SUMMARY

THE **EUROFI** FINANCIAL FORUM 2019

HELSINKI | 11, 12 & 13 SEPTEMBER

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

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Summary
Views Magazine
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EDITORIAL

The Eurofi Financial Forum 2019 took place in Helsinki during the Finnish Presidency of the EU Council. More than 1000 participants from the EU and international public authorities and the financial sector attended this three-day international event.

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

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

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

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CONTENT


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Helsinki 2019

SUMMARIES OF THE SESSIONS

Detailed output of the sessions

EU AND EUROZONE CHALLENGES AND PRIORITIES

Key priorities for the incoming Commission

1. The EU financial system is more resilient but poorly integrated

1.1 The EU financial system is more resilient

An official stated that Europe's financial system is more stable today than 10 or 15 years ago. The question is whether that is enough to face the challenges globally or closer to home. Another official noted that, between 2015 and 2019, the Banking Union and Capital Markets Union (CMU) progressed towards a more resilient and consistent framework for European financial services, covering aspects such as prudential ratios, central clearing or transparency. This deepened approach began after the financial crisis, and aimed to restore buffers, increase reporting and tighten supervision.

1.2. European financial markets remain underdeveloped and poorly integrated and the Banking Union is far from effective

An official advised that time was spent after the financial crisis to enhance the financial framework, bank capital and financial regulation. Institutions such as the Single Supervisory Mechanism (SSM), Single Resolution Fund (SRF) and Single Resolution Board (SRB) were created but fragmentation in the banking area is worse than before the global financial crisis and policies have not been implemented to support growth. Market integration in Europe also lags despite high household savings. This is the reason why a group of German, Dutch and French experts were asked to work on CMU to define priorities and bring sufficient political support and dynamic to focus on delivering regulation which reaches that outcome.

1.3. The global competitiveness of EU financial markets is challenging

An official considered Europe in the world as an important element. The US is challenging on international cooperation. China is becoming a major financial industrial and technological player. For Europe to remain in the global picture, it must be able to act as a global entity at a global level.

Competing with major players at a global level is relatively new in the European agenda considering EU sovereignty and the domestic market's capacity for major global players. This is evident in technology, with Google, Amazon, Facebook, Apple (GAFA) and others, as well as in the financial sector, where trends are not favourable for European companies. European banking remains domestic, limiting the ability to compete globally.

1.4. Deeper integration, fostering growth and improved financial stability do not conflict

An official considered that deepening integration, boosting growth or strengthening financial stability are key priorities that do not conflict. The single market helps to deepen integration. The destination has not been reached in areas like services, but deeper integration and a single market will boost growth. Strengthening financial stability does not conflict with boosting economic growth. If not done well, it can, but a reliable financial system gives confidence and is growth-boosting. Getting the balance right is a task for the next Commission and the Council, especially the Markets in Financial Instruments Directive (MiFID) and Solvency II reviews, Alternative Investment Fund Managers Directive (AIFMD) and other issues that arise. Lessons are usually learned from past mistakes, in an ongoing process.

Another official stated there is no prioritising between the three goals or priorities. Financial stability is a prerequisite for growth is agreed. A public decisionmaker also agreed that fostering integration, growth and financial stability should be priorities and there is no reason to rank them. There are many uncertainties, with major risks including trade, Brexit, geopolitical tension and others, so caution is needed. The economy is slowing, so avoiding recession is key and being ready to act is important. There are margins of manoeuvre and the European Central Bank (ECB) has taken some steps. The work on the European dimension of revamping and relaunching new investment plans is crucial and linked to financial-related issues and so financial policies require reflection. Financial regulation requires acting to support growth and not impede it with negative impact.

An industry representative advised that growth is Europe's goal. Integration and stability are fundamental ingredients to achieve long term and sustainable growth. The priorities have already been stated. The two main streams are completing the Banking Union and strengthening the CMU, as it is lagging behind. Stability is further along than integration. Stability must not be forgotten, but a concentrated effort is needed on banking sector fragmentation and the CMU components. An integrated and concentrated banking sector is required, as is building up the CMU. That is tantamount to creating a single market in services because the difficulties touch all the delicate points of a single market for services. A Banking Union looks simple compared to a CMU.

Implementing structural reforms, making the Banking Union effective and strengthening the CMU are key priorities that were discussed during this session.

2. Implementing structural reforms within each member state with a view to achieving a steady real convergence towards resilient economies is fundamental

2.1. Member States need to accelerate their homework and implement structural reforms in order to improve the competitiveness of firms and increase trust between member states

Monetary policy cannot do everything. High sustainable growth in Europe can only be achieved by reducing reliance on debt and reinvigorating productive strength. An official advised that recent years have seen an expansionary monetary policy. Analysing that policy's effects is vital. Limited progress was made on economic performance and new vulnerabilities were brought into the financial system. The focus should have been on convergence, even if it is easier said than done. There is

more focus and pressure on policymakers, particularly in the field of fiscal policy and on structural reforms.

Structural policies can accelerate re-allocation, innovation and the diffusion of technology. Structural reforms suggest areas like pensions, healthcare or social security systems and public administration face challenges from demographic trends. Structural reforms also relate to skills, education, innovation and digitalisation. Any action in the pension system cannot improve a ratio of 1.3 employees per one pensioner. It can assist, but nothing can be done without sound growth, new jobs and increased productivity. Demographic challenges are an additional stress and must be emphasised alongside the four key priority areas, in line with the strategic goals to grow, connect, protect citizens and be more visible globally.

2.2. Defining the appropriate policy mix in the euro area

2.2.1. Fiscal policy could play a more supportive role in Germany

A public decisionmaker stated that there is room for providing budgetary support in the EU at this stage, with different margins of manoeuvre in different countries. The work on the European dimension of revamping and relaunching new investment plans is crucial. An official advised that the fiscal situation is being monitored carefully in Germany and diverging economic signals noted. The draft budget for 2020 is balanced but Germany is willing and able to act if there is further economic deterioration.

2.2.2. A dedicated centralised fiscal capacity is still needed

An official noted the work on the eurozone budget via the Budgetary Instrument for Convergence and Competitiveness (BICC). Consensus was not achieved that stabilisation should be part of the eurozone budget but is needed. An ambitious proposal for national unemployment schemes to provide liquidity to each other in a crisis did not find a majority in Europe to continue the debate. The topic will reappear in the next crisis, as will the centralised fiscal capacity.

3. Strengthening the CMU is a key priority

3.1. A great political interest for improving the CMU

An official stated that the CMU is popular. The finance ministers' expert group is grounds for optimism. If other member states ask to be included, it shows interest in the topic and provides encouragement. The work so far encourages ambition. Decisions must follow on inter alia harmonising insolvency and capital markets-related tax laws. A decision must also be made on the proposal to introduce qualified majority voting for tax legislation. It would help with the relevant and difficult CMU-related topics of taxation. Germany has changed its position on taxation and is open to the proposals, so it will be interesting to see how that is taken up.

3.2. Improving small to medium sized enterprises (SME) financing

An official emphasised the need for deepening capital markets and hearing similar arguments from several member states is encouraging. SMEs still fear capital markets, so the banking sector must improve further in a challenging monetary environment where yields are still historically low and even negative. Another challenge is the real estate market. Lessons that should have been learned from the financial crisis have not been. There is a need for a further improvement of financial literacy and better information for institutional and retail investors, as household citizens have savings that should be used directly or indirectly through institutional investors. Strengthening local markets is key.

The Chair noted that SME financing has been an omnipresent issue for Eurofi. Europe is still not doing well enough. A paper was written 20 years ago without much advancement since. Brilliant and innovative SMEs do not grow into world-beating top companies. No European companies appear in the top 50 global bigtechs. This is key for the Banking Union and particularly the CMU. An official gave examples of local innovation in electrical cars or in IT. Founders often talk about requiring financing support early in their history. It is also needed when preparing for the next step.

3.3. Priorities in insolvency, accounting and tax issues to strengthen the CMU

An official advised that the same problems are faced. A full and true CMU is important. The focus should be on improving the retail client's experience and encouraging the investment that is key to creating a more equity-owning culture in Europe. The financial system is one for efficient risk-sharing. Issues need to be remedied for that to happen, such as a harmonised system of insolvency rules. The outcome for the bondholders in a cross-border insolvency shows why this is important.

A neglected element is financial information, especially for SMEs. A large, publicly listed company uses International Financial Reporting Standards (IFRS), but SMEs are likely to use one of 28 different EU accounting systems that are not well understood outside national borders. This obstacle will not be easily remedied. Harmonisation is obvious, but insolvency rules seem to be part of the national heritage in some countries and people are attached to national accounting systems. This is true for another key area: there is indeed no harmonised European definition of a security. The concept exists in European legal texts but is defined in national law, which is a problem for crypto assets. They fall under national rules in some countries but not others. The CMU requires this to be harmonised. The tax issue also exists and is even more complicated. Another official added that PEPP was agreed. It may not be successful, although it is a good idea, as taxation is difficult.

The CMU has not progressed as far yet. There is not as much evidence on growth as there is no proof that either a capital markets finance-based system or a bank-based finance system is better for growth. However, there is academic proof that a capital-market-based system is better at financing innovative and risky new companies. That is why the US has Google and Amazon and Europe does not. There is a chance to get that growth boosting element right.

The Chair noted that a European Electronic Data Gathering, Analysis and Retrieval (EDGAR) would benefit cross-border investment. The technology exists, and language is not a problem. It is an achievable bonus.

In addition, securitisation can be reviewed when enabling regulations are right. An industry representative advised that solvency laws and procedures link with securitisation. Packaging assets from different countries with different insolvency procedures is impossible. Progress will be difficult but must follow. Europe must look inwards to strengthen and create capital markets while remaining at the centre of the global stage. Creating an open market is vital to ensure the best possible condition for capital in Europe.

Furthermore, the industry representative stated that the CMU has acted on stability in the event of banking failure; however, a technical issue is central counterparty clearing houses (CCPs). The issues of a CCP failure are still there and must be confronted.

3.4. Linking capital markets with the green agenda

The Chair asked if the language should change to link capital markets with the green agenda. An official agreed. Taxonomy must be done quickly, and work is being done to get agreement soon. The EU must demonstrate that

it has uniform criteria. Forthcoming presidencies offer opportunities to work together to move agenda items forward and discussions with the Commission have already taken place.

An industry representative responded that Europe is a global leader in sustainable finance. Customers need clarity and transparency; financial firms need consistent corporate level disclosure of useful information for investment decisions. There is demand in the market, with a generational push. Europe can be the benchmark for rule-setting, as the US is not focused. There is interest from China. Europe can provide integration and excellence. EU authorities should approach climate and environmental factors for financial institutions from a risk-based perspective and appreciate that firms have varying exposure to them.

An industry representative advised that Europe can be a global thought leader on sustainability. People want it to happen. An official considered that Europe was right to pioneer the sustainable finance field. A drawback of dramatic uptake is the risk of further market fragmentation across labels and definitions. The Commission should harmonise the concepts of sustainable and green finance, with a standard that can be referenced globally. The taxonomy of sustainable activities will be crucial.

3.5. Securitisation, MiFID and AML are also important issues

3.5.1. Securitisation should be a key pillar of the CMU

An industry representative stated that Europe should implement Basel IV with care and mitigate the impact of regulatory pressure with a workable securitization framework that allows banks to shift assets into capital markets and provides investors with access to previously illiquid exposures such as mortgages or loans to corporates and infrastructure projects. Securitization should be a key pillar of the CMU. It can be a major driver for private sector risk sharing across the Banking Union and serve as quasi-safe asset if combined with appropriate high-quality criteria. This 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 due to the importance of bank financing in the EU economy.

3.5.2. Revisiting MiFID is also necessary

An official stated that MiFID is at the intersection of the CMU and the Banking Union. Papers on retail investor participation in capital markets have been well-received. Retail investors' access to products like corporate bonds has been restrained. The proposed legislative changes on secondary MiFID II issues such as data provision, open access and share trading obligations are needed and MiFID should be revisited.

3.5.3. Greater efforts are required on AML to increase confidence in financial services

An industry representative raised the issue of anti money laundering (AML). A sustainable world benchmark in capital markets and banking requires more in anti-money laundering. Europe must have an integrated approach. A single institutional authority would be a positive step, but there must be single rules before that can exist. It is best to think about regulation and then a single authority. The Chair recalled that current rules allow for the identification of 1% of money laundering and maybe the new rules will double it to 2%. A new collaborative approach that uses technology should be supported.

4. Making the Banking Union effective is also needed

4.1. The Banking Union needs to be completed

An official noted the progress on deepening economic and monetary union, particularly the Banking Union. The two pillars (Supervision, Resolution) already enacted can be further strengthened as the third pillar (European Deposit Insurance Scheme) is awaited. An official advised that the steps taken on banking package and establishing the common backstop are deeper than credited. Progress is vital but discussions with bank representatives confirm a dilemma. Despite the progress made on fragmentation and establishing a true internal market for banking services, the subjective perspectives of the banks and the empirics show a more disintegrated market. That must end.

4.2. Going beyond the risk reduction risk sharing issue

Progress must be made on complex issues ranging from establishing an internal market for banking services to thinking about the kind of capital and liquidity waivers for cross-border banking groups, and burden-sharing instruments needed. That should consider all the legitimate financial stability concern in countries with large foreign ownership of their banking systems. Those issues must be taken extremely seriously and addressed.

Substantial gains have been made in reducing non performing loans (NPLs). Consensus must be found on issues that hinder progress towards completion of the Banking Union, notably deposit insurance and the regulatory treatment of sovereign exposures which are not consensual. It is important to be cautious and proposals must avoid financial stability risks, while enabling progress.

An industry representative stated that it is crucial to transcend the host and home debates. Without that, a truly integrated banking sector with stronger, larger, more competitive European banks will not be achieved.

4.3. Towards pan EU competitive banks and an interconnected, modern payment system

An industry representative stated that Europe needs large banks that can operate and compete with the US global banks. They are lucky in having a large, liquid single market that is well-priced. American financial institutions benefit from good shareholders and huge economies of scale. Europe is fragmented by comparison. Achieving a market-based economy in Europe and a corporate sector able to compete requires strategic decisions to strengthen banks with the capacity, business model and willingness to do that job.

Europe is lagging on payment system technology, but an interconnected, modern payment system is a must have. It is critical but easy to do and efforts must be made in the official and the private sector.

An official advised that Europe must make progress in the intersection of digital financial markets and payments. Implementation of the second Payment Services Directive (PSD2) shows either non-existent transition periods or three to 18 months. There is a patchwork across the EU that should not happen in an internal market for banking services. Existing payment systems must be digital and integrated, with positive elements leveraged. This is a priority for Europe to compete with platform economics in the US and China.

5. A new financial agenda is called upon

5.1. Europe needs a political vision and momentum for financial markets without the UK

There is a question about how to deal with the UK after Brexit. A large part of the financial system is in London. The perception that Europe is fragmented may increase. Europe must set the vision for its financial markets without the UK. The last three years have been tactical; now it is vital to be more strategic about setting deadlines, executing and getting political momentum behind the CMU. The initial excitement has faded to

feeling underwhelmed by the progress made. It requires strategic thinking and political momentum.

5.2. A renewed financial framework is needed

An industry representative noted that there is a new Commission, Parliament and chair of the ECB. A renewed framework would be positive. There are many nationalistic reasons not to act but the euro would not exist without the willingness to act for a European common good bigger than nationalistic interest. It is urgent to renew this in difficult times. Research and industrial policy are not always popular but require consideration. Sustainable priorities for the collective good must be discussed. Banking is about serving this.

The Germans like stability and the French prefer growth. It is about the justification for operating. It is vital to be proud, to have vision and to know what is required to manage the policy mix. That is the politician's job, not the banker's. The bank's job is to allocate capital and resources according to policy. In difficult times, consistency and understanding the framework are key.

5.3. Securitisation is key in the current monetary context of the "Basel IV" agreements

It is vital to be honest and prepare for the new increased of capital requirements. Finalised Basel III will come and there is a question of whether the system is ready. It must be reviewed so if it is not, it can be made ready. There is a serious discussion to have about Europe's banking infrastructure.

There are two ways to address increased capital requirements: one is to make more money, which is not easy with a decreasing interest rate curve, the other one is securitisation. The US banking sector in the 1960s and 1970s shows that securitisation was key in the move from bank-based financing to a market-based system. A bank-based or market-based system is not important, but it is not possible to be half pregnant. If the market-based system is chosen, it is important that banks should be able to offload assets from their balance sheets otherwise capital cannot be reused. That is key to preparing for finalised Basel III. The system will not work without it. Much time has been spent but the situation is blocked. Implementing increased capital requirements is key to avoid future difficulties but the EU financing system as it is today cannot be final. It is in the middle of the road and it is dangerous.

The Chair asked whether securitisation could work without a Freddie Mac and Fannie Mae, which is not being argued for. An industry representative stated that the US in the 1970s created a fully marked-based system dependent on government support. Europe has neither market nor official support but wants more capital in banks. This is wrong. The next Eurofi meeting should discuss securitisation. It should be possible to create an efficient asset class of securitising mortgages in Europe which are not subprime loans.

European savings are hunting for yield. It is not found in the bund or in mortgages, but in US Treasuries so there is a flow of savings from Europe to the US. German savers such as insurance companies are looking for better than negative interest rates. That is fair but having a class of assets at home that give a better investment than foreign sovereign bonds would be a better use of the money.

The usefulness of the head of treasury has always been to think about how savings circulate in the economy, while taking part of it for the state. Insurance companies and investors need a new, secure and safe class of assets with some return. The official sector's support may not be needed if the gap in the yield is enough. That is an open discussion. It is on unsafe ground, but that is how to think about it.

5.4. Getting political momentum is essential to make progress

5.4.1. Getting inter-institutional agreement before starting work on the regulation

The Chair noted the need for political arbitrage. The Commission will make proposals and draw on other proposals such as the capital markets work. There is the question of process and whether priorities should be driven by economic value added, also measures to dynamise Europe's economy. A tripartite agreement between the Commission, the Council and the Parliament to deliver proposals by a date would avoid drift. An official agreed. A key priority is to define the objective and not the regulation as an objective. The outcome must be defined, and the process assessed rather than adopting texts that do not deliver. An inter-institutional agreement ex ante before starting to work on the regulation would be useful.

An official noted that agreement on the concepts should be possible because they are often discussed at ECOFIN meetings. There should be a message of consensus. Agreements are usually made; sometimes there is a compromise, but the work is generally intensive and constructive. An official underlined that the tripartite agreement is often mentioned but there is the question of whether it can create the necessary political momentum. The Council lays out roadmaps and then there is a debate around what they mean, and dates are missed. It is difficult to see how that would be different with a tripartite agreement. Leadership must come from the top. There must be political will at the top level because it requires ministries of justice and the interior as well as finance. Only the top people can create that consensus.

An official agreed that everyone is aware of the responsibilities and what should be delivered. Much has been achieved, but there are more challenges and work ahead. Each of the headline goals must be worked on or covered in parallel. The consequences of collapse are clear. It is difficult to prioritise between them, but the focus should be on growth, jobs, productivity and everything to enhance and fight these challenges, not only in respect of the financial system but more broadly.

5.4.2. Improving the EU legislative process

An industry representative stated that 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. The national regulators' focus on their own markets' financial stability makes sense from a country perspective but leads to inefficiencies and traps financial resources. The definition of home and host member states highlights the lack of integration between regulators; a system founded on flows of information between authorities is needed with robust processes to guide cooperation. Any new regulatory framework should be flexible, graduated and principle-based with oversight tied to scale and risk.

An industry representative advised that using digital technology to improve the efficiency of regulatory regimes is tactical but nonetheless important for regulators and users of compliance regimes. When setting rules, how much goes into level 1 text versus outside is important. It is currently complex if regulatory evolutions are required when the modification is in level 1. Regulators will say it is impossible and continue with a system that nobody likes. Therefore, the EU legislative process needs to adapt and contribute to competitive and efficient financial markets. Re-establishing the distinction between level 1 and 2 is the right way forward.

Strengthening the international role of the Euro

1. The euro is the second most important currency in the international monetary system

1.1. The euro is widely accepted for international payments, but the dollar is the preferred reserve currency

An industry representative emphasised one simple quantitative observation: considering how the international role of the euro has evolved over the past 10 years, the euro is on par with the dollar in terms of international transactions, but it is not on par with the dollar as a reserve currency. A Central Bank official suggested that incumbent international currencies have a substantial advantage which takes a long time to disappear. The existential crisis experienced by the euro area contributed to the decline of the euro's importance. Nevertheless, in terms of transactions, the euro is more or less at par with the dollar. As a reserve currency, however, the euro is far behind; indeed, the euro represents around 21% of international reserves of foreign central banks while the US dollar remains the leading global reserve currency, accounting for 62% of international reserves in foreign central banks.

1.2. Public support for the euro has been reinforced in the euro area

A Central Bank official felt there is a demand among the European population for Europe to play a more important role in the 'international power game', i.e. the new geopolitical environment in which Europe is squeezed between the hegemon and the candidate for a new hegemon (US versus China). This question around the international role of the euro has therefore gained more importance. Bloomberg has recently published an article suggesting that a significant majority of the European population want Europe to play a more important role in international affairs. Over many years, the demand for Europe to play this kind of enhanced role has been higher than governments and politicians have incorporated into their decision making. Another Central Bank official considered that the international popularity of a currency is primarily a market-led process and market participants decide which currency to use. The euro is now the second most popular currency in the world. After 20 years of use it is a successful project, but there is further room for improvement.

1.3. The benefits of a wider use of the euro are well known

A wider international use of the euro would benefit both European citizens and European companies. The latter would benefit from lower cost and risk in international trade and more reliable access to finance through more integrated and liquid financial markets. This greater role for the euro is also desirable because it would provide a greater degree of financial autonomy in the euro area and reduce exposure to third country legal actions through extraterritorial sanctions. A currency with global standing would be a symbol of European unity on the world stage; it would also be a tool to project global finance.

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

An industry representative noted that one obvious benefit of a reserve currency is the development of more autonomous economic policy. Having a reserve currency enables policy stances to be framed independently. Ultimately, the Fed sets the tone for interest rates worldwide. US fiscal policy is less concerned with counterproductive 'crowding out' when supporting demand, given the structural overseas demand for US bonds. The decisions taken by reserve currencies create spill overs for the rest of the world, but a reserve currency is not affected by the same spill overs from the rest of the world. However, the European Central Bank (ECB) has been able to decouple from the Fed very efficiently.

1.3.2. Being a reserve currency comes with potentially problematic conditions

An industry representative pointed out that a reserve currency must also offer a sufficiently large volume of assets for the world to invest in. This often entails running a current account deficit, which the euro area has sought to avoid over the last decade. If the euro were to become a reserve currency with a structural demand while also maintaining a structural current account surplus, this would have to be paid for with even more negative rates and perhaps an appreciation of the euro's exchange rate. The industry representative believed that the euro should become a reserve currency due to what is happening in terms of policy coordination across the world. Indeed, there was a time when monetary easing in one region was seen as a net positive for everyone. When a region engages in easing policy now, it is increasingly seen as a competition instrument notably to favour its exports. In such a context the euro should increase its capacity as a reserve currency in order to further protect itself.

A Central Bank official suggested that Europe's sovereignty is partially linked to the international role of the euro. It will not be hindered by the current account position of Europe. The current account was important until the demise of Bretton Woods, when official liquidity was the liquidity of the international system. Now this is no more the case. Furthermore, Brexit is not an important obstacle here. If anything, Brexit provides another incentive to develop the capital markets in the rest of the EU. London represents between 10% and 15% of the total issuance of both equities and bonds by firms in Europe. This is easily absorbable by increasing capital market activity in the rest of the EU.

