Priorities for the upcoming Commission

Jean Lemierre

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

As the current EU legislature comes to a close, it will be over a decade since the sub-prime crisis burst. In the intervening years, Europe has made very considerable progress in strengthening its financial system. The Single Supervisory Mechanism, the Single Resolution Board and the Single Resolution Fund represent important achievements. Even though the foundations for further integration have been laid, Banking Union has not progressed yet. In fact, it is now amply evident that fragmentation in the European banking industry has increased. In the Euro area the share of cross-border loans to households remains at barely 1%, the interbank market has dried up, and cross-border deposits are below 2% . The EU banking system is today less concentrated than that of the US. What are the implications of this? For the economy, a non-optimal allocation of savings (which do no dot circulate within European countries) to the detriment of investment and a loss in the potential economic growth in Europe.

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

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

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

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

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

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

Hans Vijlbrief

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

EMU and integrated financial markets need each other

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

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

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

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

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

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

Odile Renaud-Basso

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

Finance for the common good

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

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

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

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

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

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

Harald Waiglein

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

CMU – have we already reached the landing zone?

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

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

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

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

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

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

Roberto Gualtieri

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

Priorities of the upcoming Commission in the financial sector

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

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

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

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

We have adopted basically all the legislation proposed by the European Commission: securitisation, prospectus, PEPPs EMIR refit and 2.0, SME growth markets, covered bonds, cross border distribution of investment funds, investment firms, disclosure and benchmarks for sustainable finance, ESAs review. This is positive, and it will have lasting and deep consequences in enhancing our financial integration, diversifying source of funding, increasing proportionality and protecting consumers. However, we have to acknowledge that despite the profession of faith that we have all heard about CMU, Member States have currently very limited appetite on a fundamental component of CMU that is a more European supervision.

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

Vittorio Grilli

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

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

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

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

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

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

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

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

Leonique van Houwelingen

Chief Executive Officer, BNY Mellon's European Bank

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

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

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

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

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

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

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

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

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

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

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

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