these considerations are a robust regulatory framework, including authorisation regimes, governance, distribution rules and corresponding supervisory powers. To promote safe products also means implementing relevant controls and limits on product design, including through product oversight and governance measures.

Finding innovative solutions for the PEPP, based on the learnings from the current, challenging economic environment, changing demographics and the modern forms of labour, and embracing the opportunities of digitalisation, will make this personal pension product future-proof for the benefits of the European citizens. ●

Frederic Janbon

Chief Executive Officer,
BNP Paribas Asset Management

PEPP - solving the pension crisis and financing Europe's future

Demographic change poses a clear and present danger to Europe's public pension system. As our populations age there will soon be too few workers putting money into the system to support the benefits already promised to those in retirement. Member states have tried to meet that challenge by gradually phasing in reforms that reduce the generosity of the schemes for future generations. The workers of today will therefore have to increasingly rely on voluntary personal pension plans.

The asset management industry must play a leading role in enabling this shift towards personal pensions by providing long-term investment solutions. In the process, >>>

>>> asset managers will deliver long-term returns for retirees and play their part in financing the transition to a more sustainable and prosperous future for Europe.

We will need to educate savers about the opportunities and the risks that are potentially open to them as long term investors. In theory, illiquid instruments are a good fit for private pension plans, particularly in a world where long-term government bond yields are stuck in negative territory. Illiquid products can offer a much-needed additional return to investors with long investment horizons. But in practice, this will require changes in the regulatory framework to unlock the distribution of the next generation of long-term investment vehicles. Multi-strategy funds diversified over different asset classes, with controlled volatility, could fit the bill.

Pan-European Personal Pension Product (PEPP) has the potential to create a single market for personal pensions and is therefore an important pillar of the wider Capital Markets Union initiative. Asset managers, such as BNPP AM, that are active in many European countries will be well placed to develop a Pan-European offering. With the harmonisation of the rules on providing advice and assessing suitability and the ability to sell online, there is the potential to seamlessly sell one product across national boundaries. The flexibility of investment options and out-payment types of the PEPP will help producers innovate to provide products best suited to investors' needs.

> *"Industry will deliver long-term returns for retirees and play its part in financing the transition."*
>
> \- FREDERIC JANBON

There are teething problems that will need to be addressed if PEPP is to be a success, including the limitation of fees, the cost of capital protection, the disparity of national tax incentives and the need for national authorisations.

The Basic PEPP, the mandatory default investment option, will have costs and fees capped at 1% of the accumulated capital per annum. Capping the cost sounds attractive from the perspective of the customer, but it is important to be clear about the consequences. As with any transaction, capping the cost could constrain the quality of the service that the provider can afford to offer. After all, providing good investment advice costs money. Moreover, fee structures tend to vary across countries (part of the investment management fees often includes distribution costs) so the fee cap could have a material impact in certain jurisdictions.

The capital protection, included in the basic PEPP, is attractive for risk adverse investors but could significantly erode the performance and does not seem economically optimal considering the long investment horizon. Therefore, the possibility given by the PEPP to offer clients lifecycle investment strategies is very important.

Last, but not least, the process of harmonisation is not yet complete. The decision to provide the all-important incentives to participate in the PEPP via the tax code still rests with the Member States. Likewise, PEPP providers will be supervised by their national competent authorities, albeit with EIOPA in the background encouraging the process of convergence.

The moral here is don't let the best be the enemy of the good. PEPP is a welcome step in the right direction towards meeting the pensions challenge and financing investment in Europe's future. The asset management industry should embrace it. However, defining a coherent fee cap and life-cycling and risk mitigation techniques as well as tax incentives will be crucial to make PEPP a success. European Member states will also have an important role to make sure national funds and distribution rules are compatible with a pan European product. ●

Xavier Larnaudie-Eiffel

Deputy General Manager, CNP Assurances

PEPP regulation adopted, but still a long way to go

In June, the EU institutions adopted a Regulation introducing a pan-European personal pension product (PEPP). The PEPP aims to promote private pension savings and long-term investments. It also seeks to foster a more integrated European market for personal pensions that facilitates the portability of individual pension savings across Europe.