1.3.3. The euro is part of European sovereignty

A Central Bank official stressed that sovereignty is a difficult theme, noting the difference between sovereignty and independence. Independence is sometimes formal, and it exists at the level of the nation state. Sovereignty is real, but in order for it to be for real it must sometimes be shared. This is what was done for monetary sovereignty with the euro. It has been a success, and it is supported by a strong majority of citizens in 19 member states. On average, 76% of euro area citizens want to keep the euro. There is no contradiction between sovereignty, sharing sovereignty in particular cases and maintaining popular support.

2. The obstacles to increased international use of the euro

The lack of progress on banking, capital market and fiscal union, the absence of a joint risk free asset and the persistence of negative interest rates environment are the main obstacles to wider use of the euro.

2.1. The eurozone is not functioning as a truly integrated monetary union

A Central Bank official suggested that the fact an existential crisis in Europe contributed to the euro's decline indicates the first precondition to further development of the euro's importance: establishing a rock solid monetary union which is safe from existential crises. The deepening and strengthening of monetary union is vital for increasing the international role of the euro. Moreover, the euro area's macroeconomic policy mix continues to maintain a pro cyclical bias due to fiscal policy rules. This should be slightly adjusted.

2.3. Europe's capital markets are too fragmented, and the Banking Union is far from complete

2.3.1. There is no integrated banking market

A Central Bank official highlighted the national obstacles to cross border bank mergers in Europe. In the US, the five most important commercial banks have a market share of over 40%; in Europe that number is 20%. This indicates how significant the lack of internal integration is. Additionally, there are internal obstacles. For example, there are too many liquidity waivers within Europe for subsidiary solo based regulatory approaches.

2.3.2. There are too few cross border banking mergers

An industry representative stressed that there are not enough cross border banking mergers. When considering the question of why there is an insufficient level of cross border banking mergers, it is important to consider the fact that people continue to like having sovereign powers. The industry representative reminded the audience of the fallout following the Jérôme Kerviel scandal in 2008. Christine Lagarde, then the French Minister of Finance, held a press conference, and the first question she was asked was, 'Madame Lagarde, would it be possible for Société Générale to be sold outside of France?' She answered, 'No, it is not.' A Central Bank official noted that Madame Lagarde made this statement before the introduction of the Banking Union. Nowadays, the authorisation for mergers and acquisitions lies in Frankfurt with the Single Supervisory Mechanism (SSM). The industry representative suggested, however, that the French authorities do not care about these authorisations. An official reminded the audience that the French authorities comply with all EU and Banking Union rules. To take one simple example, HSBC's main European retail operations are in France; two decades ago, it bought the CCF.

2.4. There are concerns around inertia and the neutrality of the ECB but things are changing

A Central Bank official emphasised the role of two important historical obstacles. Firstly, there is a strong inertia in behaviour. A century ago, sterling was the international currency and the dollar had a very minimal role; 10 years later, however, the dollar was at par with sterling. In between, there was a war. The Central Bank official clarified that this does not mean that war was an appropriate method of developing the international role of the euro, noting however that 10 years is an extremely short period for this change. The second historical obstacle relates to the position taken by the ECB. The development of the euro's international role is not one of the EU's treaty objectives. In the early years of the euro, Wim Duisenberg, the first President of the ECB, indicated that the ECB was neutral towards the international role of the euro.

However, the Central Bank official considered that things are changing, and a more positive stance is being taken on this issue for two reasons. First, there is a growing political concern around the development of the international role of the euro. The dollar is a powerful asset for the United States, and China is keen to develop the international role of the renminbi; Europe should not step aside. Second, Europe is deeply aware that the way forward is through international and internal strengthening of the eurozone, which is clearly part of Europe's internal monetary and financial agenda. Quoting Eurofi's paper on this topic, the Central Bank official stated, 'The barriers to the euro's global role are within Europe.' These barriers are mainly within Europe, and it is in Europe's utmost interest to progress both inwardly and outwardly.

2.5. Persistent negative interest rates complicate the re launch of the CMU project

2.5.1. The current monetary environment is detrimental, because it is weakening the EU financial industry and discourages savers from investing in long term assets

An industry representative suggested that they had been invited to this panel to play devil's advocate, noting that there is a large elephant in the room. Other panellists had called for 'rock solid monetary union' in order to increase the international importance of the euro, but this cannot yet be achieved. First, Europe needs competent monetary policies. Without competent monetary policies, the euro will continue to go backwards.

The industry representative explained that the current environment is highly detrimental and emphasised the importance of not destroying the euro with 'really stupid' monetary policies. It is impossible to make the euro an attractive international currency if it is not backed by investment, a powerful life insurance industry and a profitable banking industry. But the lasting low interest rates reduce euro-zone banks' intermediation margins and the return on their excess reserves, leading to low bank profitability. The low interest rates severely also affect life insurers first by increasing the actuarial value of their liabilities, and second by reducing the returns of their assets. The very low interest rates also lead to hardship for savers by reducing the interest they receive, and they tend to keep liquid instruments. Such a preference for liquidity diverts savers away from long-term investment. This misallocation of savings and the weakening of banks reduce potential growth in the euro zone. In addition, the yield spread between the United States and the euro zone is leading capital to flow from the euro zone to the United States.

2.5.2. The unconventional monetary policy of the ECB has avoided deflation

A Central Bank official wanted to comment on the international role of the euro and not EU monetary policy, noting however that it is necessary to comment on the remarks on monetary policy by another panellist. The eurozone would be in a very difficult position if it had experienced deflation or if it had not benefited from the positive effects of growth and employment caused by the unconventional monetary policy of the ECB. In such an environment, any discussion about the international role of the euro would be simply impossible. Secondly, two of the least arguable 'safe haven' currencies are the Swiss franc and the Japanese yen, which both have negative rates. The international role of a currency is not directly linked to its monetary policy. The Central Bank official described how they had been surprised to hear an earlier speaker suggest that their preference would have been for bolder monetary policy and the purchase of larger amounts of securities while also complaining that monetary policy is a negative cause of the obstacles to financial integration and CMU. It is impossible to believe both of these things at once. It is not reasonable to criticise the reality of monetary policy if it should have been bolder earlier. The Central Bank official

agreed that the policy should have begun sooner, noting that the monetary policy actions which were taken were what had to be done.

Another Central Bank official agreed with these comments. In reality, there is no single European yield curve but rather 19 separate yield curves. The yield curve of German bonds is different from other curves. The ECB's yield curve is based on considerations of safe assets, which are now mostly bonds. The ECB also published an average yield curve which is not representative of, or useful for, monetary policy. One of the gains of developing a European safe asset would be the establishment of a pan European yield curve. Negative rates are not the obstacle here, however. Sweden, Denmark, Switzerland and Japan also have negative rates. Negative interest rates have not emerged because of monetary policy. The structural conditions in the world economy are important here: there is an excess propensity to save by populations of advanced economies and insufficient private investment, which creates an environment where equilibrium interest rates have become very low or negative in order to restore a measure of macroeconomic stability in these countries.

2.5.3. 'Too little, too late'

An industry representative stressed their desire for more inflation, noting that they had wanted expansion eight years ago. This is too little, too late and Europe has 'screwed up badly'. A Central Bank official observed that it is nothing new for central banks to be blamed. Monetary policy is not a cause of the current situation. The current situation is the result of conditions in the world economy. Central banks do what they must under the current framework; it is important for other actors to do their jobs, especially fiscal authorities.

3. Ways to strengthen the global role of the euro

There is an agreement to recognize that any international currency requires deep, liquid and efficient capital markets. There is no way to develop the role of the euro without a real Capital Markets Union (CMU) and an effective Banking Union. A European safe asset is considered as an urgent necessity. Improving market and electronic retail payments infrastructure is also required. Moreover, deepening the EMU by agreeing on a macroeconomic function (e.g. rainy-day fund) which would not necessary require permanent transfers would certainly strengthen the international use of the euro.

3.1. Europe must achieve a Capital Markets Union and complete the Banking Union

A Central Bank official considered Europe's first priority to address CMU. This could possibly be rebranded as a financing union for investment or an innovation, savings and investment union. The rationale for the CMU must be explained; Europe must seek greater political support for the project. Deeper financial integration is necessary to better foster and use its abundant private savings. On the side of economic union, the key priority is the Banking Union and CMU. These should not be separated; having a common brand for them such as a 'financing union' would be useful.

The Central Bank official stressed that Europe should not oppose a model with banks and capital markets. This mistake was made several years ago. After the financial crisis, people in Brussels sought to move Europe from a bank based model to a capital market based model. However, this is a decision for corporates and investors; Europe's task is to facilitate and broaden choice. While the ECB has been traditionally neutral on the international role of the euro, it has never been neutral on internal financial integration and the CMU. There is unanimity between the 19 governors and the Board, but there has never been enough efficiency to drive the CMU. It would be excellent if Europe were able to use the trigger of strengthening the international role of the euro to strengthen internal financial integration and eliminate the obstacles created by national borders.

Another Central Bank official pointed out that the strengthening of the euro is directly related to the ability of Europe to compete globally, which is highly related to internal integration in many different areas.

Regarding the Banking Union an official stated that its most important aspect is its completion. Of the outstanding elements, Europe must tackle the continuing lack of a European deposit insurance scheme (EDIS) and amend the present rules which create ring fencing in capital and liquidity for cross-border banking groups.

3.1.1. The current monetary environment and Brexit complicates the relaunch the CMU project

An industry representative agreed that capital markets are vitally important. Capital markets make a currency, but Europe's capital markets face two problems. First, the euro yield curve is not going anywhere, which significantly complicates the relaunch of the CMU project. Second, Europe is about to destroy the liquidity in its capital markets due to 'stupid measures in connection with Brexit'. Therefore, Europe is facing a huge challenge not merely due to its less than successful monetary policy but also because it is losing its biggest capital market.

An official noted that Brexit removes a significant market from the European Union, which means Europe must be stronger. Additionally, the official felt that the CMU action plan is too complicated. It has 27 or 28 points; this is too many. No political organisation can focus on a topic unless there is a maximum of six points which can be remembered without briefing notes. This is a big challenge for the new Commission: to develop a short action plan focused on the essentials and to secure commitment from member states.

3.1.2. Europe must act to preserve the liquidity of financial markets following Brexit

An industry representative stressed that liquidity is not created by regulation. Liquidity requires solid institutions, but it goes no further. Ultimately, investors bring liquidity. Liquidity is lost very quickly as a single market is split into smaller markets of roughly equal size. This is why Europe has benefited from London, which is the only European financial centre capable of competing with New York. If Europe cannot develop an arrangement which preserves this liquidity, the banks and the European industry will suffer, and Europe will not grow its capital markets. To have an international and 'truly great' euro which is able to compete with the dollar, Europe must have deep and liquid capital markets. This requires CMU, but that is the smaller problem. The bigger problem is creating the market, particularly as Europe is partially dismantling its de facto capital market. The industry representative suggested that people who work in bureaucracies like to deal with the rules of bureaucracies, but markets are not bureaucracies. They are driven by investors, whose greed drives capital markets. If Europe does not understand this, it will not have a proper capital market – and therefore it will not have a truly international euro.

A Central Bank official agreed that liquidity is partly created by private investors and markets, noting however that in more difficult years these private investors were happy for 'bureaucracies' to provide liquidity. If central banks had not existed and done their duty after the great financial crisis, Europe would not be able to have this

discussion about strengthening the role of the euro. An official suggested that there is one intermediate conclusion to this discussion: the implementation of CMU is the first priority of the next six months of this Commission. This might be 'too little, too late', but large institutions cannot be turned quickly.

3.2. Building a safe asset: there will be no CMU without a European safe asset

An industry representative considered the requirement for a proper European safe asset to be an 'emergency' due to the benefits it would have on stability and solidity within the euro area. This is necessary because the current risk free assets are disappearing. Indeed, the pool of safe assets is now limited to a few sovereign and supranational issuers. Extrapolating from the current state of fiscal policy in Germany, it is possible to plot bund growth in Germany. Given the current level of interest rates, there will be no more bunds left by 2038. There have been fears concerning the disappearance of risk free assets, such as at the end of the 1990s in the US, when there was a feeling that surpluses would reduce the supply of risk free assets. At the end of the 1990s, banks started creating interesting ways to circumvent the lack of a risk free asset. To some extent, this fuelled the behaviours which led to 'some fairly bad consequences' six or seven years later. Europe must build a safe asset to replace the assets it has been relying on for the last 20 25 years. This is what is sending rates into negative territory more so than the impact of monetary policy.

A Central Bank official stressed that the existence of a European safe asset is a particularly clear requirement. This would increase the size of Europe's debt market, which is vital for a greater international role, because investors want to enter and exit markets quickly. A European safe asset can be built without the mutualisation of debts through two principal ways. The first is through so called sovereign bond backed securities (SBBSs). Without a degree of mutualisation in the junior tranche, however, this is a 'zombie idea'. Second, Europe could build a safe asset on the basis of seniority. This would involve a European entity issuing a layer of securities and then passing these funds on to countries with claims that would be legally senior to the remaining debts of member countries. This would allow an assurance of 20 25% of the GDP of the euro area, which means a safe asset size of over €3 trillion. Ultimately, Europe needs political decisions. Treasuries tend to 'defend their turf' and resist solutions that could disturb what they are used to doing. Top political decision making must force the creation of a European safe asset and take seriously the objective of developing a CMU that offers good prices and includes a workable solution to the over concentration of sovereign debt in banks.

Another Central Bank official agreed on the need for a European safe asset. There is no self evident technical solution here, though Philip Lane has done interesting work on synthetic assets. Ultimately, this is so important that it must not be stopped by bureaucratic obstacles or habits. Debt management agencies and private investors have bad habits; Europe will need a collective will to overcome these obstacles. An industry representative expressed their desire to link the point concerning whether fiscal integration is necessary to the ideas around the creation of new asset classes and the potential for a safe asset. Usually, this idea is conceived of as a European super state taking a chunk of public spending from national governments. Clearly, this would be resisted by national populations. Europe should focus on the issues it lacks at a national level what it needs to develop at a European level and areas where national instruments are underdeveloped. There is an obvious area here: green funding. Everybody in Europe knows that there is a need to fund a major increase in investment due to the Commission's ambitious targets on the transition to a leaner and more ecological economic model. This could trigger the emergence of a new asset class, green bonds, with support at the European level and from national governments. This would create more integration and a more liquid market in Europe without taking anything from the sovereignty of nation states.

3.3. Improving EU market and payments infrastructure

3.3.1. Market infrastructures must be improved at the EU level

A Central Bank official considered that one of the architectural issues which must be improved at the European level is infrastructure. Common infrastructure is essential for the strengthening of a currency. In this context, 'infrastructure' primarily means payments. The euro is quite a popular vehicle for payments. One fourth of global payments are made in Europe. Leveraging this could be an important way to strengthen the role of the euro. To do this, there must be a common payments system in Europe. Steps are being made in that direction, including instant payments. The industry is working on developing a consensus here, especially between main market players. Second, payment infrastructure must be open to third countries, if the euro is going to be used outside Europe.

3.3.2. A European strategy for retail payments will be necessary

A Central Bank official emphasised that Europe needs a strategy for retail payments for technological and strategic reasons. Without such a strategy, the European financial industry, especially the retail sector, will be outcompeted by American or Chinese players. This strategy must also have an international cross border dimension. An industry representative agreed on the importance of payments. The payments system in Europe is efficient and integrated today compared to many other payment systems around the world, which is an extraordinary achievement. It is important not to forget the efforts made by the Commission, the private sector and the ECB to achieve this. Europe is not one country, and payments are a very domestic issue. While it is in a very good position compared to many other economies, Europe cannot simply do nothing. Initiatives such as Libra demonstrate that the world is changing incredibly quickly. It would be wrong to suggest that Europe can rest because it is in a good position today. An official agreed, noting that without an extremely efficient payment system the challenge of crypto assets will be much stronger. Another industry representative disagreed, however, observing that the United States has the most out of date payment system of any country while having the strongest and most powerful currency.

3.4. Deepening Economic and Monetary Union is essential, but it could take a very long time

3.4.1. This is a difficult issue

Europe has no common fiscal power, and it will not have this in the coming years. However, there are some fiscal rules contained in the Stability and Growth Pact. This Stability and Growth Pact has many drawbacks, but it also introduces some appropriate limitations in terms of excessive deficits. There does need to be further discussion about whether this should be slightly more symmetric, which is essentially the aim of the so called macroeconomic imbalances procedure. Europe has a common monetary union with great gains for everybody, but there are still separate fiscal powers. However, there should be common rules on both sides (for member states with unsustainable surpluses and deficits). This difference causes a risk when

some countries introduce overly restrictive fiscal policies which are inconsistent with the common monetary union.

3.4.2. A genuine monetary union does not require fiscal union but a macroeconomic stabilisation instrument

The fiscal debate is another difficult topic. A Central Bank official stated that monetary union does not require fiscal union and a high degree of budgetary integration. However, a macroeconomic stabilisation is necessary at the Eurozone level. The stabilisation instrument could be a 'rainy day fund'. It is substantial, but this does not imply full fiscal union or even permanent transfers. A Central Bank official explained that, historically, all unions take time to integrate. Taking the example of the US, it started as a confederation and then became a federation over 200 years. Europe needs more time. An official agreed with these remarks. 2012 was a landmark year in the sense that Europe decided to try to achieve Banking Union. The official reminded the audience of the words from the famous speech, 'Whatever it takes. The euro is irreversible.' Europe must now have the same kind of breakthrough for the CMU. An industry representative considered it fascinating that so many people in Europe point to the idea that monetary union requires economic union and a heavy integration of fiscal policies, when fiscal policies do not matter anywhere. The industry representative admitted that they are an 'unreconstructed Chicagoan', expressing the need to make a 'more fundamental sort of poly etiological comment': economic policy is up to the people of Europe. Europe is made up of sovereign powers, and they have sovereign power over their budgets and fiscal policies. For this reason, it will take an extremely long time for any real integration of economic policies, because the populations within Europe are not in favour of this. The most important task is to fix the problems with the euro which emanate from recent monetary policy decisions.

3.5. A reserve currency should offer remuneration, which is no longer the case in Europe

A Central Bank official noted that a reserve currency must be stable, adding however that it is also necessary for a reserve currency to offer good remuneration for those who invest in it. An industry representative considered that the ECB has ensured the stability of the eurozone as a construct while diminishing its attractiveness as an investment vehicle. While this might be an optimal solution, a fundamental element of being a reserve currency is accepting investment from the rest of the world. Negative rates send the message that a currency is not interested in this investment, even for non-profit seeking reserve managers.

3.6. Sovereignty and immunity are necessary but not sufficient conditions for strengthening the euro: Europe must also become a political and military power

An industry representative highlighted the importance of sovereignty. Sovereignty and immunity are very important in the context of coercive measures and sanctions. It is possible to have sovereign control over an economy or a currency if a country is closed off – such as North Korea, or perhaps Great Britain – but financial, economic and military giants impose their will on others through their currency. It is possible to imagine a future world in which international currency usage is divided by three, reflecting the three major trade blocks of euro, RMB and dollar. In this very happy future, these three financial systems would be heavily interlinked, which means that any one of the three can impose its will on the other two, short of those other two uniting against the third. To that extent, growing the euro's international usage to be one of these three does not bestow on it this immunity. Europe must be more ambitious and ensure the euro displaces the other two currencies and any other currencies, becoming a primus inter pares like the US dollar. When there has been a single supreme currency historically, it has also been accompanied by military supremacy and significant patronage or colonisation. While the ECB may have demonstrated its ability to 'wield a bazooka' handily, this 'bazooka' will not take the ECB and the euro to this point. Sovereignty and immunity will not be enough.

Improving capital allocation across the EU

The Chair stated that the issues for discussion are well-summarised by the Eurofi background note, which documents the EU productivity weaknesses and its financing gap and examines the role of a risk-taking culture and whether Europe lacks one. The first issue for discussion was to explain the investment and productivity gap between the EU, the US and Asia. The second was to consider the role of policy, and priorities for policymakers, in improving the investment climate, while addressing growth areas and the digital economy, where the perception is that Europe needs to catch up.

1. The investment gap between the EU, the US and Asia

The panellists considered the current situation in the EU compared to its competitors and the underlying causes of existing conditions.

1.1. The facts

Corporate investment and productivity gains are higher in the US and Asia than in the advanced countries of the EU. The EU is falling behind the US and China in economically and geopolitically essential technologies. Europe is home to only 16 unicorns[1], versus 91 in the US and 44 in Asia. The 15 largest digital firms are American or Chinese. In this context, European success will necessarily entail a shared strategy.

A private decision-maker advised that the EU is home to 7% of the world's leading technology companies. In 2016, European private investments in artificial intelligence (AI) amounted to approximately €3.2 billion, compared to almost €10 billion in Asia and €18 billion in the US. In 2018, China attracted almost half of the 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.

A public decision-maker disagreed that there is a European investment gap. Corporate investment in Europe is as expected, considering demographic trends and the share of less capital intensive sectors such as the service sectors and digitalisation as a proportion of gross domestic product (GDP). This reduces the equilibrium rate of corporate investment to GDP, so is a specific problem. One pressing issue is the breakdown of cross border capital flows at a local level in certain countries.

A private decision-maker noted that the world is different from that of 11 September 2001, yet challenges remain. New technologies face the challenge of an interconnected global economy, with a web of contracts,

production and consumption chains. Comparisons between regions, cultures and markets are difficult and often simplistic but in the context of innovation, the cultural, linguistic and commercial realities include the different legal and regulatory frameworks of China, the US and Europe. Geography is no longer necessarily destiny. Investment in innovation should transcend traditional cultural or structural differences, which inhibit foreign direct investment (FDI) and local investment in Europe.

A market expert stated that the lagging situation of investments in Europe compared to other regions is a problem for the future of an economically independent Europe, as it concerns new and intensely technological activities. These are key to the future competitiveness and social equilibrium of the region.

Financial philosophy recognises the lack of accumulated investment, as demonstrated by the Juncker Plan's success. It needs a coordinated approach to help organisations such as the European Investment Bank Group (EIBG) use a guarantee to leverage or tap the market, and this has helped create €430 billion of new investment in close to 1 million interested firms in three years. This was achieved via local platforms and the EIBG, which is vital for creating a better regulation environment for firms. Innovation often emerges from the existing regional ecosystems of European countries. This early success preceded the vital InvestEU project, to be introduced in a future budget.

The last 70 years have had an automatic-pilot concept of Europe, where words speak for themselves. There is no government but governance. The direction of travel is towards improving strategic sectors but it lacks a shared view of the long-term destination. This is a key priority for the new Parliament and EU institutions.

1.2. Underlying causes

1.2.1. Markets are more flexible and the role of the state in economic life is less important in the US

A private decision-maker stated that firms operating in the EU face a higher tax and compliance burden than in the US, Japan, Australia or Canada. This reduces their competitiveness in global markets. A focus on education and training is needed, as is an attractive, sensible policy, regulatory and legal framework, including appropriate tax incentives and competition policies to enable Europe to develop and maintain a prominent global position in the industries of today and tomorrow.

1.2.2. The absence of a European industrial strategy

A private decision-maker noted that the EU currently does not have an agency like the US Defense Advanced Research Projects Agency (DARPA). The European Investment Fund (EIF) has made a good start in providing finance for small and medium-sized enterprises (SMEs) through: private banks and funds; the European Fund for Strategic Investments (EFSI); InvestEU, focusing on sustainable infrastructure research, innovation and digitalisation, SMEs and social investment and skills; VentureEU, which aims to boost private VC investment and innovation in Europe; and the European Innovation Council (EIC) a pilot project under the Horizon 2020 EU Research and Innovation Programme planned for 2021. These are not close to the DARPA initiative. The UK had a similar Defence Evaluation and Research Agency, which was privatised in a heavily criticised deal. It now has the Defence Science and Technology Laboratory, which has some similarities with DARPA but is much smaller.

