NEW TRENDS IN THE NORDIC – BALTIC REGION

The panellists discussed the main on-going trends in the Nordic-Baltic financial services sector and the related policy implications at the regional and EU levels.

1. Integration of the Nordic-Baltic financial services sector

1.1 Level of integration in the Nordic-Baltic region and future prospects

An industry representative highlighted the strong history of integration in the Nordic-Baltic region banking sector and its common solutions in relation to payments, ATM-owning companies, know your customer (KYC) identification (with a common utility in the region) and clearing (notably P27 the Nordic payments platform project, aiming to create the first real-time cross-currency infrastructure).

Another industry representative stated that there is also significant integration at the stock exchange level, with the same group running the exchanges of Sweden, Finland, Denmark, the three Baltic countries and Iceland. However, the sharing of best practices is not always easy and cross-border capital flows within the Nordic-Baltic region are still limited. There is still a great deal of friction, particularly in the post-trade space where more standardisation and open competition are required. It is hoped that the Capital Markets Union (CMU) project will help to tackle these issues.

An official explained that the Nordic financial institutions started implementing the EU norms and governance principles in the Baltic region, after these countries regained their independence. Now Baltic financial institutions are following high standards notably set by the Nordic banking groups and there are strong financial ties across the Nordic-Baltic region. Problems potentially faced by host countries with a strong presence of systemic foreign bank branches or subsidiaries in their jurisdiction emerged during the financial crisis in different member states. However, the experience in the Baltics is that the parent institutions from the Nordic region took their responsibilities for host markets and continued to provide liquidity to their Baltic affiliates during the deepest moments of the crisis in the Baltic economies.

The Nordic-Baltic region remains an example in terms of coordination on supervision and crisis management and of establishment of common standards. The potential challenges posed by the coexistence in the region of different monetary policy regimes in the context of the implementation of the Banking Union and the Single Supervisory Mechanism (SSM) were overcome thanks to this integrated approach. This integration also helps in addressing new challenges regarding digitalisation, cybersecurity, the fight against money laundering and the financing of terrorism.

A market expert suggested that with this integration a 'mini home market' has been created within the Nordic-Baltic region. However more could be done in terms of integration. A Nordic-Baltic CMU could be implemented with common ideas about matters such as securities law, insolvency and company law that are in the remit of the national states but not on the European agenda. Common reporting templates could also be implemented together with a common interpretation.

1.2. AML/CFT and cybersecurity in the region

An official highlighted that the Nordic-Baltic countries have recently agreed to work towards achieving much closer strategic and operational collaboration with regards to anti money laundering (AML) and combatting the financing of terrorism (CFT). There is also cooperation in the private sector with, for example, the KYC Nordic utility.

A market expert stated that greater Nordic-Baltic supervisory cooperation is desirable in the use of artificial intelligence for AML and CFT purposes for example, as the digitalisation of processes is difficult to achieve if domestic supervisors have different interpretations or methods of implementation and enforcement.

An industry representative considered that the cross-border cooperation amongst institutions and authorities in their approaches to AML and CFT is too limited at present and that there is an insufficient coordination of resources. Interpol and other police authorities for example, who know where the highest risks exist, could help the EU financial authorities and institutions to implement a risk-based approach in order to focus efforts on the main areas of vulnerability.

A public representative added that the EU AML directive needs to be upgraded and noted that Europe has a new cybersecurity centre that is concentrating on official threats but that it should also be looking at unintended cybersecurity risks.

2. Funding structure and role of banks vs capital markets in the region

2.1. Development and integration of capital markets in the region

An industry representative stated that SME capital raising is a key trend in the Nordic capital market, stronger than in the rest of Europe, whereby small companies can raise equity capital and retail household investors are offered attractive investment opportunities. This is of particular relevance to the upcoming discussions about the next steps of the Capital Markets Union (CMU). One of the key success factors behind this trend is the investment saving account regime that Sweden established in 2012 and that the other Nordic countries have begun to replicate. Such best practices should be shared with the rest of Europe. More needs to be done in the Baltic region also to develop capital markets.

A public representative noted that the Nordic-Baltic market is small and wondered if sufficient diversity of service providers and competitiveness of markets can be ensured at the regional level. It is rare for investors outside of the region to buy shares in start-ups within the Nordic region for example. This needs to be taken into account, as well as the related cost structures, when thinking about how to develop the Nordic and Baltic economies. The speaker called for an improvement of the CMU with standardised regulation, transparency and stronger European supervision. A number of member states have indeed established artificial rules and structures that hinder cross-border marketing and supervision and unnecessarily increase the administrative burden for firms. These barriers need to be eliminated, because prioritising smaller interests over bigger European ones is not the way to attain greater market effectiveness, the speaker stated. The latest review of the European Supervisory Authorities (ESAs) has not achieved its objective in this area and member states will probably keep an element of bias in their interpretation of EU legislations, which needs addressing. More efforts are also needed to diversify funding, which remains very bank-based in the Nordics as is the case in the rest of Europe. Stronger and truly European venture capital (VC) and alternative investment markets need creating in particular. The number of funds specialising in certain growing fields such as medical technology or the environment for instance is too limited and there are no European VC funds capable of taking care of e.g. a €500 million investment from China.