There is a clear and urgent need to boost individuals' savings for retirement. Increased longevity and strains on national pension regimes will translate into a massive ageing crisis if nothing is done now to tackle the pension time bomb.

At the most basic level, the PEPP has the potential to help raise awareness about the need for individuals to take responsibility for their future retirement income. A significant increase in long-term pensions savings can also help fund growth and the change to a sustainable society. Depending on the outcome of discussions on the Level 2 measures, the PEPP could also represent a significant opportunity for eligible providers to design and offer new solutions that help to fulfil the economic and societal aims of tackling the pension savings gap, at least in some markets.

The insurance industry is in a unique position to help meet the ambitious PEPP policy objectives, since it is Europe's largest institutional investor and can build on its longstanding experience as the main provider of personal pensions and guaranteed long-term savings products.

However, it is too early to assess whether the PEPP will contribute to the development of an EU personal pension market and channel savings to long-term investments. Indeed, there is a long list of key issues still to be addressed by EIOPA in implementing regulation, including: the content and presentation of information documents; what is included in the 1% cap on costs applicable to the basic PEPP; and the definition of the risk mitigation techniques, which are the criteria to be met for non-guaranteed investment options. This work will have a crucial impact, as it will determine whether the PEPP offers the safety and features wanted by citizens and whether providers are able and willing to design PEPPs.

The success of the PEPP also depends on ensuring that the regulatory framework applicable to eligible providers enables them to fulfil their role, in particular in an environment of low interest rates. As it stands, Solvency II — the regime applicable to insurers and to guaranteed basic PEPP — does not correctly measure long-term risks and as a result is overly conservative. This unnecessarily and adversely affects the cost, asset mix and availability of long-term products such as pensions, which will ultimately have an impact on the performance and diversity of PEPPs on offer.

"The PEPP has the potential to help raise awareness about the need for individuals to take responsibility for their future retirement income."

\- XAVIER LARNAUDIE-EIFFEL

The insurance industry advocates a proper investigation by the EC and EIOPA — as part of the 2020 Solvency II review and PEPP-related discussions — of the mismatch between the current regulatory approach and how insurers are really exposed to risks relating to long-term products, so that it is feasible for providers to offer such products and meet consumers' long-term needs. Improved Solvency II requirements for long-term liabilities would help insurers to provide safe, long-term savings products, including PEPPs. ●

Guillaume Prache

Managing Director, Better Finance

The EU can still save the PEPP: make it simple and use a relevant risks scale

The pan-European Personal Pension (PEPP) product was designed to create a simple and safe personal pension "by ensuring sufficient consumer protection"[1].

However, the design of the PEPP falls short of its objective: the simple, safe and cost-efficient default investment option ("basic PEPP") is no longer simple, requires advice and embeds a capital guarantee scam. For basic PEPPs that offer a capital guarantee, BETTER FINANCE asked to guarantee pension savers' contributions before deduction of fees and in real terms, or – at the very least – prominently warning pension savers that fees and inflation will severely reduce the value of this "guarantee" over time . The voted Regulation however resulted in a "capital guarantee scam", where the accumulated lifetime savings are protected only after deducting accumulated fees, without taking into account the negative effect of inflation, and without any warning.

EIOPA is to draft the delegated acts on the fee cap for the "Basic PEPP",

on "risk mitigation techniques" and on the PEPP Key Information Document >>>

>>> (KID). Unlike what happened to the level II PRIIPs Regulation, it must keep it simple and intelligible for pension savers: lifetime savings and pension adequacy are at stake here.

"The PEPP regulation is "stillborn" since it conflicts with MiFID II before its entry into force."