A market expert agreed that vital progress has been made in the strategic defence industry due to the dual innovation process. Europe is starting to understand the importance of facilitating innovation from military to civil industry and changing its original defence approach.

A private decision-maker considered European investment in AI initiatives fragmented and inadequate for promoting ideas to maturity and commercialisation. Europe acts as an incubator for the US and China, which must be addressed urgently. The development of machine-learning, AI and robotics is unstoppable. There is the question of who will write the music and who will conduct the orchestra. It is obvious that it is easier to start and operate a business in the US than in the EU since in the US, capital is more readily available, markets are more flexible, risk-taking is encouraged, and failure is not as newsworthy as in the EU or Asia.

1.2.3. The financing gaps in European risk capital markets

A public decision-maker stated that financing problems in European capital markets drive early-stage and growth-stage companies to non-European – US and Chinese – investors to meet financing needs. Skype, Minecraft and Beddit are all cases of great ideas born in Europe but bought up by the likes of Apple and Microsoft when the time came to move to the next stage in their development.

These financing gaps have three causes: a lack of funding; regulatory fragmentation across the EU, which hampers cross-border investments; and the risk-averse nature of the European investor. There is no quick fix for improving innovation financing, but there is much to be done, and the public sector can play a pivotal role.

A private decision-maker noted that Brexit will likely affect EU innovation financing. Around one third of the EU's AI activities take place in London. In 2019, the UK's investment in AI was almost equal to the rest of the EU combined. The EU must define and strengthen its relationship with the City of London.

1.2.4. Specific issues experienced by Japanese companies

An industry representative stated that Japanese companies often struggle to find employees, particularly good managers. One reason might be lack of familiarity with the Japanese company ethos. Japanese corporates are deeply concerned within expectations of long term loyalty to the company. They invest in intensive staff training on this point, so there is a cultural mismatch there. There is also an information gap. At investment seminars, Japanese investors demand accurate and detailed local information, as most have never visited Central and Eastern Europe (CEE). However increasing cultural understanding and information exchange should overcome distance and further enhance investment.

A private decision-maker considered that, despite geopolitical turbulence, Brexit and economic inequality, there is a consensus towards cooperation at the institutional level. Christine Lagarde's speech before the Parliament urged rich eurozone governments with low deficits to bolster their crisis-fighting capacities by spending money to address populism and the inequality gap. Central banks should not be the only game in town.

2. Policy priorities for improving capital allocation across the EU

There exists a range of priority policy areas able to address the current funding shortfalls in the EU market.

2.1. Defining and implementing an EU investment strategy

A market expert agreed that any discussion of future sectors must include unicorns, digital and AI. It must also include a sustainable transition to a greener economy. The President-Elect of the next Commission showed

an organigram with two feet: digital and a new Green Deal. The expectation after the euro and Lamfalussy process was for smooth-sailing and a cross-market to follow. Then came the crisis. The situation now shows more cross-border regulation, resulting in fewer cross border operations.

Confidence is a problem but, as it contains elements of sovereignty in banking or financial markets, it has been difficult to move on harmonisation for cross-border products or institutions. Both were tried and the same kinds of obstacles arose in each. Symbols of this was the discussion on the Capital Requirements Directive (CRD), the Banking Union and Capital Markets Union (CMU) – including the Pan-European Pension Product (PEPP) – and the European supervisory authorities (ESAs) review.

The challenge for the next Commission in the banking area is to remove the divide between the home/host debate and proportionality. A recommendation from Mario Draghi is about dealing with the architecture of the financial and banking sector within the EU. This will be difficult.

Furthermore, the new Commission should implement a horizontal, consistent strategy to favour investment with a comprehensive understanding of the future challenges. It must: make full use of InvestEU to build bridges with the use of structural funds; ensure a strong implementation of Horizon Europe for which the EU Parliament has requested a budget of EUR 120 billion over the 2021/2027 period from the next multi-annual financial framework; a review of the Stability Pact to include a capacity to drive investment and define the eurozone's proper fiscal stance, and for member states to use the currency's stability to support long-term investments; to utilise lessons from national promotional banks (NPBs) in re-launching the CMU, to ensure that long-term investment thresholds in green transition and digital education are met and to avoid speculation; to have a fresh look at the taxation biases favouring debts towards equity; to correct existing imbalances, especially between the north and south of the eurozone; and to consider a carbon tax as unavoidable in creating incentives for market investment. It requires a courageous answer to counterbalance potential unfair social impacts.

The Chair asked if a forceful implementation of the EU services directive could make Europe into one bloc. A market expert advised that it should not be the cornerstone of a single market. A public decision-maker agreed that there is support, but it will not be key to transforming the views of Europe or unlocking the issues under debate.

2.2. Restoring capital flows within the EU

Europe competes against the US and China, which benefit from large, relatively homogeneous markets. Data shows that financial integration 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.

The Chair asked if the eurozone's decline in cross border capital flows – particularly since the sovereign-debt stresses, despite work done in its public and private-sector balance sheets – is a different problem and whether a slowdown will follow until balance-sheet problems are addressed. A public decision-maker stated that it is disappointing. Much has been done to overturn the financial crisis' stresses, but clearly the work has to be completed. A debate is scheduled for the Economic and Financial Affairs Council (ECOFIN), with a discussion on rebooting the CMU, which anticipates giving input to the new Commission.

The issues relating to innovative parts of the economy such as research and development (R&D), the digital economy and unicorns are separate from capital flows. The CMU and the Banking Union relate to the mundane corporate investment that keeps the economy running while creating unicorns is a different discussion. There is work to be done on the Banking Union and the CMU. The obstacles are known but overcoming them is not easy. Roadmaps are being drawn up, so hopefully one of them will lead to the right destination.

An industry leader welcomed the EU's ambition to accomplish the CMU and unlock the full potential of the single market. The EU is 28 markets with 500 million people, versus the US's single market with 320 million people. The EU market is fragmented culturally, politically, linguistically and, crucially, regulatorily, so it cannot be as agile and decisive as a single national government. The EU may benefit from removing barriers to attract greater investment from third country investors, and reducing regulatory fragmentation. The creation of a single EU securities exchange as part of the CMU will increase harmonisation and be aligned with the US approach.

A market expert stated that spreading investment between the north and the south of the EU cannot be ignored. InvestEU tries to address these challenges. It is a legacy from the Juncker Commission and will need to be followed up by the next Commission. InvestEU begins to answer the need to bridge public and private money to leverage investment. It ensures that there is a good network with the EIBG and NPBs.

Eurofi's background paper for this session notes the proposal from Jacques de Larosière and others for a European savings and investment fund. The PEPP is not going to be this. It was an idea, but the delivery is not there. This product will not be a real cross-border solution for long term and innovative investment.

2.3. Boosting European capital risk markets

2.3.1. A quantum leap for private equity and venture capital is urgently needed

A public decision maker noted that there are many potential actions, some of which are partly in hand. Market feedback is crucial, so hundreds of funds have been consulted, with replies from over 300. The answers are telling. The first question was whether the public sector should be there and what it should be doing. The answer was positive beyond expectations. It is catalytic and has an important signalling effect. Public money should not be squandered but, in areas of market failures, it is vital that the public sector should be present.

Institutional investors should be reached out to. However, the sentiment on achieving this is pessimistic. Funds and ticket sizes are too small. Investors in Europe, Japan, Vietnam and South Korea have been contacted as part of a policy steer, which is something that should happen systematically in the context of trade arrangements and missions. The problem is not about the EIF making a difference but one of putting Europe on the map. Large funds such as Softbank or Mubadala may be well-informed on European VC opportunities but other institutional investors look to the US and China with more interest. The starting point is making the case for the valuable business proposition and investment and the performance paradigm in Europe.

A Japanese pension fund with 1 trillion of assets under management will not want an exposure to one

region, or even one country. They want an exposure to Europe. They want diversification, with different vintage years and stages. The regulatory framework is important. Private money will not invest in unfamiliar structures. European fund structures do not exist. There is one for each country and the result is that they turn to Jersey or US structures. Much time is spent on taxation and there are reputational issues in this. Ensuring that there is no tax evasion or avoidance is vital but having 27 different regimes makes things difficult.

Investors do not only look only at good returns. That is a precondition, but they also look at solid monitoring, environmental, social and governance (ESG) issues, and non-financial returns. Talking to sovereign-wealth funds is about cooperation as well as money, as with NPBs, and ensuring knowledge transfer. These discussions occur with Asian and Middle Eastern investors and are key issues.

The strategy must overcome fragmentation. It has begun in early-stage venture capital (VC), where prime-market failures exist, but this is not enough. Continued focus here to the exclusion of later stages means missing the growth finance question, which means becoming an incubator for other industrialised nations.

A holistic view of companies' needs is vital and must start earlier. There is a good research and innovation base but a problem with commercialisation. The European Innovation Council is a useful bridge between research and the pre-seed/seed ecosystem. It is time-intensive and involves data review and information clustering. The later stage where companies scale up is critical, as is a corporate or industrial perspective that identifes disruptive technologies for the whole funding chain, including climate change. Clean tech is equally vital. Companies must include funding for tomorrow, with attention focussed on industrial sectors which may have the industry of the future. Good policy papers exist, but pooled money is critical. A shared vision of the destination is crucial, as is pooling resources to achieve critical mass, with the right support. This means pooling together EU, national and regional funds as well as attracting private resources. It is not about throwing public money around but creating layered structures with risk-return profiles for private money of significant size.

2.3.2. Fostering and encouraging cooperation where the EU is lagging behind

The Chair asked for the Commission's thinking on these issues, and how to increase capital flow between countries, as well as for comment on the need for a European investment fund, be that a Norwegian-type sovereign-wealth fund or a savings fund larger than existing initiatives.

A policymaker considered it a funding problem. Much has been said about VC. The VC markets are concentrated and functioning well in France, Germany, the UK and Luxembourg, but a large part of Europe consists of flyover states. More states need ecosystems that facilitate matchmaking between investors and entrepreneurs. VC is about trust, so when bringing a project to investors they will invest in the people as much as in the project itself. They need to meet each other and to build trust.

Scaling up is a key issue that has been discussed by the Commission and the EIF many times. The instruments focus on seed and early stages, so when companies become profitable, they cross the Atlantic. Europe takes the risk and other regions take the profit, which is not the best division of labour. Europe cannot afford to be the incubator for other industrial countries. Efforts have been made to build instruments on a test case in the current multiannual financial framework (MFF) to support scaling up, but more needs to be done.

Mentalities are also an issue. Previously, countries prohibited the CEO of a bankrupt company from holding a chequebook for 10 years. Financing in Europe depends on banks, not an optimal VC financing mechanism, as banks are exposed to the downside and not the upside in making a loan. The VC model of financing 100 companies, having 90 fall and profiting from 10 is not suitable for banks, so more initial public offerings (IPOs) are needed. The current MFF can build instruments to support marketing financing via IPOs.

Europe is active and the EIF is doing an excellent job. The next MFF will have InvestEU with a €650 billion target, VentureEU with €400 million and the EIC financing disruptive technologies. Other actions are also needed. Regulatory fitness checks are key to ensure that obstacles to innovation are not created inadvertently. The bulk must come from the private sector, beyond public investment.

It is vital to foster and encourage cooperation where the EU lags. This has been tried for important projects of common European interest. 40% of the value of electric cars comes from the battery and 85% of battery production is in Asia, so Europe must catch up urgently. The EU has created a European Battery Alliance, to develop cooperation in this field. That is an example of the kind of cluster approach that is required.

3. Towards an EU Sovereign Wealth Fund?

The EIF thinks it is big because it is the main fund of funds for VC with a policy mission in Europe. Asia has funds that are 100 times bigger. The lack of a sovereign-wealth fund is a problem, to address tomorrow's pensions and support Europe's future industrial competitiveness. Norway has one; Europe does not.

A policymaker advised that a European sovereign-wealth fund and other ideas have been floated. The possibilities for financing within the context of the next MFF are limited. Money cannot suddenly be found that has not yet been identified, so progress in this direction will need to be made primarily by associating member states on a voluntary basis. The Chair understood that any EU-wide sovereign-wealth fund will be outside the MFF and will be an EU member state's initiative. The Chair asked for views on investment and following the comment that Norway is doing well, asked why Europe cannot do the same.

A market expert agreed that it sounds good. The question is how to do it. It is out of the question that it can be done in the MFF. MFF and programmes such as Horizon 2020 are key to the topics under discussion. It would be good to follow Parliament's proposal, which is quite ambitious for Horizon 2020. A challenge for this discussion is that the last Commission started a discussion on a sovereign fund. It cannot be done in the MFF, so must be done among the member states. The problem is how to get them to agree to it.

A public decision-maker responded that if there is a European corporate investment gap, the US's is larger, as shown by comparing the numbers and demographics. The US should have a higher rate of corporate investment than Europe, but does not. The UK has a dismal rate of corporate investment, so functioning capital markets are not an automatic solution to unlocking it. The Norwegian fund is not a tool of industrial policy and does not invest in Norway but abroad, so it is not a perfect example.

The need for a European fund focussed on late-stage VC has been identified, but this is a difficult area to work in. It may not be possible to build the structures to enable the running of such a fund on a purely commercial basis without national industrial-policy interests intruding. This would be an immense challenge and a difficult one to handle. The EIF is doing a great job but this would be far more difficult. A market expert considers it to be excellent, given that households are risk adverse. An ageing population likes bonds, not shares, and so a transformation system between bonds and shares is needed. This is the main utility of a sovereign-wealth fund.

4. Attracting global investment in Europe is fundamental

A private decision maker noted that we are a Japanese bank operating in Europe since the 1950s, and is active in supporting Japanese companies to enter the European market. Japanese financial institutions played a key role in providing liquidity for the EU economy.

Reviewing Japanese stock FDI, the European share is 27% versus 30% in the US and 28% in Asia, so there is not much difference between them. This is surprising, as Europe is distant from Japan, while Asia and the US are thought of as neighbours across the water. The US and China are huge single markets whereas Europe's borders and local regulations are fragmented, although it is trying to unite.

If the investments made over the last three years are calculated on a flow basis, the aggregate figure for Europe is 37% versus 24% for the US and 21% for Asia. Europe has become a larger destination for Japanese investment as Japan tends to acquire high-value-added companies, such as pharmaceuticals or electronic and technology companies. CEE is a candidate for manufacturing companies that continue to invest in their facilities, although logistics and infrastructure weakness is a potential barrier.

The EU is an important global partner for Japan, and it is expected that the EU will be able to attract more investment, by utilizing the EU-Japan EPA. Financial institutions would play an important role in promoting investment in the EU.

5. An EU industrial policy is required

A market expert considered it vital to be conscious of the speed of technology. It is not about creating a basis for investment. The problem of the basic manufacturing sector has been dealt with through the EIF, local platforms and maybe a sovereign-wealth fund. This is the first stage of an industrial policy.

The second problem is a lack of means and tools. Europe does not have the necessary technology to finance the giant technology platforms, given their vast financing needs. A long-term strategic view is needed and is a critical political matter. The Commission and member states have the competencies, but do not have a shared view. As noted by another panellist, corporates do not have a long-term model, so there is no trust among corporate investors or managers on the destination. This is a key task for the new Commission.

A policymaker noted that a holistic industrial policy is vital, which means marrying finance, research, industry, competition, trade and education. The necessary labour force skills must be developed through upskilling and reskilling. The efficient functioning of the internal market is key to allowing companies to grow. It is not mission accomplished when only one third of European businesses trade in another member state and only one in 10 companies have made a purchase or a sale in another member state. There is potential that needs to be tapped further. Geo blocking is an issue in many sectors.

Competitors do not always play a fair game: China is hands-on on all fronts; Japan has a strong industrial policy; and the Trump Administration uses trade policy to push its industrial-policy agenda. Existing rules must be reviewed to see if they are fit for purpose. A delicate balance will allow companies to reach a critical size. Competition is key to fostering innovation, so dropping competition rules would be stupid.

Conducting an industrial policy is easier said than done. The public sector is not good at picking winners or making the right support decisions. France was once ahead of all other countries in spreading digitalisation to a large public, with a terminal called Minitel, which offered online services. The intention was good; the technology was wrong. Authorities' efforts should support the development of the sector rather than a given company, and decisions should be sound and integrate market views. This has been built into instruments in the Juncker Plan and in InvestEU. Support decisions are not taken by the Commission or by the public sector, but by an independent investment committee composed of market experts who do not pretend to have superior knowledge. The primary focus is to encourage innovation. There are also interesting national initiatives, such as the Joint European Disruptive Initiative (JEDI) launched by France and Germany. Clearly more JEDIs are needed to win that war.

6. Rethinking competition policy and how it can support an EU industrial policy

This policy was first targeted to oppose monopoly but in a more complex world trade environment the debate has emerged on how EU competition policy should favour EU stakeholders vis-à-vis global competitors.

A market expert advised that competition policy is one of the Commission's strongest tools for influencing the EU market. It is a cornerstone of this strategy. Competition policy in a changing world means that Europe cannot remain naïve and not move. Member states have ambitions and sometimes use the European level to defend national interests. There was a huge reaction when the Commission opposed the Alstom and Siemens merger. There are good arguments for the decision, although the Chinese are entering the German market. A common understanding of modern competition policy is crucial.

A less orthodox idea is that the EU is good at contributing to a global debate and has the capacity to be creative, as with the Copyright Directive, which is unique at the global level and was invented by Europe. It is not fixed and was not easy, but it matches the real world. It could be an advantage for the EU to evaluate competition at a global level and create tools that allow for it. Another field is the High-Level Expert Group (HLEG) and green finance. There is a need for that and, if invented, it will influence world competition.

The Chair asked for a last word on competition policy. It is about what a level playing field looks like in the current world. A public decision-maker agreed that competition policy is one of the great successes of the EU and care should be taken when fiddling with it. Finland is starting a political debate around building high-speed rail lines. The idea that perhaps Alstom and Siemens will

participate in those projects as separate bidders brings relief compared to the alternative. It is difficult to create winners without picking winners. It will be difficult to create a completely level playing field in this sensitive, murky, high-risk area where most projects fail, and a few are great successes. This is not something that naturally fits into the EU policy framework, so it will be curious to see how it can be made to work.

A public decision maker advised that it is vital to be clear about the aims for tomorrow, with Europe leading or having a meaningful place. That does not mean that colleagues at the Commission or the EIF will pick individual companies but should go through a field-proven indirect, intermediated scheme with the private sector. It will be highly selective, so a fund could have two high-fliers, four that struggle through and the rest that fail, as is the case in the private sector. This is the type of system that is being considered.

[1] Private companies with a value of at least $1 billion.

Adapting EU legislative processes

1. The European legislative process is not appropriate for developing competitive and efficient financial markets

1.1. The process is too slow and delivers complex frameworks

The moderator asked the panellists to discuss the weaknesses of the current EU legislative process before coming to some concrete proposals and whether this legislative process is adequate for dealing with innovation in the financial sector.

Indeed, the current EU legislative process is often criticised as being too slow in delivering, especially when it means a directive with its usual two-year transposition deadline. There are often too many detailed requirements put in level one legislation, which complicates further necessary changes. In other cases, too much leeway is given to national transposition of European directives, or too many national options are offered in Regulations: this creates a regulatory patchwork within the EU. Such shortcomings, which often result from an opaque negotiation process between the co legislators, limit the flexibility, agility, adaptability and proportionality of EU legislation. This is particularly detrimental in the financial sector, where it is essential to tackle ongoing substantive innovations and worldwide competition.

A regulator agreed with the current shortcomings in the legislative process. It does not keep up with the environmental and technological innovations. It would be notably useful if the European supervisory authorities (ESAs) could give an opinion on whether the existing financial legislation also applies to new innovations, because all too often there are grey areas and uncertainty between countries. It is important to have a consistent application of EU legislation in member countries. More cooperation is also needed with the ESAs and the legislators in developing an EU level approach.

1.1.1. Complexity of the process

An industry representative stressed that the current process in Europe is too slow because it is too complex. Level 1 texts should set out general principles. It would be beneficial if the legislators legislated, the regulators regulated, and the supervisors supervised. Everybody needs to stay within the remits of what their responsibilities and legitimacy are.

The balance between the European level and the member states is more political. The main reason for the split was subsidiarity, so what should be done at the European level is what cannot be done at the member state level. But 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; this puts pressure at the European level to try to act fast, otherwise it is first come, first served. Moreover, Europe should try to find guidelines that should be set at the European level, and those that concern domestic targets, like in retail banking, could be done locally.

1.1.2. Reasons why the process is too slow

A regulator believed that the pace and efficiency of the legislative law making process is not fast enough anywhere in the world. The issues with the European process are exacerbated by the size of the market, the differences between local, national markets, and the number of stakeholders involved in the process. Europe should not struggle for the law to be ahead of reality; this will not work, especially in the field of innovation. The national legislators are naturally positioned to be quicker in their interactions with the markets. In fostering innovation, the floor should be given to national legislators in the areas of stability and customer protection.

1.1.3. Limitation of innovation as a result of the process

A regulator was not convinced that there is a split between the national and European level with regard to innovation. Regarding securities tokens, which could be a massive innovation in the future, it is not possible to develop them in the current European framework. It is clear that in some cases innovations can be developed on a national basis and then be proposed to be taken on board at the European level, but in some cases the European framework prevents innovation. There is therefore a need to bring some more flexibility to this case.

Regarding the EU level approach to innovation, a regulator stated that the European Securities and Markets Authority (ESMA) issued an opinion regarding crowdfunding in 2014, and the Level 1 text is not yet there. That means that many countries have drafted their own legislation. The ESAs should be given more powers; they cannot be given the powers of initiative, but they should be more vocal vis-à-vis the European institutions in assessing the need and priorities of legislation. Better interaction between level 1 and level 2 negotiations is also needed.

1.2. Subsidiarity should be promoted except with regard to financial stability and consumer protection

A regulator explained that EU legislation has its advantages over national laws mainly in terms of the safety of financial markets, especially in the areas of stability and consumer protection. This approach reduces the risk of unhealthy competition between member states which may be tempted to come up with solutions that do not

provide sufficient protection of client interests and result in a regulatory arbitrage. A regulator also felt that Europe should go back to the subsidiarity principle that another speaker mentioned. The area of laws that are intended to foster innovation in the financial market or to enhance innovation in the market should be naturally left with member states as a general rule. One reason is that the member states' legislators and regulators are closer to the markets, so their reaction may be quicker. The timing at which they receive signals from the market or customers will be typically shorter and may be more responsive to the needs of the local market.

The local markets in the EU are still quite diversified in terms of the role of innovation. There are financial markets where the traditional, largest banking players are at the cutting edge of technology. That has an impact on the fintech industry and on the level of financial innovation. Room should be left for national legislators, but with the caveat that EU legislation should step in on matters like financial stability and customer protection; those are indeed the two areas where there is a clear risk of potential arbitrage or race to the bottom as part of competition arising between member states.

1.3. The Lamfalussy process remains fit for purpose

The panellists agreed that getting consensus for legislation that works for 28 countries takes time. The Lamfalussy process remains fit for purpose but only if legislators and regulators are disciplined in how they apply it.

An industry representative stated that the European legislative process is one of the most interactive, stakeholder engaged legislative processes in the world. It is about getting consensus for legislation that works for 28 countries. It takes time to make sure all stakeholders have the opportunity to engage. Constant balancing is needed between the big picture objective and the detail that is required.

An industry representative added that in the immediate aftermath of the financial crisis there had been a tsunami of financial regulation, and people worked on many dossiers at the same time. When there are politicians in a room deciding something then the outcome will be different from having a group of regulators in a room putting together a structure on a technical competence basis. The Lamfalussy process works if it is adhered to; if the definitions of the levels are respected, then it could be made to work much more efficiently. Different pieces of legislation have had different outcomes; there will be blurring around the edges when it is a highly politicised file. There are some that are technical, such as the Central Securities Depositories Regulation (CSDR) and the Securities Financing Transactions Regulation (SFTR). Those two files were highly technical and there is much more of a division between levels one, two, three and four than there would be in MiFID, which is highly politicised and was a text not compromised.