The industry representative agreed that greater harmonisation and integration of EU capital markets should be the ultimate goal, but until this is achieved, their firm has concluded that the way forward is to build up the local capital market ecosystems in each country, according to the specific needs of each ecosystem and to encourage the sharing of best practices, such as the Swedish investment savings account. Indeed, the CMU's vision of a single SME capital market ecosystem cannot be realised without local ecosystems to build on, which need to be developed alongside harmonisation efforts. The speaker also agreed with the idea expressed by a previous panellist that the Nordic countries, together with the Baltic countries, could take a lead on the development of a CMU at regional level, while waiting for the CMU to be achieved.

Improving regulation is another aspect to be considered for the development of capital markets in the EU. The industry speaker felt that the EU has overregulated these markets over the last 5 to 10 years, in particular with MiFID II, which needs to be re-assessed. More proportionality and segmentation is needed, particularly for encouraging the development of SME growth markets that can help SMEs raise a great deal of capital from households. Care should also be taken not to stifle public markets with overregulation.

Another industry representative noted that covered bonds could help to strengthen EU capital markets, as they are an efficient way of providing 'ordinary' investors with direct access to the capital market. There are many more covered bonds in the Nordics than in the rest of Europe. Danish customers, for example, buy the bonds for their pension funds and their houses are also funded by the issuance of covered bonds in the pass-through system, which is very efficient. Covered bonds could also be an instrument of sustainable finance, with the introduction of bonds that could finance houses with different shades of green (e.g. houses that are at least 70% green).

2.2. Prospects of the Nordic-Baltic banking sector

A market expert stated that while strengthening the capitalisation of banks is positive, the upcoming Basel III requirements need to be implemented in an 'intelligent way'. Nordic-Baltic banks have very large balance sheets with low risks and their internal models show that the implementation of Basel III with the planned output floor would lead to a significant and concerning increase of capital requirements.

An industry representative agreed that achieving an appropriate finalisation of Basel III (the so-called Basel IV) is imperative for the Nordic countries. The specific social system in the region that supports people who become unemployed or lose their homes and the efficient legal system involving very fast for-closure processes if mortgage payments are not made, mean that the region's mortgage system has much lower losses than in the US. It therefore does not make sense to apply in the region an output floor that was calculated based on the US system. In addition, in Europe, including the Nordics, all the mortgages stay on the balance sheets of the banks that have granted them, whereas in the US many of them are sold onto the capital market or to government sponsored entities such as Fannie Mae and Freddie Mac. This is another significant difference resulting in the European banks, and in particular the Nordic ones, having lower-risk weighted mortgages on their balance sheets. All of this makes 'Basel IV' much more expensive to implement in the EU. Any gold-plating should be avoided and the specificities of European bank business models should be better recognised. 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.

A public representative also mentioned that the Nordic banks have effective risk management and have already implemented a number of measures in the aftermath of the banking crisis to reduce risks. This should be taken into account and is relevant with regard to the on-going discussion about how risk reduction is needed before risk sharing in the context of the banking union and the European deposit insurance scheme (EDIS) proposal.

3. Digitalisation and evolving payment systems

3.1. Digitalisation trends

Industry representatives drew attention to a new wave of digitalisation involving a number of new trends: customers abandoning internet-based interfaces in favour of mobile apps, demand for physical cash dropping in favour of electronic payment solutions, higher demand for online or remote meetings instead of physical ones, and artificial intelligence being used for customer interaction and financial advice. This is largely driven by the customers' desire to easily access financial services anywhere and anytime. A speaker added that this is true for banking but also for investments with 40% of all traffic on the platform of a leading Nordic broker coming through mobile devices.

A market expert mentioned figures showing that over the course of a month, people overall make 400,000 physical visits to banking infrastructures, as compared to using a web browser 8 million times and a mobile device 27 million times to access financial services as the first interface.

3.2. Further regulatory harmonisation and a level playing field needed to support digitalisation

An industry representative stated that certain obstacles need to be overcome in order to facilitate digitalisation. In particular, financial companies that operate in different countries are faced with different regulations due to differences in the enforcement or interpretation of EU rules or diverging domestic requirements. In some cases, individual companies also interpret the regulations differently from their competitors. When these differences are material, they impact both the market and the financial system. For example, a banking infrastructure that lacks a cross-border component cannot be relied upon for transaction monitoring which is necessary when executing cross-border payments initiated by payment service providers (PSPs). In that case, innovators in this space need to take responsibility for this monitoring. A greater harmonisation of the rules is therefore required as well as a greater harmonisation of their implementation, interpretation and enforcement to support competition and digitalisation.