- GUILLAUME PRACHE

The annual fee cap of 1% corresponds to the existing cap for personal pensions in the UK, and to the fee assumption in the study on life cycle pension savings commissioned by the asset management industry. It is higher than the average total expense ratio for life cycle pensions in the US. Likewise, it is meant to include all annual ongoing fees: total management, distribution and those charged for "guaranteeing" or smoothing returns if any. It is the opportunity to standardize the definition and components of the total ongoing charges that shall be mandatorily disclosed in the PEPP KID.

Future rules on "Risk mitigation techniques" bear two risks: to be too complex for pension savers, and to rely on inadequate risk scales. EIOPA could find inspiration in the just enacted risk mitigation rules for French personal pensions, that are not too complex an should allow for direct investments in funds, low cost ETFs and listed equities and bonds (within the risk mitigation limits tightening over time); a vital need for decent long-term returns and for achieving the CMU. And the risk scale should be at last adapted to the long-term horizon of a pension product such as the PEPP by taking into account that - over such a horizon - a diversified portfolio of listed equities is much less risky than money market funds or short-term bonds.

Lastly, the PEPP KID MUST not repeat the huge mistake done with the PRIIPs KID for disclosing performance. However, future performance forecasts seem to be back again. Besides the fact that return projections are wrong, confusing and misleading, the PEPP regulation does not require the prominent warning that "such forecasts are not a reliable indicator of future performance". As such, it seems that the PEPP Regulation is "stillborn" since it already conflicts with MiFID II provisions. Long-term (at least not shorter than for the UCITS KIID) past performance alongside with benchmark must be part of the KID. ●

1. European Commission introduction to the proposal for PEPP (COM (2017) 343 final).

Oliver Gilvarry

Head of Markets, Funds & CMU,
Department of Finance, Ireland

PEPP – focus on the opportunities

Ireland has been a consistent supporter of PEPP from the original proposal from the Commission. We see the development of Europe's capital markets is dependent on the availability of funds to invest. As can be seen in other jurisdictions with significant capital markets, a key foundation stone is the existence of funded pension schemes. PEPP is now introducing a product that will provide more freedom, choice and flexibility to EU citizens saving for their retirement. The ability to move your pension around with you within the Union is of huge benefit to Europe's workers, along with the certainty for workers over the way the product will operate across the Union.

Compare this to the current situation where you need to have multiple pension pots, subject to different operating frameworks, versus one standardised product. By making it easier for people to save for their future retirement, we are also providing a mechanism to further develop Europe's capital markets, by increasing the pools of investable monies.

At the same time, we must not ignore the challenges this new product faces. The key strengths of PEPP is its portability and the ability to switch provider. We will need to see how the Level II measures are developed to ensure that the key strengths of the product are effective. We cannot ignore the complications of having a range of providers for PEPP, subject to differing sectorial regimes across different national systems, which has the risk of making the objective of switching complicated.

It is important that the work in the different European Supervisory Authorities on the Level II measures has the ultimate objective of making PEPP easy and attractive to use by European workers. This is what will make the product successful.

The current low interest environment has been noted as a potential disadvantage to the success of PEPP, but we must remember that this is an issue for all types of long-term saving products and for pension products of all types. A real disadvantage to saving for future retirement relates to the charges and fees that are charged. The OECD last year highlighted that an annual fee of 1.5% of assets, would lead to nearly a 30% reduction in a person's pension pot at retirement compared to no charges. By halving these charges to 0.75%, brings the reduction in the pension pot to 17%.

These numbers can be used to highlight the benefits of PEPP which will enable European workers to reduce the costs they can face currently by having pensions in numerous different schemes and across different Member States. PEPP also provides for a cap of 1% on fees for the basic PEPP, which is another welcome introduction.

These benefits must be focused on in order to help ensure that PEPP can become a success, rather than focusing on the disadvantages arising from low interest rates or differing taxation regimes.