An industry representative stated that European legislation has a great deal going for it, but the concern is that the European Parliament does such detailed levels of analysis that institutional memory is lost when people move off files. When the negotiating team changes, the question is who has the institutional memory to move that scrutiny forwards. Regarding CSDR and SFTR, it is uncertain how many current Committee on Economic and Monetary Affairs (ECON) members would know what it fundamentally addresses.

2. Proposals for improving the EU legislative process

2.1. Restoring discipline in the EU legislative process

2.1.1. Re-establishing a clear distinction between Level 1 and Level 2 will allow innovation to flourish

An industry representative believed that 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. 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 the detailed rules at Level 2. Keeping such detail at Level 2 allows the regulatory bodies to respond more quickly to emerging market trends and risks, and to innovation and technological advance. Clear separation has rarely been maintained. It would be a good start to agree that no Level 1 legislation should include data, numbers, formulae or thresholds, or anything that requires calibration on an ongoing basis. If that rule is respected, then the supervisors and the ESAs would find it much easier to do their job based upon evidence and data.

A regulator stated that Europe can improve the legislative process. The deposit guarantee scheme is a good example; sometimes Europe harmonises technicalities but does not unify the underlying principles. That is the problem that can be identified in some of the pieces of European legislation; there is no political will or readiness, but for the sake of some sort of harmonisation technicalities are harmonised. This is not the optimal solution. The law making process could be amended and improved by following the original Lamfalussy principles more strictly than they are being followed after some years of development.

A regulator added that he fully agreed with the trend to strengthen the Level 3 tools that can be given to the supervisors or regulators as part of the accessibility and subsidiarity idea, which may bridge the gap between EU legislation and ensuring a minimum standard or minimum level playing field at the European level, while also leaving a reasonable leeway for national authorities to react or adjust in case such adjustment is needed for the greater good.

An industry representative believed that his company faces some challenges in the legislative process in Europe. An improved balance between the different levels of the legislative process is required. 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 to 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.

2.1.2. Setting up impact studies systematically before the legislative process starts would improve the legislative process

An industry representative requested that the Commission should have more calls for evidence ahead of a draft legislation. There are issues in MiFID that the European Parliament struggled to find data on, and if they had asked for that data from the industry before the process started there might have been a better outcome.

It would also be beneficial to see true impact studies before the legislative process is started, and also during it, if there are significant changes being proposed during the

process. Consistency checks, progress reports and interim monitoring of how the legislation is bedding in are needed. Where there are problems, an instrument is needed that allows people to go back in and fix it quickly. Sometimes a 'quick fix' is slipped into another dossier which has not been scrutinised by the stakeholders, and thus should be stopped.

2.1.3. Involving the ESAs in the trialogue is not an appropriate proposal

A speaker noted that trialogues are often not a pretty process, and some are better than others. The industry would recommend a developed, core set of principles on consumer engagement, and that those core principles should be used as a benchmark for reviewing the text.

An industry representative thought that it would be helpful for the ESAs to be present in Level 1 trialogues; they can be silent members, but they would get a granular feel for the interpretation that can help in terms of developing guidance.

A regulator noted that the trialogue is already very complicated to manage. There is a problem concerning the involvement of the ESAs at some point but putting them in the official trialogue process could be challenging, and to some extent everyone has to take responsibility for their actions at some point.

2.1.4. Members States should take a little more care about their last minute requests

An industry representative stated that when there is a highly politicised topic the Lamfalussy process becomes much more blurred. Most of the things that cause issues tend to come from member states, very late in the day as red lines, and tend to disturb the entire balance of what has sometimes taken years of compromise. If people start fundamentally changing things at the very last minute and there are no regulators in the room to ask what the consequences are, then it is inevitably going to end up with a less precise piece of legislation. Member states should take more care about their last minute requests, because that often changes everything.

In the last decade much of the legislative agenda has come from outside Europe, such as the derivatives markets legislation. When the European Parliament tried to implement a global agenda within Europe; it always had to look to other regions around the world that were moving slightly quicker in their implementation than Europe, due to the latters very careful process. For subjects like market infrastructure legislation, much of those come from global bodies like the International Organization of Securities Commissions (IOSCO), so Europe needs to stay in line. If its infrastructure does not follow global standards, then it will be heavily criticised.

2.2. A much more holistic legislative strategy is needed

An industry expert explained that Europe needs a strong policy vision and a coherent narrative to develop capital markets in Europe and deliver long term benefits for Europe's citizen-savers. Europe needs to democratise investment, and it can do that by looking at the legislative approach and the sentiment that underpins that approach. There are numerous EU directives and regulations, which do not match the reality that consumers face. The legislation in Europe is a whole mass of individual products and services and today end-investors' needs are lost between myriad siloed products 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. This creates frustration with the distributor and the end client. It also means that, as these are different pieces of legislation, policy focus is channelled into siloed and technical debates, each with their own dynamics and controversies. This diverts the attention of the policy world away from the core ambition, which is to get more retail investment into markets for their good and for the good of Europe.

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. Capital markets have a role to play in channelling investment into sustainable economy and infrastructure that can help productivity and innovative companies. From an asset management perspective, the US is a huge retail market and Europe is not. Most European consumers keep their money in deposits or in property, which impacts the productive and innovative capacity of the economy. Such a vision cannot be delivered without a far more holistic legislative strategy.

Regarding the intention underlying the investment, sometimes the approach seems dangerous and companies need to protect their consumers from investing. Consequently, it gets more technically detailed, with many complexities. If there is an examination of the Undertakings for the Collective Investment in Transferable Securities (UCITS), which was formed three decades ago, it is a really robust framework with principles and detail, which has stood the test of time, allows companies to compete, allows innovation to happen within it, and attracts capital from around the world. The European Long Term Investment Fund (ELTIF) is far more technical and complex; there are many fewer flows and tractions there.

2.3. European Supervisory Authorities should have the power to issue no action letters

A regulator stated that more powers should be given to the ESAs to issue no action letters. When some legislative provisions obviously cannot be applied, it is indeed key to have an emergency mechanism to suspend the application of the provisions concerned, in an exceptional and coordinated manner across member states. This would protect stakeholders from proceedings for non-compliance with these rules and would also help avoid major regulatory distortions vis-a-vis other countries, which is key in a globalized world. An illustration may be the second Payment Services Directive (PSD2) that is coming into force in a few days. Unfortunately, the preparedness for the required strong customer authentication is not yet there and a grace period resembling a no action letter is needed in applying it. If such a grace period is not granted, customers would suffer as they would be unable to use payment services. More generally, the ESAs and the Commission should work more closely together in order to enhance innovation in the EU. The interpretation of different member countries is different; it would mean an additional impediment to innovation to develop national regulation where the services are inherently cross border.

A regulator believed that no action letters could provide some security for the industry in some cases, but it would be more relevant if the Lamfalussy principles were strictly implemented, because there cannot be a no action letter targeting a Level 1 requirement. If the essence is in Level 1 and more is put in Level 2 then there is more room for a no action letter targeting only Level 2 issues.

2.4. Confidence must go hand in hand with a greater convergence of supervisory cultures

A regulator wondered if the principles should include a clear distinction between what is targeting retail and what is targeting wholesale.

An industry representative noted that that could be an option. Asset managers are nonetheless split, because on one side they want to see standardisation in capital markets, and on the other side they are very close to the end consumer and are embedded in their local markets. Behaviours can be changed if the supervisory coordination network focuses best practices and templates to try and build that upwards, combined with peer reviews and product intervention.

2.5. Is there a need for a European sandbox?

2.5.1. Certain conditions are essential for the proper functioning of sandboxes: equal access between all actors and a convergence of practices in each jurisdiction to avoid regulatory arbitrage

An industry representative stressed that competition is tough, which is seen in the trade wars between states. People should not be naïve and should make sure that the financial industry in Europe is able to withstand competition, including in terms of innovation. Sandboxes are one tool that organisations should not be shy of using but they have to be relatively small and used only for a short period of time. It should be very transparent as to how they are chosen and what the results of the test are. The tests must be done on a limited basis so that they do not have too many damaging consequences if they fail.

2.5.2. National legislation does not confer the right to passport services, consequently the markets potential for growth is limited

A regulator believed there is scepticism regarding sandboxes. The concern is that new entrants to the market approach the regulator and think that sandboxes can help them avoid following the existing regulation. The question then becomes doing something within the parameters of not being illegal but being more of a limited period or number of users. It could be the case that that could be used on a cross border basis in the EU, but there are doubts as to whether one can export a company with a limited licence in the EU.

Another area where entering the European market is bothersome is the question of home and host supervision, and the obligations of the home supervisor, which should be amended in the legislation. If an entity applies for a licence in a country, then they should have to provide services in that country. They should not export services, because if an entity only exports services it might be that the home authority is not eager to supervise the services as the host authority. There are stories where companies have started to complain about why they were not accepted into the sandbox and their peers were. The ESAs and the European Central Bank (ECB) are currently investigating on sandboxes.

2.5.3. The EU strategy for innovation should not be a strategy for a sandbox per se but should rather be a comprehensive strategy for digital transformation; a pan-European toolbox is needed

A regulator noted that the sandbox issue is discussed in detail in some EU member states. The sandbox should not be seen as a universal tool. It is one of a variety and spectrum of potential tools that can be used as instruments that may foster innovation in the financial market. The sandbox itself is also a broad term; it is used as the name for very different setups that may be either legal, operational or marketing setups. A regulator explained that the EU should consider developing a separate EU regime for Fintech entities, but as an integral part of a more general strategy for the digital transformation of the economy, encompassing also matters like cybersecurity, AI or big data. The EU strategy for innovation should therefore not be a strategy for a sandbox, but should be a comprehensive strategy for digital transformation, with the fintech strategy being part of it. Within it there should be a spectrum of potential tools that can be used and reviewed by national regulators; a combination of these tools can then be adapted to the needs of the local market. A pan European toolbox is needed, with the sandbox being one of the tools in the toolbox that can be suggested to lawmakers who are interested in fostering innovation.

A regulator also stressed the importance of the choice of tools for fostering FinTech which should correspond to the characteristics of the local financial market and take into consideration the technological level of traditional banking business and the appetite for financial innovation demonstrated by 'traditional' financial entities. A regulator shared a regulator's views on the issues that Europe may face in connection with the cross border operation of early stage or low scale business entities. Countries may be tempted to encourage entities to incorporate in a given jurisdiction but without a real intention to do business there. Deposit guarantee schemes are also not fully integrated at the European level, meaning Europe may be facing the risk of countries licensing, regulating and guaranteeing the operations of entities where the real set of operations is being carried out elsewhere in the world.

A participant noted that rapid legislation has the possibility of encouraging errors. Close examination is needed of the unintended consequences of the legislation because they are often hidden in the numbers referred to. Sometimes these unintended consequences can be very severe. If their legislation is adopted, then only ESAs can give the right interpretation through questions and answers.

A regulator felt that balance is important between being able to react swiftly in a changing world and adapting the regulation accordingly and taking the adequate time to put the right framework in place.

GLOBAL COOPERATION AND BREXIT IMPLICATIONS

Global cooperation on financial services

Following the 2008 crisis, global cooperation on financial regulation has become increasingly important over the last decade in order to achieve a resilient financial system. In 2009, the G20 launched a comprehensive programme of reforms, coordinated through the Financial Stability Board (FSB), intended to increase the resilience of the global financial system while preserving its open and integrated structure. Timely and consistent implementation of these reforms is essential to achieving sustainable growth. However, global regulatory cooperation is declining, and financial fragmentation is worsening in some areas at a time when emerging risks (e.g. cyber risk, crypto assets) require a continued adoption of globally consistent standards. In this context, ways forward are required for improving the consistent implementation of global standards.

1. Global financial fragmentation is emerging again

1.1. The global business model remains critical for economic growth and stability

An industry representative explained that fragmentation is a critical issue. There are three statements which the banking side can generally agree with.

First of all, global trade has been a fundamental driver of economic activity for the last several decades; global banks are essential to efficient global trade. Global banks create global economic benefits in two keyways. First, they serve multinational clients and facilitate cross-border trade, reducing costs for their clients, which in turn benefits consumers and the economy. Second, they are an important channel for directing excess savings from one country to another which has investment needs. In doing so, they broaden the funding choices available to these markets, and reduce the cost of borrowing and promoting growth.

Secondly, markets with a robust number of participants competing on a level playing field reduce cost to the end consumer, increase credit generation, improve market liquidity and financial stability.

Finally, shareholders expect a return on their capital. Incremental costs borne by the industry ultimately get passed on, in some respect, to customers and clients.

1.2. There are increasing signs of fragmentation at the global level

An industry representative noted examples showing that banking fragmentation is increasing at the global level. The first is the varied and inconsistent implementation of agreed upon international banking standards. His company has 15 to 20 risk weighted asset calculations. Across the space, in the order of 75 different capital ratios can quickly be reached that are looked at from time to time. This is actually not improving the robustness and stability of the overall system. Second, some alignment and collaboration need to occur with respect to resolution and stress testing. Some of the efforts being seen at the G20 and other meetings have been very positive in that respect, but there is more to be done there to avoid some of the prepositioning of capital and liquidity. As capital rules are "armour-plated" in many countries, there is increasingly less capital and liquidity available at the parent company level to travel to subsidiaries when a crisis occurs. Finally, there must be consistency of regulatory judgement to ensure the comparability of global banks. For example, the application of Pillar 2 should be more consistent across countries to allow such a comparability of risk profiles.

1.3. Not all fragmentation is bad

A regulator noted that whether national differences to mitigate important local risks means fragmentation was the first point discussed at the workshop between the regulators and industry and academics, hosted by the FSB in Basel. The conclusion was that not all fragmentation is bad. Full harmonisation of regulation across the world is not the aim; there is a need to reflect the difference in economic development and national policy priorities. However, not all fragmentation is the intended good fragmentation, and these unintended negative effects are the focus. There is a need for national discretion, though this is often abused to hide the weakness of domestic banking systems, or to avoid the painful things to be done.

1.4. Policymakers should look at the financial fragmentation driven by a gold-plating of the internationally agreed regulatory programme by national jurisdictions

An industry representative noted that policymakers should look again at the areas of inconsistency and fragmentation driven by the gold-plating of standards. That has been an area that policymakers at the global level have tried to stay away from, because the view has always been that the global standards are the minimum, and gold-plating is the prerogative of the national authority. Whether to second-guess a national authority's decision to gold-plate is a separate issue, but fragmentation is certainly driven by this.

1.5. The lack of international standards and a willingness to defer to another jurisdiction in case of implementation issues can also explain market fragmentation

An official noted that everything heard thus far is very consistent with the report IOSCO issued in June to the G20. There are two additional things that the report found. The first is that the lack of international standards in the first place is what in part causes market fragmentation. That is something where reflection is required in different areas. The other reason, with respect to fragmentation, is a lack of willingness or authority for one jurisdiction to defer to another when there are implementation issues following a particular standard.

2. Global cooperation in insurance: progress, challenges and perspectives

2.1. Fragmentation issues in the insurance sector

An industry representative felt that fragmentation is a reality of their business, operating across more than 60 countries and having been designated systemic in 2013. Unlike the banking sector, in the insurance sector colleges of supervisors were set up in the wake of the financial

crisis. A decade earlier, they would have been caught between different regulators on different issues and there was no structural forum for a continuing dialogue. There has been a great change in the quality of the dialogue and interaction with the regulators. There is an annual college in Paris and one in Asia. Harmonising standards is virtually impossible for political reasons but reaching a pragmatic implementation and interpretation of the rules can go a long way.

10 years previously there was a roundtable at the Securities and Exchange Commission (SEC) when they had started letting foreign issuers file International Financial Reporting Standards (IFRS) accounts without reconciling it with the US generally accepted accounting principles (GAAP). The whole debate tried to drive convergence between US GAAP and IFRS, which has gone in the other direction over the last few years. The impact of IFRS 17, at least in the insurance sector, will be much bigger than people might anticipate, and will have a real influence on comparability.

In the insurance sector there is a multiplicity of capital standards such as the risk based capital (RBC) in the US, or Solvency II in Europe. There is a project on international capital standards (ICS) to reach a coherent view of capital across the regions of the world. The ultimate objective is a level playing field, but that only works if there is a convergence with an existing framework, and if this global standard does not come on top of current requirements. That is often the risk, layering a new standard on top while the old one continues to exist.

The General Data Protection Regulation (GDPR), was a monumental directive that has been transposed everywhere in Europe. In Europe, there is focus on protecting data and citizens. In the US the tendency is to focus on commercialising data. In Asia, the focus is on controlling data. Looking underneath all the different regimes, when doing business across 60 countries, is something dealt with every day.

Finally, over the last two years national security considerations have entered the business world. Security reviews are now going well beyond security and defence companies. It is also seen in cloud services: legislation is popping up on national cloud acts and this is an element of balkanisation.

2.2. Making more effective the crisis management framework in the insurance area

An industry representative explained that in insurance there is no Basel Committee, which has been around for many decades. Over recent years it has become deeper and richer. There is always a risk that it might become a tick-the-box exercise. Their company attends the annual college meeting with all regulators. The best part is the Q&A. There is convergence between the regulators of the college of Supervisors because they have prepared the meeting: they meet for an entire day or two beforehand and the insurer goes prepared to address the questions. Then there is much open dialogue, which has become better and better every year.

2.3 Consistency of implementation is required once a regulation is reached

An industry representative stressed that there is something about putting everybody in the room. It does not happen if it is not structurally there. The colleges have regulators from 25, 30, 40 jurisdictions, many of whom have never met each other. The day and a half or two days they spend preparing and dialoguing before the insurer spends half a day with them becomes deeper and better each year. It sounds simple, but the sustained effect of that over a period of years is quite substantial. The objective is to take a step back and think about what makes sense. When regulators and supervisors do that, it is important to think about what are the broader macroeconomic objectives, particularly in an environment where people are accumulating money for retirement, which is a big issue in a low interest rate environment. Cyber-risk is a big subject for everyone. The question concerns who can cover these risks, and whether a backstop is needed.

3. Ways forward for addressing market fragmentation and key areas where global cooperation is necessary

If market fragmentation is accepted to be a negative factor, and one affecting markets globally, then it stands to reason that the response needs to be similarly global, encompassing national and supranational bodies, as well as industry actors.

3.1. Getting from fragmentation to cooperation: the efforts at the G20, IOSCO and FSB in prioritising fragmentation as a financial stability concern is a step in the right direction

An industry representative noted that the issue of whether market fragmentation is a problem to be addressed is well-established as a consensus view among policymakers and the industry, thanks to the good work of the Japanese Presidency of the G20. Policymakers essentially endorse the view that there is an issue with regard to fragmentation, that at this stage of the post-crisis reform agenda, needs to be looked at carefully and systematically. The fact that capital markets operating on a global basis are more resilient, efficient, effective and stable is widely agreed on. A number of issues came out post-crisis that policymakers have had a need to deal with, including some of the issues concerning resolution and frictions that come into the implementation of global standards, and whether there are inconsistencies in the specificity of implementation. Global coordination can be deepened, but actually can be made more resilient, by allowing for a feedback loop of global standard setting, implementation, reassessment, and then potentially recalibration based on the lessons learned.

3.1.1. Even if the current level of fragmentation can be bearable, there is still a need to start working on trends of future direction toward less, rather than more, fragmentation

A regulator noted that the report the FSB published in June 2019 has various examples of market fragmentation developments, but the current level of market fragmentation is not unbearable. The more important issue is the direction and whether it is heading for more or less fragmentation. There is enough reason to worry about the future direction being more fragmentation. There is a growing anti-globalisation sentiment around the world. All of the banking regulation is reverse engineered from the resolution situation but, with regard to resolution, there is not enough trust amongst national authorities on the single point of entry resolution approach, thus leading to more ring fencing. It is a great achievement that the global regulatory community agreed on a single regulatory standard, but it is yet to be implemented. There are many standards which had to be implemented from 2017 to 2019 which have not been implemented or have been implemented in different ways or with diverse timeframes.

3.1.2. The global financial regulatory system today bears little resemblance to its state 10 years ago, but regulatory-driven market fragmentation is a new challenge

A regulator noted that the field is shifting, and there has been a lot of progress. There have been new challenges coming up, and it is easy to try and look at the current snapshot as to how different jurisdictions

are addressing those challenges and try to find fault. These discussions are important and help lay the land for ultimately an environment where there is either more harmonisation or more deference, but one in which all jurisdictions have implemented their obligations under the G20 agreements. This is encouraging, and there is an important role for organisations like IOSCO. Developing either a baseline or a ceiling of international standards is very useful, which can be critical in a number of areas. However, the effectiveness of those standards is best when supported by a rigorous data analysis, with a public consultation process, a feedback loop and where issues that may not have been calibrated well can be recalibrated. There is a potential fragmentation in implementation. IOSCO has come out with some impressive standards. There are a number of tools held individually to manage the playing field from now to the 10-year mark to achieve harmonisation or non-fractured markets.

3.2. Key areas for further work to address financial fragmentation

A regulator noted that in 2018 the Japanese G20 presidency listed addressing market fragmentation as its priority. The FSB and IOSCO produced a report. The FSB had taken financial stability perspectives, and IOSCO had gone narrower but deeper, focusing on the wholesale derivatives market. In Osaka, the G20 leaders welcomed the reports and declared that they would address negative, unintended defects. The issue is back on the global agenda, but the two reports are not specific actions. The task to transform good declaration and two programmes into specific actions needs to be done. Without that, the world will not change.

The FSB report describes four key areas for future work. The first examines deference in the derivatives and securities market. The second area concerns the prepositioning and ring fencing of capital and liquidity. This is a difficult subject but might have the biggest implications for financial stability. The Financial Reporting Council (FRC) and the Resolution Group plan to host a workshop of industry and academics on ring fencing and prepositioning issues later in the month. The third area is the question of how to improve supervisory and regulatory communication and information exchange. The FSB report provides a section on mechanisms and approaches how to enhance coordination with specific ideas listed there. The fourth area is the fragmentation aspect, to be discussed in the effect assessment exercise the FSB is doing on regulatory reforms, and the too big to fail reform is the first topic to be analysed in that way. These areas of work will be coordinated by the FSB's standing committee on supervising and regulatory cooperation.

3.3. IOSCO proposals to mitigate the risk and potential adverse effects of fragmentation on global securities markets

An official explained that the foundation for enhancing international cooperation was laid in IOSCO's June report, which identifies three areas for continued focus. The first is fostering mutual understanding among regulators, with respect to their regulatory regimes. To a large extent, regulators around the world do not understand what other regulators are doing in specific areas. IOSCO's regional committee structure helps members understand what other regulators are doing. Secondly, it is really enhancing supervisory cooperation. This is done in a very appropriate way in some areas, particularly in the enforcement area, but when it comes to supervisory cooperation there is more work that could be done. Supervisory colleges are well-established with entities like credit rating agencies. It is developing in other areas, and needs to be picked up, in terms of making fragmentation less cumbersome. Finally, the work with respect to deference must be mentioned. Particularly around putting in some guideposts or some rules of the road in how these assessments take place, questions need to be answered concerning the time limits, the level of communication, the language used and the translations needed.

3.4. Cooperation and coordination should be differentiated according to the systemicity of market activities

A regulator stressed that that, broadly speaking, coordination approaches should be differentiated by a systemicity of activities and possible impacts. Cooperation and coordination need to be viewed through the lens of other foreign jurisdictions' interests, and how much of a company's business is in different jurisdictions. There are a number of different kinds of assessments that the regulatory community can make to create the right platform for cooperation and coordination, but it has to come with clarity and an understanding of where there is a history of strong oversight in the home country being acknowledged. The CFTC has done a number of exercises with international counterparts, demonstrating not only stress-testing capabilities but also technology capabilities, with real-time visibility into the client-level portfolios of clearing members at large clearing houses. Broadly speaking, there is a scale up to a certain point.