Several speakers also emphasized that a level playing field is needed in terms of regulation and monitoring. This is particularly important with the growing number and variety of service providers using new technology applications. Fintechs can execute mortgages for example with essentially no capital whereas banks need capital to do the same, according to an industry speaker. Equal regulation and supervision is therefore required for providers that offer the same services, in order to protect consumers and ensure that development is driven by efficiency gains rather than by cost advantages due to lighter regulation. There needs to be an adequate regulatory approach to crowdfunding, different types of mobile services, peer-to-peer lending, new savings applications, as well as PSPs, a public representative suggested.

3.3. New trends in the payments area

An official outlined three trends in the area of payments, which raise issues in terms of safety, robustness and inclusiveness. The first is the declining use of cash, which is particularly marked in the Nordic region, despite the low interest rate environment which should normally have stimulated cash usage. The key question this raises is if a payments system without risk-free central bank money will be sufficiently safe, robust and inclusive. The second is the increasing speed of payments and the greater possibility of making fully settled payments at any time, which is positive for most consumers. But again there is a need to ensure that systems handling these payments are safe, robust, and inclusive. And the third trend is the rise of new digital technologies that have allowed the private sector to launch different explorative initiatives related to cryptocurrencies and cryptoassets. The second generation of cryptocurrencies including stablecoins such as Libra is expected to address some of the flaws observed in the first years with the speculative use of cryptocurrencies, notably their huge price swings. These initiatives have created concerns among public officials, once again very much from the perspective of ensuring safety, robustness and inclusiveness.

Against the background of those trends, consideration needs to be given to the respective and complementary roles that the public and private sectors should play. The private sector has a comparative advantage when it comes to making sure that the best new technologies are being used and this can improve market efficiency, but the public sector cannot expect the market to move in an optimal way simply with market forces. Externalities will arise that call for public intervention, particularly in terms of ensuring that there is a proper provisioning of resources for aspects that are not profitable or for handling major disruptions, and also for ensuring the safety and robustness of the overall payment system and that people who have problems using modern technology are not left out. Public intervention can take the form of regulation or direct participation in the production process or both. Regulation alone is unlikely to be enough and some form of direct participation will likely be necessary. Direct participation includes initiatives such as the on-going work on central bank digital currencies and the launch by the ECB of the TIPS (TARGET Instant Payment Settlement) system. Ultimately, a holistic vision is required that offers users the best service in a safe way.

An official noted that the issue of the resilience of the payment system would be an important point on the informal ECOFIN agenda the following day. Geopolitical issues that might lead some actors to disrupt the payment system are also to be considered. A market expert agreed that this issue of resilience should be debated at the European rather than national or regional level.

4. Sustainable finance

A market expert felt that the Nordic-Baltic market for sustainable finance will develop regardless of the way the European taxonomy evolves. If that taxonomy is ultimately not adequate enough to drive sustainability, other ways of analysing investments or loan processes will be developed. The taxonomy should be flexible enough to be able to adapt to future unknown evolutions and should be 'science-based' rather than political.

An industry representative outlined the success of the Nordic sustainable bond market that was established in 2015 and that will soon be celebrating its 200th sustainable bond, mostly made up of green bonds as well as social bonds. In addition a blue bond has also been issued focused on clearing up the Baltic sea. The outstanding issuance of green sustainable bonds in Sweden already amounts to 120 billion Swedish krona, and there is demand for more. There is currently a positive problem in that there is a great deal of earmarked money but a lack of issuers of green bonds.

An official echoed the call of the Chairman of the High-Level Expert Group on Sustainable Finance, for a 'triangular perspective' on sustainable finance that takes into consideration economic and social aspects as well as the impact on climate, in order to bring necessary stakeholders onboard and to provide balanced results. The recommendations of the high level group that now form the basis of the Commission's action plan demonstrate that much can be done without unduly hampering economic activity and without affecting populations negatively. A national or regional approach in this area would be unproductive because pollution will often just move to another country, the speaker felt. Global and economic realities need to be acknowledged.

A public representative added that sustainable finance is an area where harmonised indicators and accounting methods are desperately needed, which should be attached to the International Financial Reporting Standards (IFRS) and should be global or at least European so that investors know where they are putting their money and can track their investments. Some member states would like to interpret the taxonomy in their own way but this would lead to diverging interpretations, with an adverse impact on the market and the objectives it is aiming for. Instead, what is needed is consistent regulation, implementation and supervision.

5. Solutions for the silver economy and retirement

A market expert highlighted that welfare systems vary across the EU, but they all need to be complemented with private wealth. Of importance in this perspective are insurance, care instruments and lifelong wealth management, allowing assets to grow in value and be released at the appropriate moment, so that senior citizens can benefit from adequate support financed over the years by their own resources. Public-private partnerships are also useful in this perspective. However, initiatives such as the pan-European pension products (PEPPs) do not seem helpful. Building on existing welfare models, which are very different across Europe, should be the preferred way forward.

A public representative disagreed with these comment on PEPP. PEPPs, as well as other insurance based instruments, are all needed to complement the system. Currently, one-third of EU citizens working in different member states will have patchy social security and pensions. A European structure is required to ensure better transferability, trust and common rules, and a better understanding of what could and should be sold to complement the national systems.