The ability to easily port your pension across the Union or switch provider or the ability to reduce costs are all strengths of PEPP. This is why the development of Level II measures by the ESAs must ensure that the key strengths of PEPP can come to fruition and make the use of the product easy for consumers. The success of which will help Europe build another pool of funds to be invested, which in turn will help grow our own capital markets in the Union. ●

Peter Paluš

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The first step in creating Pan-European Personal Pension products market

Negative demographic developments of us, the Europeans, provide for one of the most fundamental challenges we will soon be facing. Its impact on the pension schemes leads us to the necessity of providing our peoples with sufficient and attractive opportunities to save for their retirement. Single market, as we are building it, creates useful European-wide opportunities to come with such reforms. That is why we are here today, discussing the creation of first pan-European Pension Product (PEPP). The question is, have we so far been able to achieve what we intended?

I look at this topic from two different perspectives.

First, we have the project of creating single market for capital, or Capital markets union. It aims at improving cross-border investments, and indeed, real portability of a pension product could be a game changer, especially in light of increased mobility of our workers. It is true that we already have various instruments at EU level, particularly as regards the 1st and 2nd Pillar, but PEPP is truly a pioneer project in the field of personal pension products market at EU level.

Second, PEPP is supposed to be a simple and cost-effective 3rd pillar retirement framework that will increase competition among providers with possibility to tackle new/local markets.

Having said this, I have some doubts whether it will be the real game-changer for use of personal pension products at EU level. Here, I cannot help the feeling that it looks much better on paper than in envisioned reality.

Where I see the limitations? Most obvious ones are touching upon issues such as consumer protection, taxation, historical context, effective supervision – just to name a few. Combined with a complexity of this product, its use in practice may be impeded. Although some of those obstacles are natural, such as the historical difference between pension systems of the Member States, others can perhaps be eliminated. We need to seriously pay attention to the uptake and then, step-by-step, start with improving the framework to move further.

To be even more concrete, in Slovakia the portability of pension products is already possible (here I am talking about pension products provided by SK IORPs). On the other hand, some of the biggest proponents of the CMU project among member states were during negotiations rather skeptical as regards the possibility to introduce the real portability within the PEPP (such as the possibility to consolidate various compartments). If we are serious about PEPP and about CMU, we need to be honest, as it is crucial to support the demand and uptake of PEPP.

Same goes then for the area of supervision, but I do not want to go too much into the whole ESAs discussions.

However, I saw similar developments when banking union was negotiated – on one hand, we had countries with big financial markets demanding single jurisdiction with the banking union, but on the other side, the same countries are ring-fencing investments in the pension sector. Solving PEPP may be a good stimulus to move also the banking union project bit further.

To end on a positive note, I believe in Europe and I believe that pragmatic approach is needed here. Partnerships may be one of the answers, because after all, we are all partners and allies in our Union. ●

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About EUROFI

The European think tank dedicated to financial services

- **A platform for exchanges between the financial services industry and the public authorities**
- **Topics addressed include the latest developments in financial regulation and supervision and the macroeconomic and industry trends affecting the financial sector**
- **A process organised around 2 major international yearly events, supported by extensive research and consultation among the public and private sectors**

Our objectives

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

Our approach

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user standpoint.

We organise our work mainly around two yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allows us to structure effective debates and offer extensive input. The output of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proved over time to be an effective way for moving the regulatory debate forward in an objective, open and collective way.

Our organisation and membership

Eurofi works on a membership basis and comprises a diverse range of more than 65 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, services providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

Our events and meetings

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends.

These events assemble a wide range of private sector representatives, EU and international public decision-makers and representatives of the civil society. More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan...) and international organisations. The logistics of these events are handled by Virginie Denis and her team.

These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

Our research activities and publications

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (technology, sustainable finance...).

Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance.... These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net :

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 150 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of the conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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22, 23 & 24 April 2020

Zagreb - **Croatia**

9, 10 & 11 September 2020

Berlin - **Germany**

April 2021

Lisbon - **Portugal**

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