3.5. Key areas where global coordination is necessary

3.5.1. Climate and sustainability issues

An industry representative noted a range of areas where much good work is being done, including in climate and sustainability. There are significant regulatory and supervisory interests. Cooperation and collaboration amongst supervisors in terms of their expectations is helpful. Financial technology, products and innovations compose another area where more consistency in supervisors' expectations would be useful.

3.5.2. Effective international regulatory and supervisory cooperation is an important precondition for integrated financial markets

An industry representative noted that the big improvement that has occurred on the issue of fragmentation is that there has been, as a result of the G20's work, a clear statement of the issues regulators are trying to solve. Maintaining and enhancing global markets is one of the outcomes that should be considered in the work that regulators do. From that flow many other things, including making sure that the supervisory colleges work effectively and have the right participation in terms of the supervisors invited to attend. It is the same with crisis management groups in terms of putting some pressure on resolution authorities to make them work collaboratively. Some works together naturally, such as the Bank of England and the US authorities' track record of coordination. For other authorities without that history, a global mandate for cooperation would be a welcome outcome.

3.5.3. Improving the transparency of the global standard setting process

An industry representative stated that whether some of the inconsistencies in national rules are a necessary by-product of different macroprudential dynamics in particular markets is a fair enough point but would be eliminated naturally in the standard setting process if it is as transparent and as robust as it could be. There have been some steps forward in terms of allowing broader

participation, input and visibility, which is helpful. To take the Net Stable Funding Ration (NSFR), the funding added on to derivatives for derivatives was never part of the consultation process; it was added late in the finalisation process. Europe diverged from that in implementation, for reasons which ultimately became understandable. Basel then clarified that national discretion is allowed in that area. The Basel Committee took the right decision in reassessing after the fact, but it could have been avoided with more transparency in the process.

3.5.4. Debating the appropriate amount of internal TLAC

An industry representative noted on Crisis Management Groups (CMGs) that it is for everyone to recognise how much progress has been made in that regard. Resolution planning is not something with the same history as capital standards or even liquidity standards, which are also very recent. Giving those bodies more power is one of the things that will improve the efficacy of how they operate. Many people have been talking about internal total loss absorbing capacity (TLAC), which is calibrated at the high end of the range. The original design would have been slightly more firm specific, and that is an area where it is possible to see a group of regulators getting together and debating what is the appropriate amount of internal TLAC to have at various levels. Nobody believes that 100% prepositioning improves financial stability. It actually makes it worse, but a common framework cannot be used to see how the problem can be considered to try and address the trappings of capital and liquidity that might be seen in a real stress crisis.

3.5.5. Crypto assets and financial innovation

An official noted that crypto assets constitute an area that a fair amount of time is spent on and that keeps morphing. It started out as initial coins, and now is morphing into stable coins and different things of this nature. The focus is on understanding these products, how they are really operating, and what is their economic function. It helps to then think about what the areas are where IOSCO really intersects with how these things function. Financial innovation is related to crypto-assets and the rise of this type of new product. It is the enabling ability of technology that is giving rise to the proliferation of many new things being seen in the marketplace. In part it is understanding what is actually happening and what innovation is really taking place. Related to that is artificial intelligence and machine learning, and understanding how these technologies are being used, not only by intermediaries, market participants and by regulators, and how these products, technologies and approaches can be used to do things better. These are a number of areas IOSCO are focusing on and will continue to focus on for the next year. There will be additional issues as well as the markets keep evolving.

Latest Brexit developments and future of EU-UK relations

1. Level of preparedness of the financial services industry regarding Brexit

1.1. High level of preparedness of the financial industry

An official stated that following a process initiated by the industry after the Brexit referendum and supported by supervisors, there is a high level of preparedness in the UK financial sector for the possibility of a no deal exit after current transitory arrangements are over. The aim was to answer the expectations of clients, shareholders and regulators. Preparedness includes not just being resilient to possible shocks within the financial system caused by a no-deal Brexit, but also being able to continue to serve the economy. This has been a remarkable achievement by firms and regulators in a difficult political climate. The industry will nevertheless have to keep engaging on those issues if a no deal situation is confirmed.

An industry representative felt that the financial industry is probably the best prepared sector in the UK economy, and also among most member states. Unfortunately, being the best prepared is not a guarantee of being able to ensure a smooth functioning and continuity of service in all areas. Another industry representative agreed that although there is a high level of preparation, care is needed because the devil is in the detail.

Another official subscribed to the overall assessment that preparatory work has been intense, both from the private sector and public authorities at the European and national levels. Everyone is prepared to keep risk in check, and monitoring is ongoing.

1.2. Remaining risks in the case of a no-deal Brexit

An industry representative believed that remaining risks are potentially manageable. Speakers on the panel identified different areas where potential risks remain to be tackled in the short term in the case of a no-deal Brexit.

A first area is liquidity. The liquidity gaps that a no deal Brexit may lead to could disrupt the provision of certain services for some market segments, an industry representative warned. It is hard to know to what extent this will be the case and which services will be affected, but there will be cost issues. The issues that cause the most worry are the unexpected and the unidentified ones. Firms are dependent on thousands of people in the market understanding how to operate in a different regime on the day and also on regulators and policymakers continuing to talk to each other, which one can hope will happen despite possible political hostilities.

An official agreed that thin liquidity in the weeks immediately after a no deal exit is a risk, which could be exacerbated by the consequences of the share trading obligation (STO) of MiFID II. Many people are expecting the UK to say what it is going to do about the STO, but there is also the question of the operation of the STO, which originally was intended to facilitate and stabilise cross border trade, and how that could play into what may happen immediately after a no deal exit. The challenge is in particular for the 6,229 shares that are not included in the STO, an industry representative noted.

For another industry representative the biggest concern in terms of market liquidity is US dollar liquidities, because the majority of transactions for certain

instruments are in US dollars e.g. 87% of the FX market in US dollars. If a liquidity crisis happens, funding costs will go up and investors will sell the papers they hold.

Clearing is a second area of concern, an official stated. The European Commission's temporary equivalence decision on clearing was very welcome but it is due to expire at the end of 2019, which means that this question will resurface in December if the direction is unknown. If the arrangements are not renewed or replaced that would be a serious issue. It is to be hoped that there will be some pragmatism about this.

Regarding uncleared derivatives, the UK's concerns are well known, the official added. It is a 'slow burn risk' that is very hard to identify, and potentially long running and difficult to manage. A number of member states are taking action to address that. An industry representative felt that the Commission had taken a relaxed view on this question and on the related risks; as a result member states have implemented somewhat different regimes, which is quite hard to manoeuvre for the industry. Some of these regimes also are not clear and explicit enough about how they may work, which means that they are difficult to put into practice in the market.

Data transfers are a further area to be considered, the industry speaker believed. The private sector is mostly using the standard contract clause solution. That has legal uncertainty, and it is hoped that the market will not respond badly to a lack of a standardised, transparent solution and that barriers will not come up as a result.

1.3. Progress made with customer repapering and customer transition

An official stated that the dry run to a no deal exit in the spring highlighted that in many ways the client is the constraining factor regarding preparedness, which continues to be the case. Client behaviour is changing, but the authorities and the financial sector are generally more aware of the various Brexit scenarios than corporates. An industry representative emphasized that the least well prepared companies are SMEs. Larger companies are well prepared and have started to be more cooperative in the repapering exercise, but the reality is that they do not particularly want to move. Another official confirmed that repapering is not fully done; the question is whether the situation is manageable. Supervisors put pressure on banks to move along and onboard as many clients as possible and have also taken steps to facilitate the repapering process for some aspects, but there will always be remaining risks, although these should not be systemic.

An industry representative stated that a key issue for their bank has been to assist customers to transition where appropriate from their UK entities to their new German entities. Good progress has been made but after Brexit was delayed after 31 March customers considered transition to be less urgent. Larger customers are well prepared, especially the automobile sector, who are already changing their factories from the UK to continental Europe. Other challenges for the speaker's bank are the need to build up the revenues of the new entities in Germany, which is impacted by the slower than planned customer transitions and the difficulty to implement staff changes in the current period of uncertainty. In the short term the bank will use its significant middle and back offices in the UK to support the operations of the new entities in Germany. Repapering is being completed and no issues have been raised so far. Their bank has focused on the large corporates and, as it is not present in the SME portion of the market, it is unlikely that there will be major issues.

2. Future of EU-UK relations in the financial sector

2.1. Possible post-Brexit scenarios

The Chair suggested that there are various options for the UK if it leaves the EU. It can have a regulatory regime for financial services which is very close to the European one, in which case one would expect the equivalence mechanisms to be the way of organising trade relations. A more radical option is to 'cut and run' and try and gain competitive advantage from lowering standards, but there have been no signs from London that that is a course of policy which is favoured. The third option is a model where the UK would try to build parallel agreements with different large markets like Switzerland, Australia, and Canada. The model that the UK eventually decides on will determine whether there is going to be regulatory divergence and whether that is manageable or not.

An official did not see the UK stepping away from the international standards that currently structure the functioning of the financial market. As long as financial services are a very large part of the UK's economy and the UK plays a leading role in this sector it is essential that the UK should participate fully in global financial institutions. Divergence with global standards would indeed go against the competitive, political and economic interests of the UK.

The risk of divergence over time with the EU is a critical point however, the official stated. The UK will leave on 31 October with exactly the same rules as the EU in all key areas of the financial sector. So far there has been no call from the UK based financial industry to review or change these rules. On the contrary they ask the authorities to avoid any haste in changing the regulatory approach because they would prefer the present regulatory dialogue between the UK and EU to continue. There are concerns about some regulations, and in due course financial firms will ask how they can be addressed, but there is no immediate pressure. It is hard though to see there being exactly the same rules in 20 years' time. One of the reasons is that the EU will be making rules for its 27 member states and not with the UK's specificities in mind. This will inevitably lead to some differences in the way regulation operates over time.

An industry representative agreed that changes will not happen quickly. UK regulators until now have shown a very high tendency to gold-plate EU regulations rather than to undermine them. If the UK continues to import risk and export risk management with a strong financial intermediation sector, risk management will remain essential and the UK will not become 'some kind of Singapore' contrary to what some have suggested. In terms of fragmentation, whether the Capital Markets Union (CMU) develops as an alternative source of capital markets for European issuers and the European real economy and how it develops is important. Fundamentally one cannot develop an international capital market without being open to global capital. The UK serves the European issuers by being open to global capital, and the development of the CMU is going to be a very fundamental part of what happens in the future.

An industry representative noted that the role of the US should not be underestimated in this debate. The share of the capital market business in 2010 was 53% US and 47% Europe, and is currently 70% US and 30% Europe. A key objective for Europe should be to increase the scale of its capital markets and diversify its financial system building on technology and capital pools available in the EU, otherwise the biggest beneficiary of Brexit may be Wall Street.

2.2. Potential issues raised by regulatory divergence between the EU and the UK and possible safeguards

An official highlighted the materiality and the implications of gaps that might appear between the EU and the UK. Gaps that may allow regulatory arbitrage are a concern for everyone, as they may damage the stability of the system. Moreover divergence may create barriers and fragmentation within the European market. That would be a commercial concern for firms and an economic concern for European economies including the UK, leading to a less competitive European financial services sector and a reduced contribution of the sector to the economy, with firms suffering from an uneven level playing field.

This having been said, the extent to which that gap emerges is not just a consequence of the UK's approach; it has also to do with the EU's strategy concerning its financial services system and how the dialogue between the EU and UK is working, which is partly a regulatory and partly a political question. In addition, rules should not be the only focus, because it is the supervision of the rules that often determines the outcome. But eventually, what happens in the financial sector and whether the policies defined in the EU or UK are a success or not are going to be determined by the clients and where they want to do business i.e. which entity they will use and in which jurisdiction.

An industry representative felt that the main issue is the risk management of how divergence is controlled, and whether there is some framework of common supervision that can encourage a shared view. Another key question is how equivalence regimes are used i.e. as an industrial policy or as a political strategy possibly with a certain degree of protectionism aiming to leave UK firms out.

Another official stated that the time dimension is important when discussing the risk of divergence. What is important are the safeguards that can be built into the system to limit that risk. One has been referred to - the global standards – to which EU jurisdictions adhere as much as the UK. The continuity of this engagement at the international level is essential. The equivalence regime can also be seen as a safeguard against tendencies to diverge and compete on regulation. Europe is facing a situation where it needs to further develop and integrate a diversified financial system for the Euro. This does not mean that it should reduce its openness to the global market, which needs to be maintained. That has never been part of the intentions or the mandate given to the EU authorities, including from a financial stability perspective. However the EU also needs to ensure that the appropriate mechanisms are in place vis a vis third-country entities for ensuring financial stability.

Enhancing financial policies dealing with third-countries

1. Strengths of existing EU third-country arrangements

A policymaker stated that the European Commission sees equivalence as the key instrument going forward for managing EU trade relations in the financial services sector. Equivalence is appropriate because it opens EU markets to third country providers but also allows the management of the risks that may be created by this access. The regime also facilitates market interaction, while allowing each jurisdiction to retain its autonomy. Finally, it is quicker for the Commission to deliver than a bilateral agreement would be. In economic terms, the upsides of equivalence are that it promotes competition in the European market and reduces compliance costs for the industry, while helping to mitigate risks.

An official agreed that the European regime addresses the different dimensions of equivalence (i.e. access, prudential treatment…). A further strength is that it is considered for each sector or activity as legislation is drafted. Many firms are concerned that the EU approach to equivalence differs across legislations, but this also means that the particular issues of each legislation with regard to third countries are addressed specifically. In addition, these arrangements are put in place through a fairly transparent process of negotiation.

A market observer emphasized that from the point of view of the users, equivalence reduces overlaps and facilitates compliance with regulatory requirements. The openness of the regime and the competition it creates however require significant supervisory and regulatory cooperation.

2. Weaknesses of existing EU third-country arrangements

2.1. Insufficient predictability

An official stated that although the risk of withdrawal of equivalence is an extremely rare tail event it causes major anxiety to the industry and will continue to be a challenge, as equivalence regimes are developed and are used. That anxiety may undermine the viability of equivalence as a structure for trade if it is not appropriately addressed. The withdrawal of equivalence in the summer for certain third-country jurisdictions in the field of credit rating agencies (CRAs) was much less disruptive than might have been expected, but this might not always be the case.

A policymaker acknowledged there are some downsides for third-countries to the EU equivalence regime, such as the possibility of withdrawal but this is a risk mitigation tool inherent to the regime. The possibility to withdraw equivalence leads people to say that it is uncertain, but this potential risk is overstated. EU countries indeed benefit from opening their markets and before July 2019, the Commission had never withdrawn an equivalence decision. The withdrawal that happened in July concerned the CRAs of five jurisdictions that decided not to implement legislative adjustments to the CRA regulation given the scope of activity to be covered. This had been discussed and prepared with those jurisdictions a long time ahead.

Another official reiterated that equivalence regimes should not be seen as a pure trade tool. There is a debate about the European Union being open or closed with these regimes, but it is not the right one. By definition when you have a third-country regime it is because you want to be open, but you also need to be able to monitor and master risks, which is why some conditions are needed for jurisdictions to be deemed equivalent. Financial activities may have major social or economic consequences for the EU if there is a failure of risk management or supervision in a foreign country, therefore there is a need for appropriate safeguards. The European Union is accountable for putting these safeguards in place within the equivalence regime.

A market observer stressed that the most important safeguard for the EU in terms of risk mitigation is that equivalence is a unilateral decision that can be repealed. If equivalence was granted forever then the EU might completely lose control of its financial stability risk or be obliged to follow the rules of dominant jurisdictions that have large shares of certain financial markets. The EU needs to be able to decide which activities and entities can operate in the EU and those that should be left outside.

2.2. Possible politicisation

An official noted that the possible politicisation of equivalence processes is another concern. The decision regarding Switzerland for share trading raised many questions about the operation of equivalence and how these systems may be applied to the UK in the future. That is a reputational challenge for this system that will be in people's minds as the UK leaves the EU.

A regulator considered that the political dimension present notably in trade 'disagreements' undermines the attractiveness of and trust in these regimes. The withdrawal of equivalence for Switzerland regarding share trading for example has led to a classic 'tit for tat' situation that has resulted in a lose lose scenario for open markets and a loss of liquidity. The more third-countries have the feeling that there are overarching considerations that will dominate the decision that has been technically prepared, the less they will be ready to invest in going through this process in the future.

Another regulator stated that equivalence decisions and assessments need to be transparent and technical in order to make appropriate decisions on whether to give access to the EU market and whether this will support the global financial markets. At the same time one should not be naïve. These decisions can be part of broader political negotiations in certain circumstances. In the case of the Swiss share trading obligation it was quite clear from the communication of the Commission that the decision was part of a broader discussion related to the framework agreement between Switzerland and the EU. For both the Swiss and the EU this ended up being a negative sum game and fragmented markets. Ultimately, the financial markets were not better off in this case.

In addition, a policymaker explained that it is always possible to consider that not granting or withdrawing equivalence for any reason that does not directly relate to the regulation of that sector could be a politicisation. However it is not that simple. Equivalence decisions have to take into account a wider context to ensure an appropriate mitigation of risks. For example, if the Commission does not think that the anti-money laundering regime of a given country is right, this cannot be ignored.

2.3. Time-consuming and uncertain process

A regulator considered that another issue with equivalence is the complexity of the assessment and decision-making process. The time investment for a smaller jurisdiction in operating these processes is enormous. The EU financial market is extremely complicated, with approaches that vary across member states. The process is also very painful with a number of turgid documents and evaluations to go through and a result difficult to anticipate until the last moment.

Another regulator stated that the EU has no desire to make this process painful. The supervisors in charge are just doing their best to verify that the conditions for keeping EU markets open are met. Access to the whole EU internal market provided by equivalence is a 'big prize' to obtain, as this takes away a significant part of the effort that would otherwise be needed to obtain a licence in all 28 member states, which is the base case in most other jurisdictions. For instance, there are at present 34 third-country CCPs that are recognised following equivalence decisions taken by the European Commission on the basis of a relatively quick process at ESMA and thus have full access to the European derivatives markets. It is fair for the EU to make sure that this full access to that part of the EU financial market does not result in importing excessive risks, which involves having sufficient information on potential risks and being able to evaluate whether they can be mitigated.

3. Changes potentially required with Brexit

An official felt that one concern with equivalence is that some measures have only been tested on a limited number of occasions, which makes predictability difficult. That should change with the UK leaving the EU, which will be the most demanding test for this approach so far, because of the scale of the EU-UK trade relationship and the impact of potential regulatory divergences in the future. Another issue is the degree of informality of present equivalence processes based on informal MoUs for example. The equivalence measures in the acquis will probably need some expansion over time for the relationship with the UK, with more formal equivalence assessment processes and the setting up of a structured cross-sectoral EU-UK dialogue to support equivalence between the two jurisdictions. This could potentially be replicated for other jurisdictions.

The official then described the main factors of success of an equivalence approach with the UK. First an unprecedented degree of supervisory cooperation, formal and informal, will be needed to make it work. That is how it works at present, with the UK part of the single market. When the UK leaves the EU this level of cooperation will need to be maintained because there will still be a great deal of flow happening between the UK and the EU despite the frictions and barriers that may develop. Secondly, this process needs to be robust, which means that the decisions need to be defensible and the cooperation arrangements must be 'supervisable'.

A regulator emphasized that with the UK leaving there can be situations where market participants from outside the EU pose specific risks to the EU. It would be wrong from an accountability perspective for the EU to completely rely on the third country regulator and supervisor in that case. As a member of the single market, UK regulators currently provide the rest of Europe with information on UK based market participants. If in the future this access to information is reduced, EU supervisors will no longer be able to make sure that risks posed to the EU27 are properly assessed and can be acted upon. These issues would be increased by any divergence between EU and UK regulatory systems in the future.

A market expert felt that if equivalence is pushed to the extreme there is also a risk that the EU might end up

completely relying on a third country, the UK or another, for some segments of its market. That is only viable if there is a high degree of regulatory alignment and if supervisory cooperation works well, as is the case at present in the EU. In the future, if one of the jurisdictions decides to change its regulation e.g. lowering its rules or if supervisory cooperation does not work so well, it must be possible to withdraw equivalence if this poses excessive risks to the EU. A withdrawal of equivalence would however create major disruptions for the users in this case. Ensuring that there is an acceptable balance between the activities that take place in the home jurisdiction and those that are provided from third countries through equivalence is therefore important in terms of managing risk in the long term.

A policymaker agreed that intensive regulatory dialogue will be necessary with the UK in order to anticipate potential problems as upstream as possible and with enough time left for addressing potential problems. This is however easier for regulatory than for supervisory issues.

4. Suggestions for improving EU equivalence processes

4.1. Towards a more global approach to equivalence arrangements

A regulator highlighted the problems stemming from the design of equivalence processes, when considering them in a global perspective. If a country is a third country to every other financial market in the world and vice versa this will lead to a very 'baroque" architecture, which will become increasingly complicated as the financial market becomes more multipolar. Expanding networks of bilateral equivalence designations will also be extremely time-consuming to put in place and manage. It is uncertain whether the complicated bilateral matrix this will result in is really operable and whether all these bilateral agreements are generating added value for their constituencies. A different type of design should be thought of, leveraging the global standards and assessment processes that exist in many areas of finance.

An official added that the idea of a more global perspective to equivalence beyond individual jurisdictional interests is gaining attention at the international level with events such as the UK leaving the EU, the growth of financial markets in Asia and also the emergence of new kinds of products, services with risks that must be regulated in a coherent way across jurisdictions. A regulator added that more international cooperation would also help to optimise the use of supervisory resources which are scarce.

Another official acknowledged that using global standards and common processes defined at the international level could help to simplify equivalence assessments and added that efforts should be made to ensure that European legislation is understandable for third-countries. However, relations based on equivalence should remain bilateral rather than multilateral, the official believed. Jurisdictions should be accountable and remain sovereign in using equivalence tools and should be free to withdraw equivalence if necessary.

A market expert moreover emphasized that international standards are more developed in domains where the equivalence regime is not applied, such as banking supervision and regulation and less so in the capital markets. A regulator noted that data is another important area where there are no equivalent solutions.

An industry representative was in favour of equivalence processes, which can help to narrow down cross border divergences and incompatibilities of regulations and considered the EU's process as one of the most advanced. This bilateral process, which is quite time consuming and relatively slow with all the parties involved asked to produce separate questionnaires and conduct individual equivalence assessments could however be improved with further coordination between the parties involved and a reduced number of individual equivalence decisions.

The speaker outlined the example of a significant effort being made in Asia to make the equivalence process more efficient. In October 2016 the Japanese FSA launched the so called 'platform for equivalence assessment' in order to evaluate the equivalence of OTC derivatives margin regulations with the authorities of Australia, Hong Kong and Singapore. This platform aims to enhance mutual understanding, make the assessment process more efficient and streamline the approval process. A single questionnaire was used to collect all the information, outstanding questions were addressed collectively and there was a mutual agreement on the equivalence decision with an aligned timing of publication.

The EU is moving in a similar direction with the establishment of coordination groups, which should improve alignment within the EU in the future. The EU equivalence process could however better take into account international standards and be further standardised with a global perspective, the industry speaker believed. Continuous regulatory dialogue is also essential at the global level to help alleviate the effects of current fragmentation trends illustrated e.g. by the ring fencing of activities or initiatives around bank liquidity and capital, such as intermediate parent undertakings (IPU).

A regulator felt that this initiative underway in Asia shows that within the 'bilateral world' a more multilateral process, based on common sources of information and evaluations, can be used to make assessments simpler, shorter and more predictable.

A policymaker agreed that a more multilateral approach to equivalence would be desirable. However following the financial crisis, risk tolerance and trust among supervisors have diminished within the EU and at the international level. Less burdensome approaches should nevertheless be sought.

4.2. Improving risk monitoring

An official considered that the monitoring of financial risk in the context of EU equivalence arrangements could be improved. This involves first a systematic check of existing equivalence arrangements from a risk perspective on the occasion of reviews. Secondly, there may be a need to provide more gradual answers than the current 'black and white' system of equivalence / withdrawal, particularly in areas where there are significant flows of business and where a withdrawal may lead to a difficult cliff edge. The EMIR 2.2 process adopted for clearing houses goes in the right direction, the speaker believed, with a tiering approach depending on the magnitude of possible risks. Some aspects of the recent investment firm review are also interesting to consider, such as the information about the proportion of business done in the EU. The trust of third-country counterparts in EU equivalence regimes could also be improved, with more predictability and transparency. Some common principles could be established, with more explicit criteria for granting and withdrawing equivalence and an enhanced dialogue involving the ESAs. A horizontal equivalence system

does not seem appropriate however, since risks depend on the market segment considered,

A regulator agreed that at more gradual equivalence system is necessary. The present system with full reliance on a third-country supervisor can be maintained when there are no specific financial stability issues. But if there are financial stability concerns for the EU then the equivalence system needs stepping up with direct supervision and a more granular assessment of regulations, as has been done in the context of EMIR 2.2. A market expert also concurred with the suggestion that a greater clarity of requirements for granting equivalence is needed, as well as more predictability. Decisions made must be understandable and consistent. Equivalence arrangements must also be robust, which requires effective monitoring, regular assessments and on-going discussions between the jurisdictions concerned. In addition, the EU must ensure there is reciprocity, which goes with the openness of the equivalence approach towards third-countries.

Another regulator suggested that equivalence assessment processes should be more risk-oriented and less focused on the letter of the law. A detailed literal examination of regulations increases the burden and may ultimately miss the objective, which is to ensure that there is no regulatory arbitrage or a race to the bottom between jurisdictions so that business can easily move between them. The way regulations are supervised is also essential and may have more effect in the end than the way they are drafted. Assessing supervisory effectiveness is however not easy. It needs to be based on an evaluation of whether the main risks are covered in an appropriate way and whether this is likely to continue in the future.

A regulator considered that the equivalence decisions that have been made by the EU were quite outcomes-based and did not go into a line-by-line comparison. A policymaker noted that what is precisely an outcomes-based process is not easy to define. An international resolution to determine this would be helpful.

PROSPECTS OF THE EU BANKING AND FINANCIAL SECTOR

Improving the global competitiveness of the EU financial sector

A regulator noted that the objective for the session was to discuss the challenges faced by the EU financial sector. The sector should be able to address the transformation of the industrial sector while also securing the appropriate financing of the economy. The persistent low profitability in the European banking sector is somewhat shocking compared with international competitors, particularly in the US. Unprofitable banks cannot support economic growth, and this issue makes it difficult to build up capital buffers.

1. The EU financial sector continues to suffer from low profitability

Banks in Europe are more resilient, but their profitability remains disappointing. Beyond cyclical factors, Europe's fragmented banking markets play a negative role, hampering cost-efficiency and technology investment. The fragmented EU fund market also hampers competitiveness against US peers. Profitability levels have been similar for European and US property and casualty insurers for the last 10 years. As in the US, the EU insurance market is predominantly domestic.

1.1. EU banks' profitability remains weak, particularly in comparison with banks in the US

An industry representative outlined the position in terms of profitability among EU banks. Comparing the top 20 banks in the EU and US, the industry representative noted that average return on assets over the last five years for EU banks is around 40 basis points versus around 110 basis points in the US. Overall return on equity for EU banks was in 2018 6.3% versus 9.2% in the US. A leader of the industry stressed that profitability is weighted at around 15% in the assessment scorecard, and there is a three notch difference in the profitability score between the top 20 EU and US banks. Europe's profitability factor is one notch above non investment grade. Another industry speaker highlighted the increasing amount of EU capital requirements. Overall, trade tensions between US and China and the perception of political risk in Europe affect the way we do business.

1.2. There is very little difference in the overall profitability between the EU insurance industry and the US industry, but EU asset managers lack scale compared with their US counterparts

An industry representative noted that there is very little difference in the overall profitability between the EU and USas both insurance industries are fragmented; the EU industry is dominant in the few business segments which are global (e.g.; reinsurance) . However, EU asset managers lack scale compared with their US counterparts in a context where the asset management industry is experiencing pressure on fees, which makes size even more important. The top 10 asset managers in the US, which benefit from the single market in the US, manage around 22.1 trillion of assets, 33% of the global total, while in Europe the corresponding figure is 7.9 trillion (12% of the global total). Smaller EU firms are struggling to sustain high margins amid long-term trends towards lower fees and higher costs. Furthermore, for asset managers, the profitability of European players has also lagged behind US counterparts due to a smaller and less diverse capital market. Lastly EU asset managers are largely owned by large banking and insurance groups and are impeded by the same obstacles as their owners.

2. The EU banking sector is held back by low growth, interest rates, fragmented markets and regulatory and supervisory issues

The scale and profitability of many EU banks falls short of their US counterparts. Lower interest rates and slower economic growth in the EU contribute to this shortfall. Moreover, there is no true single banking market for the EU; instead, it is segmented along national lines and cost inefficiencies plague some domestic banking systems. Large EU banks still lack the necessary scale to compete with global banks, and they will soon face significant challenges from bigtech and fintech firms. Furthermore, specific EU regulatory issues also impact the competitiveness of EU banks.

2.1. The negative consequences of lasting zero and even negative interest rates and low growth

Monetary policy is one source of the non level playing field between EU and US banks. An industry representative described how interest rates in the EU have been virtually zero or negative compared to 2.25% or 2.5% in the US. Likewise, growth prospects in the EU have lagged behind the US by approximately 70 basis points. An industry speaker suggested that low profitability emerges from the profile of the curve. At the short end, the impact of transfers of excess cash to the ECB is around 40 basis points, which is equivalent to a transfer of roughly €7 billion. On the long end, banks must hold liquidity reserves to constitute their liquidity ratios, and these portfolios produce poor or negative yields. European banks hold €1.3 trillion of excess reserve, which is affected by negative interest rates. In the US, the systemic banks hold $0.9 trillion, which is remunerated at the Fed's current overnight rate. Another industry representative highlighted the contraction revenue from interest margin in France, noting that in the Czech Republic or Romania, for example, revenues from interest margin are up 10 15%, with a normalised curve.

A Central Bank official highlighted that conjuncture is currently worse in Europe than in the United States. Interest rates are important, but their impact must be qualified. Low interest rates have a negative impact on the net interest income of banks, but this is a partial equilibrium. A recent Banca d'Italia study concluded that monetary policy has a negative impact on net interest income but a positive one on loan provisions and loans more generally.

2.2. The fragmentation of banking markets along national lines holds back profitability

An industry representative described how Europe remains relatively fragmented both across the EU and within individual countries. Within Germany the top five

banks only represent 43% of total assets, compared to 58% in Italy and 80% in France.

Another industry speaker offered their condolences for UniCredit's Chairman, Fabrizio Saccomanni, who recently passed away. Returning to the subject of the panel, the industry speaker acknowledged that there are manifold reasons for low profitability but highlighted in particular the role of regulation. The European banking system is under higher regulatory pressure than the US banking system, and there have also been stronger tax incentives in the US. There is also fragmentation in Europe caused by obstacles to the free flow of liquidity and capital within cross border banking groups, which is impairing the efficient running of cross border banks and the consolidation of the sector.

2.3. The impacts of the EU resolution framework on the global competitiveness of EU banks

2.3.1. A source of concern

Considering resolution, an industry speaker explained that total loss absorbing capacity (TLAC) is required only for Global Systematically Important Institutions (G-SIIs) in the US, while the European framework requires all banks to comply with minimum requirements. There is a non level playing field here also because the EU's TLAC requirements for subsidiary banks go beyond the requirements of international standards. More is required from subsidiaries of European banks than from third country subsidiary banks, which is a contradiction. This should be addressed in the new third capital requirements regulation (CRR 3). Additionally, European banks are paying significantly higher risk premiums than US banks for minimum requirement for own funds and eligible liabilities (MREL).

2.3.2. 'Stop mourning and do your homework'

A regulator quoted Felix Hufeld's recent remark, 'Stop mourning and do your homework.' The financial crisis had a substantial cost to societies and taxpayers, and the Banking Union was a reaction to it. The US and Europe responded to the crisis at different speeds. Additionally, Europe had a double dip crisis, and its regulation was a reaction to that. However, the regulator sympathised with the comments made about MREL. For regulators, it is important to implement the EU legislation that has been passed and to avoid starting the next reform before the last one has been implemented. Resolution is only for a few significant institutions, not for the many smaller ones. When smaller institutions fail, insolvency should be the rule. There is also a need for further consolidation in order to remove overcapacity and ensure profitability overall. Clean up consolidation can work between neighbours or within a country, but it can be very difficult to create synergies between vastly different member states.

The regulator also highlighted the relevance of the Single Resolution Fund (SRF). A political decision was taken to have a last resort fund to avoid relying on the taxpayer. The SRF is paid for by all institutions, but it is important to have proportionality here. It is essential not to 'change the gears every time' regarding regulation, but regulation is not the root cause of Europe's lagging profitability. Cost income ratios do not emerge from regulation. Regulation might be 'the icing on the cake', but it is no more than that.

2.4. Software treatment: EU banks are at a competitive disadvantage versus US banks

An industry representative described how US banks do not have to deduct their investment in software from capital, while currently every euro invested by an EU bank in IT must be backed by one euro of CET1 funding. This disincentivises investment in innovation. In the banking package, the European Banking Authority (EBA) has been entrusted with the task of establishing what should be deducted and what should not.

Another industry representative highlighted two important imperatives: First, non performing loans (NPLs) are a drag on profitability in the EU, whereas the US tackled NPLs very swiftly after the crisis. Second, there is a need for greater digitalisation and overall investment in both front end and back end technologies.

3. The way forward: both market participants and regulators must 'do their homework'

There is no single solution to improve bank profitability in Europe. Several avenues for progress were discussed: There is an urgent need to complete both Banking Union and Capital Markets Union. Regulators must ensure that regulation is properly implemented, particularly Basel III. Digitalisation remains a key focus for market participants, and there must be a level playing field for traditional institutions to compete with bigtechs. Excess capacity has not been eliminated since the crisis and consolidation is not taking off. Consolidation could be a path to greater overall efficiency, but the retail markets in Europe are not yet integrated, which reduces synergies from cross-border mergers. In addition, achieving sustainable profitability requires not only cost cutting but the adoption of innovative business strategies and further adjustments to the way banks perform intermediation by leveraging their ability to bundle credit provision with other products and services.

3.1. Achieving a true single market: there is an urgent need to complete both Banking Union and CMU

An industry speaker considered that a true single market 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 to improving credit quality.

3.1.1. Finalising the Banking Union

A regulator suggested that the EBA's 'homework' is now about implementing the recent major regulatory changes. The EBA's main focus is secondary legislation. The EBA has over 100 mandates to develop over the next few years. It is essential to ensure that the high level regulatory framework works effectively. The EBA's goal is an effective Banking Union and integrated single banking market. An industry representative agreed on the need to complete Banking Union and the CMU, observing however that there are some practices which should be avoided. At present, some member states still introduce national profit damaging measures such as taxes on assets and the forced convection of mortgages in foreign currency with retroactive application. The Commission must play a stronger role in ensuring the free circulation of capital, which is a freedom enshrined by the Treaty.

A regulator noted the need to finalise the Banking Union, which will entail finalising the backstop to the Single Resolution Fund and liquidity in resolution. There must also be a harmonised liquidation framework for banks. For the moment, the insolvency of banks with a negative public interest test is administered according to national procedures; some of these procedures function better than others. Furthermore, Europe must have a solid answer for depositor protection in its liquidation rules. A Central Bank official agreed on the need to consider the agenda for authorities, noting that many of the stumbling blocks on the path to Banking Union are political rather than technical.

Additionally, according to an industry representative changes to the prudential treatment of sovereigns would negatively impact banks' profitability. Another industry

representative considered the construction of the Banking Union the key priority. Europe must continue to work on ensuring the free circulation of capital and liquidity within EU transnational banking groups, which requires solving the "home-host dilemena".

3.1.2. Completing the Capital Markets Union

A regulator stressed the importance of completing the CMU which would notably ensure that banks benefit from an enlarged home market for capitalization and investment. To fund the financial industry, it is necessary to fund the banking industry. CMU is essential to create a fungible financial market. The progress on CMU has been restricted mainly to 'peripheral cleaning'; Europe has not tackled the behaviour of investors. Investors demonstrate an inevitable home bias because they know the 'rules of the game' in their home country. To overcome this, there must be changes to insolvency rules, company rules and resolution procedures. Investors always need to understand how they will be protected if something goes wrong.

An industry representative felt that proposals such as the financial transaction tax could not be implemented alongside CMU. If certain transitions are taxed in only a limited number of member states, these transactions will simply move to different jurisdictions.

3.2. Reducing the overcapacity: the expected benefits and challenges of banking consolidation in Europe

A public decision maker stated that consolidation does not drive profitability by itself. However, creative destruction will contribute to profitability: more efficient institutions will gain market share while less efficient institutions exit the market. At the same time, consolidation enables operating synergies which allow firms to provide better services while enhancing profitability. Cross border consolidation is less appealing because there are fewer overlaps in staff and branch networks between banks operating in different countries and hence fewer opportunities for cost reduction. According to a stock take by the EBA, market participants also worry about differences in supervision, national applications of macroprudential measures and the ring fencing of capital and liquidity. Regulation should not create unnecessary obstacles but ensure a basis for healthy competition. A Central Bank official noted the importance of well functioning cross border groups, along with mergers and acquisitions in individual countries. If the problem is cost efficiency, however, cross border consolidation is generally not a solution. The problems concerning fragmentation and banking overcapacity will not be solved by creating more European mega banks; consolidation at a lower level will be important. An industry representative added that consolidation is more challenging in retail banking due to the complexity of mobilising cross border synergies.

3.3. The Basel III agreements must be implemented fairly and pragmatically to ensure EU banks' competitiveness

3.3.1. The full implementation of Basel III, under conservative assumptions, will increase the average minimum capital requirement (MRC) by 24.4% but would contribute to ensuring a well functioning global banking market

Turning to Basel III, a regulator emphasised the importance of terminology. Europe is implementing the existing regulations, not developing new ones. This process is the finalisation of Basel III, not 'Basel IV'. Some of these outstanding issues are substantial, but this is not a new change to the system. The EBA's overall message on the call for advice was about adhering to the Basel rules as much as possible. Over the medium to long term, this will help maintain global standards and a global banking sector. There can be European specificities, however, if they are well identified, well explained and well justified using a risk based approach. A question from the audience suggested that the participants in the Basel Committee had not had enough leeway in their discussions, but the regulator reminded them that Basel III covered some of the 'idiosyncrasies' of the European industry, particularly regarding the risk sensitivity of the models for small and medium sized enterprises. The supporting factors will be less effective after the implementation of Basel III and hence the marginal value added is small, which is why the EBA has suggested eliminating them.

The regulator encouraged all participants to read the EBA's publication on the subject. The headline is the average increase of 24% in risk weighted assets (RWAs) in the system. This increase in capital requirements implies an aggregate shortfall in total capital of €135.1 billion (€91.1 billion in CET1). The regulator noted that this calculation was somewhat conservative as it was static or ceteris paribus. Basel III uses pillar 2 measures to compensate for the weaknesses identified in risk management, and these are already being put in place. Banks will adjust to new measures and authorities will adjust to the new environment. Therefore, it is misleading to think that these figures reflect the actual impact of Basel III; it is likely to be significantly smaller. Additionally, the impact on banks will not be homogenous. The majority of the capital impact occurs in large globally active banks.

3.3.2. However, the transposition of Basel III could jeopardise EU banks' business models

An industry representative emphasised the importance of a simple, pragmatic and fair transposition of the 'Basel IV' package. There must be a level playing field and a common regulatory rulebook between Europe, the US and Asia. While this fair transposition of the Basel rules is essential, it is also necessary to consider the specificities of the European market. Because the EU is a largely intermediated economy, the impact of the package is very specific. The implementation of output floors will have a significant effect on mortgage books in Europe, for example. It will be important to ensure that the financing of corporates is not penalised, because in Europe 90% of financing to non financial corporations comes from banks; in the US, 50% of this comes from the debt market. Another industry speaker agreed with these comments, adding however that regulation is not 'the icing on the cake' as another panellist had described it. The EBA's impact assessment calculated an increase of 24% to MRC, which not everyone may consider is 'icing'. The industry speaker called on the Commission to conduct an overall impact assessment of the regulations which have so far been enacted.

3.4. Digitalisation: a key challenge for markets participants

The pace of technological advances in the competitive landscape represents a key strategic challenge, especially for banks. A Central Bank official suggested that banks should continue to focus on digitalisation. There are still large differences between the cost income ratios of banks in Europe. The shift from a brick and mortar network to a digitally orientated supply is a key challenge here. It is important to note that the prevalence of digital banking varies hugely across Europe. The adoption of digital banking correlates very strongly with education and infrastructure, which suggests that there is also a role for supervisors alongside banks. The challenge from bigtechs poses an existential threat to the banking system. While a bank offers a bundle of services, new competitors can offer unbundled services at potentially lower costs than traditional banks. However, banks exist because there are synergies between their activities. Banks must think

strategically about their ability to exploit the advantages of bundling banking services in a 21st century environment. An industry representative also highlighted the importance of digitalisation. Cybersecurity has significant cost requirements, and digitalisation requires upfront costs before any cost benefit can be realised.

A regulator noted that one comment from the audience queried the integration of products across different banking or financial groups. Aggressive bundling or cross selling can lead to substantial problems in terms of mis selling, inadequate customer management and customer protection. A Central Bank official clarified that they do not advocate bundling in that sense, citing these serious consumer protection issues. There should be tough regulation and enforcement on consumer protection. There are synergies in banking because banks collect information about their clients, which allows them to create products with value for clients on both sides of the balance sheet. The Central Bank official suggested that this is part of competitiveness in the banking system. Banks cannot be competitive if they are not trusted.

A regulator invited the panellists from the industry to comment on the European data framework. An industry representative observed that GDPR embraces all possible sectors in Europe. However, there is no consistency between the second Payment Services Directive (PSD2) and GDPR: there is a duty to ensure data protection, but banks must also open their data to third parties.

Another industry speaker agreed, noting that competition from bigtechs necessitates a regulatory level playing field in respect of GDPR. The industry speaker stressed the importance of ensuring that competition between bigtechs and financial institutions takes place on an equal basis. A regulator confirmed this need for a level playing field. Ultimately, there is nothing more important than transparency and appropriate market regulation, but there must also be proportionality. 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.

Impacts of Basel III on EU financial activities

1. The current situation

1.1. Initial impact assessment and underlying assumptions

A regulator noted that in order to assess the impacts on banks' risk-weighted assets (RWAs) and increase of capital requirements of implementing the last Basel III measures, the European Banking Authority (EBA) did an analysis of comparative aesthetics looking at the existing situation of banks' portfolios.

That came out with an average impact of 24.% increase in Tier 1 minimum required capital (MRC) for the industry overall. However, the impact is not homogenous across the distribution of banks within the EU. When looking at the distribution of banks, the median impact in the sample is an 10.6% increase in Tier1 MRC. For the smaller banks, it is 5.5%, and one quarter of the sample is subject to a T1 MRC increase close to 0% or a capital relief. It depends on a bank's business model. A policymaker noted that the EBA figures indicate that the impact on EU banks' MRC is likely considered to be quite significant. Not only because of the estimates for the average impact in terms of MRC, but in particular the more specific impact for globally systemically important banks (G-SIBs) that of +28.6%.

An industry representative noted that the increase in capital requirements will be difficult for the industry to absorb and will imply a big deterrent on overall economic growth. The potential shortfall of total capital is estimated to be about €135 billion for the sample, of which €91.1 billion of common equity tier 1. A simple analysis is also provided, which is how much of that capital could be absorbed by those entities facing shortfalls by their ongoing operations. The EBA had looked back and asked what the profitability had been for these banks in the period 2014 to 2018. Assuming they retain profits during the transitional period to rebuild their capital base, only EUR 58.7 billion of the shortfall in total capital would materialise in 2027. This shortfall is mostly borne by institutions that did not make any profits between 2014-2018.

At the same time, a regulator stressed that the EBA has based itself on very conservative assumptions on a number of issues. Additionally, it assumes that banks' balance sheets remain static during the implementation of the Basel III reforms, while in reality banks optimise their assets/liabilities structure in reaction to new requirements. Furthermore, some of the existing requirements, particularly those under pillar 2 or for macroprudential purposes, may be addressing issues that have been identified as weaknesses in the current version of Basel III. Supervisors can therefore be expected to reconsider the appropriate level of these requirements. Also, the impact was computed using the calibration of the outdated 2016 market risk regime, disregarding the revisions to the FRTB that the BCBS agreed in January 2019 and that are expected to lower the increase in capital requirements. Taken together, these caveats provide strong indications that the actual impact of the final Basel III reforms is likely to be much lower than one would expect from the headline figures in the EBA's report.

At the same time, we should not downplay the enormous challenges that the final Basel III standards will entail for European banks.. That is why continued work is needed to understand the drivers behind the impacts, and what this will mean, not only for the capital ratios of banks but also for financing the economy. That will be the purpose of the Commission's impact assessment, which will be published together with the legislative proposal in Q2 2020.

In the meantime, the final report by the ECB on the macroeconomic impacts of the reform will come forward in November 2019. The results suggest that there are modest transitional costs of the final Basel III implementation, which fade over time. The overall macro impacts of the reform are highly positive, according to the ECB estimates.

A regulator explained that the impact on Japanese banks is also mixed. Some banks are affected by the increase of the risk rate on equities. Advanced internal rating-based (AIRB) banks tend to be affected by output floors. Finally, a significant number of banks would require adjustment in their capital strategies, but many banks have gone through a period of reduced dividend payments and share buybacks, so the preparation for the implementation of finalised Basel III is broadly completed in capital strategy terms.

2. The industry perspective

2.1. Impacts anticipated by the industry

2.1.1. The proposed framework penalises at one and the same time EU consumers, corporates, the shareholders and the economy

An industry representative noted that everything depends on implementation, but it looks like a big mistake is perhaps being made. The capital framework should reflect the real risk being run and implementing this as proposed will definitely penalise particularly low-risk portfolios with high-quality unrated corporates, of which there are a large amount in the Nordics. It will penalise retail mortgage, where the Nordics have loss ratios of close to zero going back 20 to 30 years. This could have an unreasonable impact on the Nordic financial system. The country with best availability of credit and lowest cost of credit for SMEs is Finland; it has a very efficient, good banking system. Loss ratios are low, credit cost is low, and credit availability is there. There is a very serious concern that these proposals will have a real impact. The banks will survive, as they are strongly capitalised. The ones who pay for it are the customers.

An industry representative explained that their organisation sees a strong impact for corporates, and for corporate banking as a consequence. Indeed, a huge number of corporates in general in Europe do not have ratings. The European market of financing is very much banking focused, and therefore there is no upside for them to go into the rating procedures. As a consequence, this leads to either an increase of the costs of those lending procedures for corporates, or a significantly reduced variety when they want a certain instrument. Both are out of line with what is wanted in Europe. Another issue is the impact of the projected regulation on classical risk hedging, which corporates need to do, especially those unrated. There at present an expected uptick of 250% which drives some of hedging instruments out of business. There is a risk that Europe reduces the number of banks that can offer that, leading to a situation where only a non-European bank can offer certain financing. That is not in Europe's interests.

Another industry representative explained that their organisation has come to the conclusion that if, over time, it wants to come to the new regulatory capital targets, it has to curb the growth of its RWAs. With the same level of RWAs, everything being equal, €135 billion of additional money has to be frozen in the EU banks. This money will never be recovered by the shareholders, because the reserves are going to be the same as before, and the same business will be done. It is exactly like a tax over the years. Consequently, their organisation is going to limit its business and find the middle of the road, where it can keep certain activities and reduce others. Ultimately it will constrain the economy.

An industry representative emphasised the importance of accuracy. The anticipated €135 billion is only the shortfall of the current outstanding capital compared with the forthcoming minimum capital requirement. However, the true shortfall will be in fact the additional capital required to maintain current ratio of capital to RWAs, which is today in Europe 14.1% in average. It will require all existing capital in excess, plus €135 billion. Indeed, what matters for investors is the coverage of RWAs by capital. Beyond the expected regulatory adjustment, the banks will have to replenish that also. The real shortfall is much higher and has not been calculated by the EBA.

In this context, investors are not confident today in the future profitability of banks. The euro stocks banking index is close to the minimum reached during the crisis, and investors are not ready to invest in European banks. The new Basel IV requirement means future profitability will be lower.

Finally, the representative stressed that if the anticipated no macro impact or positive macro impact on the economy were right, then the regulatory capital ratio should go directly to 100%. However, the consequence of capital requirements on credit, the simple ratio to be considered is that, any additional capital requirement of €1 billion, reduces the ability to grant credit by €10 billion.

2.1.2. The projected standard represents a deep shift of the founding principles of bank regulation

An industry representative noted that the output floor and what is called 'Basel IV' are the outcome of a complete shift in the prudential approach. Basel II introduced a completely new approach based on risk-calculated internal models. Basel III confirms this approach, but with higher requirements. The Basel Committee now proposes keeping some internal models, but with input and output floors leading to almost excluding internal models. This happens in a context where in the last 20 years, regulatory instability has been eroding market confidence. At present the European bank stock index is close to the worst level reached during the financial crisis.

The main objective of the output floor is to reduce the excessive viability of the RWAs across institutions, although internal models are approved and controlled by supervisors. In addition, both the ECB with its Target Review of Internal Models (TRIM) exercise and the EBA with its IRB Repair Initiative have gone a long way to enhance internal model assessment methodology and comparability. All of this should address any supervisory uncertainty attached to internal models. Finally, the question is what the output floor will bring in addition to supervisors in terms of certainty, that the current supervisory powers and efforts cannot. Furthermore, whenever internal models are properly verified, they give the best objective assessment of RWAs.

An industry representative noted that like for the credit risk aspects for which the introduction of the output floors and the input floors introduces a complete change of approach, the Basel III latest proposals regarding market risk aspects are also a complete change. Indeed, the Fundamental Review of the Trading Book (FRTB) introduces a shift from a value at risk (VAR) approach to the expected shortfall one, which relies on a completely different in philosophy. Finally, it entails a lot of IT investments. Even smaller banks, who may be less affected, will have to pay for implementing the new, much more complicated, "standard approach".

2.1.3. Implementing the standards in the EU requires important consistency efforts

An industry representative noted that when implementing the new Basel III framework, the enforcement of output floors, it is just one component which may be balanced by an easing of other requirements. However, regulators are not actually coordinating and are not taking a holistic view. The end result is a capital base unrelated to the underlying risk.

An industry representative added that when considering implementation, it is also necessary to think about what the ratings of the parent company and its subsidiaries, should be. The rating of the Parent company needs to be further considered for the whole group, and this case the framework could be simplified. The environment is one of relatively stable negative interest rates.

2.2. Implementing Basel III in a context of reduced growth and unconventional monetary policy is per se a challenge

An industry representative noted also that banks already face conflicting demands from the same supervisors. On the one hand, the ECB tries to incentivise banks to grow eurozone lending. On the other hand, most banking supervisors in the eurozone incentivise banks to reduce lending by setting the counter-cyclical buffers to reduce what they see as overheating. More than half of European supervisors have such buffers, which are directly contradictory to the ECB. Today, the ECB tries to restore some moderate inflation and to stimulate credit further, by lowering the reference rate to 50 basis points to push people to borrow more. On the other hand, the Basel Committee and its EU members announced a further tightening of capital rules for the so- called Basel IV triggering and an anticipation of credit slowdown. The ECB, by lowering rates, wants also to lower return on savings, to incentivise households and corporates to invest in the economy. On the other hand, regulators impose on banks to finance their balance sheets with longer maturity, the net stable funding ratio (NSFR), with more subordinated debt, which is not only the TLAC but even the minimum requirement for own funds and eligible liabilities (MREL), which is a pure European thing, and hence sterilise a significant portion of investors' money for compliance to regulations.

A representative of the industry is of the opinion that the input and output floors are the outcome of a negotiation in the Basel Committee, they are not based on an objective or factual approach. They calibrate the Basel parameters mainly to reach a supervisory goal, ignoring the objective risk assessment given by internal models properly approved and controlled. In this context, since supervisors have no intrinsic democratic legitimacy, they could be challenged by legislators who may take into account other aspects, especially EU growth and competitiveness. Indeed, an industry representative stresses, it is the macroeconomic environment which led to the 2016 ECOFIN position that the ministers do not expect from the new framework any significant increase of regulatory capital in the EU. Today the environment is unfortunately one of relatively stable negative interest rates, with the side effects onto economies. That needs to be taken into account during the implementing process of the latest Basel III reforms in the EU, by considering notably whether corporates have access to appropriate financing to carry out their projects.

EU governments set a very clear mandate to the EU members of the Basel Committee, about the finalisation. There are many Europeans sitting at the Basel Committee table who made their case, yet the balance of powers at the Basel table led to this mandate being completely ignored. Indeed, the impact will be significant in Europe. According to supervisors themselves, bank profitability is insufficient. The gap of 10-15% additional capital will be reached and will perhaps trigger a triple dip in Europe. EU policymakers need to take a political decision as to whether it is still relevant to suffocate the banks, or whether the priority should be to implement growth-conducive strategies. Precisely implementing Basel IV would increase the un-level playing field, increasing the gap between the state of the regulation in the US and in Europe.

A policymaker noted that it is true that investors are worried about banks' profitability in Europe, but this has also to do with the banks themselves. Banks should first see themselves what they can do to enhance profitability. The idea that the US is not going to implement Basel III is not in line with signals the European Commission has received.

A regulator noted that the Japanese FSA and the Bank of Japan together with many European authorities insisted on the various points made all throughout the negotiation process of Basel IV. At the time of the negotiation, only Japan had real life experience of living in a low-for-long environment for more than a decade. It can affect the basic profitability level of banks. A capital market requires a certain level of internal equity for all industries.

3. The future of international standard setting

3.1. The EU legislative process should clarify whether in the EU the projected evolutions focus on reinforcing weakest banks, preserve an effective level playing field and reinforce mutual trust at the global level

An industry representative felt that between the financial or macro impact, macro impact is the one always looked at. However, the banking industry players also need to be looked at, and whether a level playing field for banks that are running lower risk businesses, or lower risk models, is achieved. In the Nordic region, banks are known to run relatively low business model risk. Much of the excesses are attributed to the G-SIBs, however they are already strongly capitalised banks. However, a system is eventually being produced in which the strong banks are being held back and the weaker ones propped up, and there is a suffocated European banking system. The industry is over capacity, and if this is implemented wrongly it will result in a suffocating the banking industry.

An industry representative thinks that should European banks not be capitalised enough, investors would be unsettled. Yet this is not happening. The evidence of the way the markets are looking at the credit quality of a bank is reflected in the credit default swap (CDS). Looking at banks as they are now, the CDSs are showing that they are not better in the US than in Europe. For example, the CDS of Crédit Agricole is better than JP Morgan. The depressed level of the value of the European bank stocks, express the lack of confidence in their capacity to deliver some return not undercapitalisation. Part of this EU bank undervaluation stems from the looming bank regulation. Conversely in the US, it is widely accepted that even Basel III is not going to be fully implemented let alone Basel IV. The current mood in US regulatory circles is not to add new constraints on banks.

A regulator noted that more capital requirements are not an end in itself, but capital requirements should be risk based. There is no proposal for 100% capital requirements or anything like it, but given the experience during and after the crisis regulatory and supervisory action was and is warranted to restore confidence in the risk-based capital framework. The goal of the Basel Committee is to provide global standards that provide a foundation for a resilient banking system including through adequate risk management and adequate capitalisation of the risks that banks are exposed to, with a view to promoting trust in the global financial system. The real estate market have been mentioned. These are very sensitive markets. A large part of the crises seen across the world had their roots in real estate markets, and booms and busts in these markets channelled through the banking sector. That issue is a cause for concern.

3.2. The EU policy objectives regarding the implementation of latest Basel III standards in a global context

3.2.1. The evolutions should preserve the risk sensitivity of Basel requirements

A regulator explained that Basel III would be a difficult agreement that took a long time and that would be perceived as an equilibrium. From the European perspective, the most important aspect of the Basel agreement is that it preserves a big emphasis on risk sensitivity. The risk sensitivity aspect, particularly the use of internal models, is widely recognised as a positive aspect. Part of that risk sensitivity is a trade-off and ultimate compromise on applying as a backstop, floors in some cases.

3.2.2. The concerns expressed by the banking industry are taken very seriously

A policymaker did not feel it is entirely fair to portray what is a capital requirement aiming at financial stability for everyone as a tax on very specific economic actors. This being said, the concerns expressed by the banking industry are taken very seriously and will be duly analysed by the Commission.

However, people should not leave the debate with the illusion that the implementation of Basel III can be done away with, or that Europe could deviate in a major way from the core elements. International standards are needed, and to not implement Basel III or introduce major deviations would significantly hurt confidence in European banks. On the final capital impact, the European Commission needs to await its own impact assessment. It is unlikely that the capital impact will be as large as it has been described by the EBA.

The output floor has to be implemented by 2027, not 2022, and that will also give time to banks to smoothen the impact. The output floor does a good job at catching banks that have low risk weights but should have higher risk weights. At the same time it may also catch banks that have low risk weights, but in a justified manner. That is something that needs to be looked at carefully.

A regulator also explained that the EBA actually has a mandate from the Commission to assess before yearend the relationship between the capital requirements and the total loss-absorbing capacity (TLAC). Part of the challenge is that some of the TLAC target requirements are still being worked through the banks, but an assessment will be done on the impact of the implications of this.

3.2.3. A consistent implementation globally

Regarding the preparation for implementation in Japan, a regulator drew attention to 11 standards agreed after the agreement of the initial Basel III, and before the finalised Basel III. Those are expected to be already implemented between 2016 and 2019. Japan implemented nine out of 11, Europe five out of nine, and the US three out of nine so far. This is not a promising number.

It was noted that the European Commission would be committed to the Basel III agreement and its faithful implementation in the EU. Implementing the agreement would be good for maintaining global regulatory cooperation and a global playing field. In addition, it is also good in that it preserves the very essence of risk sensitivity.

However, there are specificities where adjustments could appear necessary in the European context, and should be evaluated and analysed against the benchmark. Basel III is a good agreement, which fits in the global integration of financial markets, and is important to ensure a level playing field argument.

A regulator insisted on the fact that emphasis should be given to the importance of the mutual reliance on other jurisdictions' capital adequacy rules. The foundation of international banking is that banks from other countries can be trusted as truly well-capitalised. If that disappears, things go back to mutual recognition regimes.

3.3. The global consensus results from a complex decision-making process which has to encompass various regional banking specificities

A regulator noted that when Basel II was agreed many books published in Japan emphasised the defeat of the Japanese negotiators. There was a similar newspaper article after Basel III in the US. Also, there are reports in Europe emphasising that European banks are disadvantaged.

A policymaker highlighted that they were Europeans who had been at the table of the Basel Committee. The intention of the US was to do away with internal models completely in the first place, and to have an output floor around 85% or 90%. Thanks to good European cooperation within the Basel Committee, a compromise was reached, which preserves risk sensitivity in the system and internal models. It is something that that can be implemented in the EU.

An industry representative added that the framework applies across regions in the world, to banking systems with huge structural differences in banks' balance sheets. Indeed, compared to US ones European banks hold the assets on the balance sheets, in general for far longer. This leeds to apply the output floor on different basis one on either side of the Atlantic.

Making the Banking Union effective

1. The post crisis European banking landscape remains fragmented across national borders notably because member states use the flexibility in the regulatory framework to restrict intragroup cross-border free flow of money (capital, liquidity, MRELs and large exposure regime)

The European banking sector is at a crossroads: Protracted profitability below the cost of equity, the challenge of technological change and digitalisation, issues of overcapacity in a number of markets and a more challenging monetary and macro environment ahead make it all the more important that the regulatory framework should operate smoothly and without distortions. However, the Banking Union is failing to deliver the degree of financial integration expected. 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 demand from businesses and households is greatest. This leaves them unable to compete with their bigger and more efficient global peers and could also explain the absence of major European bank mergers in the last decade. Moreover, the macroeconomic environment is not conducive to banks' consolidation. Completion of the Banking Union is therefore needed.

A central bank official reflected on a similar panel at the previous year's Eurofi. Essentially, it dealt with the same questions that have been collected this year, which is a little

sobering. At the same time, there is a new Commission coming in with new priorities, so maybe this is a chance to kick-start the Banking Union. This session would first briefly revisit the impediments to the Banking Union making more progress: legacy issues, lack of trust between authorities and the sources of financial fragmentation. After sketching out the landscape, it would move on to possible remedies.

1.1. The facts

An industry representative commented that integration has recovered from its 2011-12 trough, but most indicators of financial integration, including cross-border loans and the dispersion of rates between countries, have not exceeded pre-2008 levels. For example, 83.6% of loans by Eurozone banks to households and businesses are lent in the home country. Lending across borders increased in the Eurozone between 1997 and 2008 from 2,3% in 1997 to 5,2% in mid-2008, but progress has come to a virtual standstill since then. In deposits, a retrenchment to home markets has been observed since 2008. Today, 54.1% of bank deposits are collected domestically, while the share from elsewhere in the Eurozone has declined to 19.2%.

Another industry representative pointed to some specifics. There is a perception of insufficient integration, which is proven in the European Central Bank's (ECB) aggregate index composing the prices of loans and deposits. This index is still below its peak of 2004 to 2008, after all the progress made towards Banking Union. Government or corporate bond holdings have increased, but this has only worsened the situation. Now, they are more than 60% of domestic bond holdings, when they were less than 40% in 2007. The situation is similar for cross border loans as has already been said. The dispersion of lending rates is less than it was before the crisis, but this has much to do with the abundant liquidity provided to the financial sector.

Despite efforts made towards the Capital Markets Union (CMU), single rulebook, supervision, resolution and deposit guarantee schemes across Europe, progress has not been as expected. Although the system has gone a long way, the Banking Union is still far from weakening the bank/sovereign nexus. The correlation between credit default swaps (CDS) and sovereign bond spreads remains. An official added that for banks in troubled countries, recent capital gains made on sovereign holdings will not incentivise them to reduce this nexus any time soon.

1.2. Cross-border banking groups are not able to allocate efficiently internal capital and liquidity as they face limitations that block resources from flowing to where they are most in demand from businesses and households

A representative of an institution active in multiple European jurisdictions named as a major impediment to a closer Banking Union the lack of trust among Eurozone members and the lack of understanding that doing more together will ultimately work better. Currently most, if not all, European bank retail customers deposit money in their own member state and take products from that same bank. This is not appropriate for competition. Customers do not go to cross border banks, so the banks will have to come to them. To encourage them to, there must be a greater benefit from monies flowing within a bank from one part of Europe to another. The free flow of funds is a major impediment to developing a pan European market and to cross border mergers. Even within an existing banking group, undertaking a merger across one or two member states is very difficult.

Another industry representative saw the same cycle repeating for new banking and finance competitors. Digital is, by definition, cross border and cross industry, but nonetheless it is regulated locally. This could be self destructive if things are not done properly from the start; yet some countries are allowing the massive use of digital onboarding – use of the cloud and artificial intelligence – while others are acting with caution. Anti money laundering (AML) requirements also differ. This is hindering potential progress in banking integration. Regulating digitalisation at the EU level is the right way forward.

1.3. The macroeconomic environment is not conducive to the consolidation of the banking system

Central bankers are unanimous in their assessment that an effective Banking Union is needed as an additional stabiliser in case the EU is hit by shocks. They also know what the regulatory and supervisory challenges are. At last year's panel, there was little discussion of the macroeconomic environment or monetary policy not being conducive to the consolidation of the banking system. A high level of liquidity leads to a lack of pressure to consolidate the banking system, because it is easier to keep banks alive than otherwise. Not only that, but the costs of risks are pretty low, which contributes to banks not consolidating. More astonishingly, despite banking prices being at their lowest since the crisis, there are no takers. There are few incentives to purchase or invest in banks in Europe, despite the low prices. This is highly distorting.

Another consolidation worry relates to small tech, bigtech and the other innovators, but this could all be barking up the wrong tree, in the view of one central banker. An audience member asked whether the ECB truly wants a Banking Union, because lasting negative interest rates can only weaken the sector and increase financial risks. The same central bank official confirmed that the ECB wants a Banking Union because, ultimately, it wants functioning, integrated banks that are prepared for any shocks that may hit. But not everybody wishes to perpetuate negative interest rate policies.

2. The root causes of banking fragmentation

Distrust among member states is the root cause of banking fragmentation. Indeed, host countries still see the need to protect stakeholders, creditors and taxpayers by ring fencing practices, while regulators believe that capital and liquidity will be trapped in individual member states if a pan European banking group fails. The weak profitability of the banking sector and the persistently high level of non-performing loans (NPLs) in certain banks also contribute to explain this lack of confidence among member states.

A central banker described how financial fragmentation is due to national regulators pursuing their own mandates, while another kind of fragmentation relates more to different technical definitions, traditions and national discretions. Participants were asked to give their impressions on whether most fragmentation came from having local financial stability and resolution mandates, or if it was more from the technocratic side, in which supervisors have certain expectations of the rulebook, and to what extent each is soluble.

2.1. Host countries still need to protect stakeholders, creditors and taxpayers by ring fencing practices

An industry representative saw fragmentation arising from various sources. National Competent Authorities (NCAs) apply their own rules pursuing national mandates leading to local add ons. In addition, they exercise their microprudential rights or obligations also leading to national requirements. Moreover, the Single Resolution Board (SRB) has not properly tested resolution plans, and they may not be tested for some time, but they must have a

better understanding of how they would work in practice. A European bank might appear as such in life, but then become a bunch of individual country banks in death. This is a further impediment towards closer integration. He therefore concluded that, to achieve a truly integrated Banking Union alongside EDIS, national discretions should be removed to the extent that they impede the efficient allocation of funds within cross-border banking groups.

2.2. Distrust among member states lies at the root of fragmentation

A second industry representative agreed with this view. Incentives still exist for the domestic transposition of European or global rules from local traditions, internal pressures and dynamics. These might only be disassembled at the political level, for which there must be agreement and trust among parties, because discretions are too large and abundant to be justified. Liquidity is trapped in certain jurisdictions, which prevents the diversification of risks and introduces systemic weaknesses. Europe is far from being a single banking jurisdiction, and this notion is inconsistent with banking or monetary union. The protection of national depositors has been a strong argument for ring-fencing measures. Moreover, it is not in the interests of a bank that becomes national in death to allow its capital and liquidity to flow. In this context, everything is interconnected. One needs a grand view and then a political impetus to break down this resistance.

Trust is key, because there is much political difficulty around risk sharing. There is little such difficulty in joint decision making on single rulebooks and supervision but, when it comes to resolution, cracks start to appear. Without more sharing of deposit guarantee schemes, at some point there is likely to be acrimony and recrimination should a bank fail without a buyer. The king's clothes will reveal themselves to be absent.

2.3. Regulators still believe that capital and liquidity will be trapped in individual member states if a pan European banking group fails

A central bank official agreed it is in the interests of the ECB and the euro system to maintain a well functioning single banking market that helps meet the ambitions of monetary policy. Points were made earlier about the sources of fragmentation and how bad it really is but solving it could come down to the question of deposit insurance. This also answers the problem of liquidity trapped in different countries. Regulators still believe that capital and liquidity will be trapped in individual member states if a pan European banking group fails. From a host country perspective, it is understandable that, if a member state is responsible for a bank in its death, it would want some protection. That is where liquidity and capital ring fencing problems originate from.

2.4. The weakness of the banking sector, demonstrated by low returns on capital and the time needed to clean up banks' balance sheets, is also a stumbling block to the completion of the Banking Union

There has been clear progress on the resolution of NPLs. Nonetheless, they keep impeding further progress. There is around €580 billion NPLs in the euro area, where the average ratio of NPLs to total loans is still above its pre crisis levels and much higher than in the United States or Japan. Croatia has seen much progress on this issue already, as has Europe more widely. The market and services for NPLs are there, and people are making nice money out of them. In Croatia, at least, people are now getting enviable yields in this market, and in Italy large chunks of NPLs have been sold. A central bank official also commended the Commission's efforts to facilitate a faster resolution of NPLs by creating the infrastructure to trade them across Europe and for the extrajudicial collection of collateral in insolvencies.

It is much easier to tackle the problem of NPLs if the bank is adequately capitalised and so can 'take the heat' better. This helped in the Croatian case, because their average capital adequacy ratio is almost 24%. Even during the crisis, with high leverage it was easier to resolve NPLs. This is thus one of the preconditions to having an integrated banking market in the future, but not the only one.

2.5. Progress to reduce NPLs has been held back by the chronically low profitability of EU banks

A central banker stated that it is unfortunate so little progress has been made on the last leg of the Banking Union. Common deposit insurance is needed. This could notably solve the problems of NPLs, but ultimately, this all comes down to the low profitability of European banks in general, and this is a problem of business models. A low price to book value makes it difficult to raise new capital and to grow out of NPLs.

3. Possible remedies

3.1. Banks need to speed up the process of cleaning up their balance sheets

Although the level of NPLs has reduced, it is too early for one central banker to say whether there are similar levels of risks in the banking sector of all European countries. It would be therefore difficult for ministers of finance to decide tomorrow that there needs to be a functional European deposit insurance scheme (EDIS). Even if Europe went 55 60% down that road, a political decision would be needed at the highest level for risks to be equally shared and mutualised.

3.2. Pan European banks need to be European in death

3.2.1. Improving the EU resolution framework

A central bank official argued that allowing the free flow of capital and liquidity within cross border banking groups would make the Banking Union more effective. However, these same banks would have to remain not only multinational in life, but also in death. The functioning of the current resolution regime for large cross border banking groups begs a number of questions which have not yet been fully addressed, such as single purpose entity (SPE) implementation across borders at a time when the Minimum Requirement for own funds and Eligible Liabilities (MREL) is gradually building up. Liquidity in resolution is another case in point. Here too, a staggered approach including the implementation of the Single Resolution Fund (SRF) backstop could form the basis for future advances in home/host cooperation and thus render the banking union more effective.

3.2.2. Harmonising insolvency regimes is a necessity

An industry representative described the harmonisation of insolvency regimes across member states as a major project in furtherance of completing the Banking Union. It could be testing, but it has to be done. A true single rulebook would help tremendously. Another industry representative agreed a single harmonised insolvency regime managed by the SRB, and with a single creditor hierarchy, would make the EU crisis management framework more effective.

3.2.3. Is harmonising macroprudential regimes necessary?

Additionally, according to a speaker, the harmonisation of macroprudential requirements, not so much the application but the requirement setting itself, would help. There is the ambition in Europe to drive towards completing the Banking Union, but a major impediment is the lack of willingness to reach out across

borders, both by banks and regulators. A central banker, however, insists that macroprudential supervision should remain at the national level. It should indeed be accepted that there are different financial cycles in different countries and that there may be different buffer requirements in place at different times. This does not look good from a multinational bank's perspective, but it is the way that macroprudential policy has been designed. It is just unfortunate that the creation of a macroprudential toolbox in host countries has been hampered by home countries' fears about ring-fencing.

3.3. Without EDIS, the fragmentation of financial markets is likely to persist; achieving a consensus on the design and implementation of EDIS is therefore essential

3.3.1. EDIS: an urgent need

Agreement on EDIS would symbolise the Eurozone's willingness to share risk. A well funded deposit insurance system is also key to eliminating zombie banks. The right home/host balance remains a contentious issue closely related to the EDIS discussion. The panel explored what is concretely needed to make EDIS function properly. There have been proposals in particular for liquidity sharing. The question is what is needed to conclude that EDIS is in place.

An industry representative saw EDIS similarly as a symbol. It is a symbol of the union's willingness to take responsibility for the rights of deposit holders within banking groups.

All panellists understood that full blown EDIS could not be achieved from day one. Perhaps it should make its case on the reinsurance side first. Seeing it having more than just a high symbolic value may be optimistic anyway, but a central bank official argued that, to achieve less fragmentation and a smooth flow of liquidity and capital across borders, common deposit insurance is needed. Without solving this problem, no progress will be made in reducing NPL risk.

An industry representative agreed with much of the above. A properly built Banking Union should seldom need to use EDIS, because of the many barriers that go before it that have been constructed since the crisis. The technical design of EDIS could also help foster confidence, but a question has to be asked about the extent to which a legal or reinsurance only EDIS is needed to stop short of providing insurance to all deposits in the Eurozone, so that €1 held in Athens is worth the same as €1 in Berlin.

Quite a lot is missing without EDIS. The cross border deposit market, for instance, is non existent without it. Some banks are exploiting this loophole and offering deposits with higher rates in certain countries (e.g. Greece), but they do not tell you that the deposit insurance or guarantee scheme in place is also of that country.

A central banker therefore stated that Europe has to clean up its banking system, as there are far too many inefficient banks. But there will be no credible and efficient elimination of ineffective and sometimes disruptive market players without a well funded deposit insurance system. Croatia has closed down two thirds of its banks over the last 20 years, which it accomplished using such a system, without ever resorting to ministry of finance money. The whole clean–up was financed by the banks and it worked. If this is not done elsewhere, supervisors would be able to turn a blind eye to any problems they know will be difficult. Once they have closed down these banks, they can do whatever else is necessary.

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

Also on the table during Croatia's presidency is sovereign concentration risk and insolvency. As has been said, different insolvency regimes cannot operate across the great institutions of Europe, if there is to be a truly integrated and efficient banking market and a common deposit insurance system. This is difficult to do piecemeal. A central banker questioned the preconditions for achieving a smooth flow of liquidity and capital. Work must be done on these from the outset.

3.3.3. The critical question is how much risk reduction is needed before the risk sharing needed to make this work

Another central bank official saw cost resulting from both non-implementation as well as an ill designed implementation of EDIS. There is a contrast in the view that EDIS would essentially be a last resort, as well as the first element a consumer needs to be given the confidence necessary to invest money. It is conceded that there are different views of what people in the industry and consumers expect.

Consideration needs to be given to whether EDIS could be done earlier, as a phased approach or wholescale. The argument was made that, by trying to do it, one gets the confidence to know how to do it. However, if a shock were to hit and EDIS were to fail, the hope of bringing it back to the table would be lost for decades. The critical question is how much risk reduction is needed before risks could be shared sufficiently to make this work. There is the matter of whether to include NPLs and, linked to this, how to price risk. Many uncomfortable decisions still need to be made that, unfortunately, will include further risk reductions before risk sharing can go ahead.

A central banker thought EDIS should at least have a pre funded central fund, even if it has different pockets for different countries, then it could start collecting payments centrally. When ready, the risks could be quickly shared. Another issue in this context is that, if EDIS is called on, the deposit insurance scheme becomes a player in the insolvency procedure, and national regimes differ in their effectiveness at recouping money. Historically, loss given defaults of deposit insurance schemes have varied from zero in some countries to almost 50% in others, and this discrepancy needs to be tackled.

3.3.4. A pragmatic and staggered approach

According to one central banker, agreement on EDIS should be part of a broader EU agreement that includes the harmonisation of insolvency regimes. A deposit guarantee scheme should not be the second step in the insolvency procedure of one country and the sixth in another one. However, another central banker described waiting for a common insolvency law to be in place across all countries as like waiting for Godot. A federal insolvency law needs to be created that would require all countries to follow the same legal procedures. It would take too long to wait until civil law is implemented in an equivalent way. A further central banker therefore believed that ministers of justice, not finance, would need to take these decisions and that they require an understanding of insolvency laws.

An industry representative widened this issue from the harmonisation of insolvency laws to decision making and governance. Fernando Restoy has a proposal to empower the SRB, in the case of small institutions applying resolution, so that it acts like the Federal Deposit Insurance Corporation (FDIC). This concerns

not just legislation but its application and is key to banks remaining European in death.

3.4. Is the Eurofi proposal to solve the home/host issue, with outright group support of parent companies to subsidiaries or with branchification of subsidiaries located in the euro area for banking groups that wish to operate in a more integrated way, the right way forward?

Another question for panel members concerned the Eurofi proposal to solve the home/host issue. A central bank official expects the parent to support its subsidiary, though this also depends on the resolution planning. The parent is supposed to have an SPE strategy, but resolution needs to be tested first. Until there has been that experience, there will be a lack of trust, because European regulations are not always implemented in the same way everywhere. How things will work in practice remains to be seen. A second central banker stated that cross-border branches eliminate many of the home/host problems being debated by the EU regulators. The preference for establishing subsidiaries may be a missed opportunity in financial market integration. Some of the energy spent arguing whether regulation should apply at the solo or group level could be better directed at understanding why banks are using subsidiaries instead of branches.

An industry representative was not surprised by Eurofi's suggestion related to guarantees, but also pointed out that there is another way to achieve these goals economically, which is to allow a bank to make branches of all its subsidiaries within the Eurozone. Local regulations do not really like that though. Banks would be able to move liquidity from one place to another or move dividends upstream, but this can take many months to accomplish as Banking Union has not been finalised. It must be remembered that this solution is a contractual arrangement, so whether it holds in a bankruptcy is doubtful. It is much easier to accomplish the whole thing at once via branchification. A central bank official and this industry representative agreed that, in such circumstances, the local deposit insurance scheme would need to cover all deposits Eurozone wide. EDIS must be in place, working and trusted.

A central banker has also seen the branchification of cross border banking groups taking place in the Nordic/Baltics region, suggesting that there is trust there that is lacking elsewhere in Europe. Estonia has traditionally been a host market for some of the larger Scandinavian banks, which have had both branches and subsidiaries there. The situation has changed in the last couple of years, with a Baltic banking operation now headquartered in Tallinn, which also has a business in Latvia and Lithuania. In a way, Estonia is a home country now and this has worked well. Banks have the choice of having branches instead of subsidiaries, which avoids all the problems of waivers or liquidity and capital requirements. But it is not only down to policymakers to make this work in a single market; it is something for commercial bankers to take on themselves. This central banker therefore felt that Eurofi's proposal is heading in the right direction, but there are questions about how far such an arrangement could be trusted. The regulators would prefer to see real branches other than subsidiaries that are not run as independent banks, but from a different country.

3.5. In a single jurisdiction, the home/host distinction is nonsense

An industry representative commented that the host/home distinction makes little sense to the goal of becoming a single jurisdiction, as there is a disconnect from the responsibilities of functions. Regulators and supervisors love multiple point of entry (MPE) institutions, because the capital and liquidity management, and risk management, are all under control. This is not how a single jurisdiction Banking Union should function, however, so there is a need to wait before such a proposal can be implemented. An official assed that liability and control have to exist at the same jurisdictional level.

3.6. Lowering Basel III implementation standards?

An audience member asked whether the panel agrees with a French proposal to lower Basel III implementation standards to make EU banks more competitive globally. A central banker referred to the impression that, on the other side of the Atlantic, there are movements to deregulate, and asked if it would be a good idea for Europe to act similarly.

An industry representative supported the idea, pointing out that France has been at the forefront of European financial integration and that revenues go down when interest rates do. Banks do not influence this. Additionally, costs have risen with banks taking on more know your customer (KYC) measures, which has further affected their profitability. At the same time, capital requirements are rising, perpetuating this vicious circle and explaining why the price to book of most European banks is below 100. If banks are already well capitalised, and the liquidity measures imposed on them are an effective tool against failure, they should not need more capital.

Another industry representative stated that regulation is here for good reason. A lot of misbehaviour and problems in the crisis occurred because of low or non existent regulation. Hence it is inadvisable to compete by being more lenient towards banking supervision and regulation.

Having said that, the regulatory tsunami that washed over the banks has not yet been analysed in depth. Overlapping regulations represent overkill. Such a review has been promised time and again, but is still missing, and its absence impacts profitability. Banking institutions need profits to survive, and to attract investment in lending to the real economy, which permits monetary policy to work. In that sense, European regulation is not excessive, and Europe can still compete with a deregulating US, but only if it looks first at which elements of its regulations that are excessive and contradict others. Regulations have been imposed in multiple waves without a global analysis of their consistency.

A central banker likewise advised balance and urged caution about becoming much more lightly regulated, given recent experience of thinly capitalised banks. They gave their agreement that a review is needed soon, though clarified that banks can be well capitalised and also profitable. There is not necessarily a conflict between strong regulations and well capitalised and successful banks. A second central banker supported this call for regulatory review, both for the banking system and more generally, conjecturing that regulations of the last decade have substantially reduced productivity across many industries, not only banks. At the moment, such regulations seek to specify every possible outcome, when they could become more principles based. A third central banker agreed that not all the many different layers of regulation are necessary. From looking at the American banks, their leverage ratios and their price to book, it might appear that capital is not the problem. An overhaul of the regulations would make life easier for the banks, even though they are partly to blame for this tsunami. The Financial Stability Board (FSB) has also concluded that, after rolling out such a major financial reform agenda, it is logical to carry out some targeted evaluations of whether its objectives have been achieved and if there have been any unintended consequences.

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.

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FINANCIAL STABILITY AND SAFETY

AML / TF detection, supervision and EU coordination

1. Lessons from the past

1.1. The EU Commission post-mortem regarding Banks, AML competent authorities, and EU and National bank supervisors

An official stated that there have been important anti money laundering (AML) scandals in recent years. Major banks are being heavily criticised for failing in their duties in combatting financial crime. A policymaker added that that affects the international reputation of the EU financial system and the trust of consumers in banks, regulators and policymakers. The official also highlighted that supervisors have been heavily criticised for a lack of resources and a lax approach to scrutinising supervised entities' compliance. There have been investigations by US authorities and sanctions applied.

However, individual countries have implemented the AML directives in their own ways. Cooperation with financial intelligence units (FIUs) is improving.

A policymaker noted that in July the European Commission published a post-mortem analysis of recent scandals, because before deciding what to do, it is important to understand what has happened in the EU banking sector over the last few years. The policymaker detailed the problems identified.

Banks in many cases were not prioritising AML compliance. They ran risky business models from an AML standpoint, that were pursued with no commensurate AML controls.

Often in large banks there was no group-wide AML policy and the AML function was scattered across the different parts of the organisation. An official noted that the post-mortem exercise pointed to behaviours that led to the possibility that banks could be used for money laundering, for example ineffective or non-compliance with legal arrangements, governance failures, misalignment between the risk appetite and risk management and negligence regarding group policies.

AML competent authorities often have insufficient resources, lack prioritisation and have insufficient resources and have very different powers and sanctioning regimes. Indeed, AML national legislation has resulted in very different sanctioning regimes. In particular, the sanctions in place are not dissuasive enough, and sometimes they are not applied in a strict manner. There are not many on-site inspections carried out by AML supervisors.

National bank supervisors are uncertain as to what they need to do on AML and the type of supervisory measures that they should apply in the licensing process, though they have responsibility in the licensing process, the approval of shareholders and the approval of members of the management board. There are numerous hesitations about withdrawing licences on the basis of AML infringements.

There is no thought through cooperation of AML supervision into the Supervisory Review and Evaluation Process (SREP). Many authorities are involved, including AML authorities, prudential authorities, home and host authorities, in addition to the Financial Intelligence Units (FIUs). There is a lack of structured cooperation between all of the authorities involved, no joint supervisory decision process and no joint supervisory action in many cases. That does not necessarily mean there needs to be a single supervisor but there is, for the moment, very often difficult and inefficient cooperation between competent authorities.

Cooperation with third countries has also been difficult, with hesitation about sharing confidential information and, apparently, a lack of trust between EU authorities and third countries' ones, resulting in information sharing asymmetries.

1.2. Know Your Customer (KYC) lessons learned from throughout the EU

A regulator commented that it is often stated that problems arise because of the lack of rule of law in certain jurisdictions, and poor cooperation amongst supervisors. Neither of these issues held in the case of Danske Bank's Estonia branch. Estonian supervisors had shown incredible courage in 2015 when they threw out the non-resident Danske Bank customers. Nobody could have done a better job. Anybody who knows Scandinavian culture will know that cooperation and consensus seeking is not a problem. On the contrary, there are many who are frustrated with the amount of sitting down together and agreeing on how to do things that happen in that environment.

Rather, there was a rogue branch and an issue of failed lines of defence.

Two issues were particularly important. One was that know your customer processes failed and the other was that when the customers were thrown out, they could walk into other banks without them knowing who they were, because those banks also had poor know your customer processes.

Looking across the EU, it is difficult to find a country or big bank that has not had similar problems. The list includes BNP Paribas, the French authorities, Deutsche Bank, the German authorities, Nordea, the Swedish authorities and ING Bank.

That suggests that it is not a question of a failure in an individual institution, and that is also what the European Banking Authority (EBA) Board of Supervisors decided in relation to the first cause brought in, to determine there was not a breach of EU law. The authorities have a greenfield opportunity here, compared to other areas where there would be duplication and complication of work among authorities and in the national value chain.

There is a need to build a know your customer (KYC) infrastructure which banks can report into. Yet, banks cannot do that because it raises serious questions in relation to the General Data Protection Regulation (GDPR), data integrity and bank confidential information. These issues have to be dealt with and settled at a political level, and at the EU level given GDPR and other regulations. That would

be a significant contribution to fighting AML. It raises really difficult questions, and trade-offs for policymakers in terms of AML versus data confidentiality and GDPR.

Addressing KYC issues represents an opportunity where a difference can be made. There are opportunities to addresses problems leveraging notably innovative technologies, the benefits of which far outweigh the costs associated. Rather than discussing duplication of new institutions, there should be serious efforts across the EU to address this issue.

1.3. Latvia's response to problems faced from its banks

An official explained that Latvia without waiting for the results of the post mortem, has adapted and implemented a comprehensive set of reforms, with political commitment and the involvement of different public institutions and private sector players. Latvia's priorities are clear: decreasing the risks in the banking sector, enhancing coordination, increasing transparency, improving its sanction regime, in addition to properly liquidating ABLV Bank.

The first part of the strategy is the de-risking and consolidation of the banking sector. This goes together with the changes in the legislative framework and the supervisory activities. With the changes to AML and the combating of the financing of terrorism (CFT) legislation, Latvia banned banks and payment institutions from doing business with high-risk shell entities which threatened the integrity of the financial system in the past. Banks have eliminated that part of their customer base. In 2015, Latvia's banking sector had an almost 53% non-resident customer base. Now, excluding the EU customers, it is around 7-8%. With all of those changes, the banks have re-considered their business strategies and look for the new target markets, customers, alternative business lines and services. The supervisors have looked extensively at how the banks implement the new strategies.

The second pillar of the strategy is strengthening the AML/CFT supervision, including some changes in legislation. The international recommendations on how best supervisors can execute their AML/CFT role, were followed. There is one supervisor for AML, which is the prudential supervisor for banks. The aim was to maximise the synergies in one institution. In parallel, during the last two years, the resources of all supervisory and control institutions have increased, in some cases more than doubling, so the institutions can supervise more effectively.

The third part of the strategy is increasing transparency. Since April 2019, beneficial ownership and enterprise registers are publicly available. In mid-August, almost all entities registered in Latvia have disclosed the beneficial ownership information. The enterprise register has a right to de-register those companies that do not follow this requirement and apply to them simplified liquidation. In combination with the account central register, it is very efficient at eliminating AML/CFT risks.

2. Main short-term areas for improvement:

2.1. Clear AML leadership, existing rules enforcement, and then the creation of an AML EU single rule book

A policymaker added that before moving to major legislative or supervisory changes there must be a consideration of what can be done immediately. First, better compliance is needed from banks. Banks must attach a higher level of priority to combatting money laundering. There should be a better enforcement of the existing rules, even if they have their weaknesses. National authorities should make sure that AML is a priority. There will be more active involvement by the EBA, with more powers and more resources.

The European AML rulebook is quite loose, especially compared with the rulebooks for banking and insurance. There is scope to be more prescriptive about what financial operators and competent authorities should do. Turning some aspects of the AML directive into a regulation may help, as they would shed more light on supervisory measures and sanctioning powers. However, there should be more consistent rules throughout the single market and the Banking Union.

2.2. Improving customer onboarding

A regulator stressed that another essential aspect is the on-boarding of customers. The implementation of on-boarding policies is different in all EU countries. Furthermore, there should be some guidance regarding what should be considered to be an appropriate on-boarding to aid with standardisation. The EU will be as strong as its weakest link, and customers will eventually find out whether there is an easier way for them to get an EU authorisation to operate within the EU.

A policymaker agreed that know your customer processes do not work in a satisfactory manner, and that is something to fix, if possible, with new technologies.

Furthermore, GDPR does not necessarily stand in the way of KYC. The question is more about interpreting GDPR and applying it in a proper manner, which suggests some education is required. GDPR should not need to be changed.

Finally, private organisations and public bodies need to collaborate better in order to move away from a box ticking exercise and towards a smarter approach for detecting money launderers. Some member states have experiences of this, with public and private partnerships set up so that banks in particular understand what public authorities are looking for, and that is certainly something to work on.

2.3. An holistic approach to the anti-money laundering risk

A regulator indicated that another aspect is what role the prudential supervisors should have. The EBA has a risk-based approach to AML, but as for any risk-related part of prudential supervision, this means taking measures to make sure that the rules and procedures for AML are adequate for banks. Beyond the checks of individual transactions, which are the competence of the AML authority, there should be rules, processes and procedures, which should be an integral part of what national supervisors complete for the prudential supervision of banks.

Additionally, an intelligence database should be built. It will not be about individual transactions or individual subjects. It will be about intelligence and aggregate information that could be shared easily across authorities within the existing regulations on personal confidentiality. The hope is that it will help in detecting common trends and common collaborations within the industry.

2.4. The role of the EBA on coordination

A regulator stated that one of the big challenges cited, is coordination among agencies, within countries and across the EU.

A regulator noted that the EBA has just gone through the current review of the ESAs' founding regulation, and it has a new mandate, among the three European Supervisory Authorities (ESAs) – the European Securities and Markets Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA) and the EBA – to lead efforts on anti-money laundering. The conclusions of the post-mortem exercise that the European Commission put forward were shared. These changes in organisational structure do not require going beyond the changes agreed in the ESAs review.

One of the mandates the EBA gets in this context, is an AML standing committee in which all of those organisations are required to be participants and to engage. The EBA's analysis suggests there are over 70 authorities that should be represented in the committee, so it is not a simple committee to manage. The rules and procedures of how it will operate are being worked on, but it reflects the organisational complexity in the EU with regard to these issues.

Collaboration among authorities is really a big issue both within the EU and across third countries. There is again the experience of supervision. The college of supervision has proved to be very effective. The EBA will suggest that there should be AML colleges for multinational groups, so that the AML authorities discuss these issues and make sure that there are group policies in place, that those group policies are effectively implemented and that there is intelligence being shared among those authorities that are supervising the same banking group. The Chair asked whether the EBA has become a supervisor. The regulator confirmed that it has not.

3. Should the EU have a single AML authority?

3.1. Better supervision is needed

A policymaker stressed that there is no formal view at the moment from the Commission on a single authority yet. However, on the supervisory front the status quo is not an option. The political guidelines from the President-Elect state that better supervision is needed, and the mission letter given to Vice President Dombrovskis also refers to the need for better supervision.

Nonetheless, better supervision does not necessarily mean a single supervisor. What might be needed is a network of supervisors who work and collaborate more effectively than currently. In that network, national competent authorities would retain an essential role.

The EU is as strong as its weakest link. If there are a couple of supervisors that do not do the job properly in the wrong corner of the single market then dirty money can flow into that country and then, by virtue of the single market and the Banking Union, that money can be laundered throughout the EU. That may trigger a number of reflections on the organisation of supervision in Europe.

A regulator confirmed that the EBA gets information and questions to investigate by many interested parties, and not just within the organisation, so there was whistleblowing. An authority without regulation is not really feasible currently. There needs to be convergence on regulation before consideration of an authority.

3.2. A single AML supervisor is an attractive solution…

An industry representative suggested that there are four good arguments for considering a European regulator. One is resource and critical mass. The FIUs are outgunned, which could be countered by bringing them together. Second is the weakest link problem. If there is a weak supervisor that lets in a weak bank, then criminals will use that bank to access the single market. Third is the ability to see the whole picture. One FIU can today not see all the Suspicious Activity Reports (SARs). This could be compared to the role of ESMA in securities markets who sits in the middle on all of the transaction flows.. Fourth is the need for a credible partner for the US, who is today scrutinising the European AML practises and handing out large fines for wrongdoings in the past.

An official is in favour of the single supervisor said that otherwise all of the initiatives, like a KYC infrastructure and better regulation, cannot find the best way to fight such a cross-border phenomenon.

3.3. … However, a single AML supervisor may face important challenges

A regulator noted that conducting AML supervision is a dirty job with dire reputational consequences. It is not a coincidence that the proposal is to give that gift to an institution which does not exist; it cannot say, 'No, thanks.'

However, the regulator expressed the view that a single authority would not have solved any of the problems there have been. One should first deal with the issues in the value chain. The regulator stressed that while more cooperation, exchange of experiences and all of the work that goes on at the EBA is positive, the question of the definition of an appropriate value chain able to finding money laundering is essential. In this respect the fact that the main value chain and the most relevant institutions are essentially within the banks and the police, was stressed, while underlining that supervisors play an ancillary role and should not be too overconfident in terms of what they can achieve. Indeed the role of supervisors is to look at what banks do and ensure that they live up to the rules.

The regulator insisted on the fact that is the bank and the police nexus which have to work, and they have to work speedily because money moves incredibly fast. In this respect creating a new supervisor risks moving the process away from the national level where a speedy process takes place. This is unlikely to achieve anything but a slower response. The regulator warned that value would only be added by doing a greenfield operation rather than something that complicates an already complicated value chain that needs to be improved.

Sovereign / financial sector / Central Bank loop

1. The sovereign bank nexus still needs to be addressed 11 years after the global financial crisis

The Chair explained that the topic is not something new and the question is whether the topic is still relevant. The sovereign debt crisis demonstrated bank risk and sovereign risk are closely intertwined. The entire 30 year German public sector yield curve is currently in the negative. Bank exposures to sovereigns are still on average around three quarters of Tier 1 bank capital, and could still wipe out almost all bank capital should there be a problem.

2. The evolution of the sovereign-financial sector loop

2.1. The sovereign bank loop is a reality across geographies

An industry representative explained that the negative financial sector sovereign feedback loop is a structural reality around the globe, which reflects both the direct exposure of banks to what is sovereign, but also indirect exposure. When considering the weight of sovereign and banks in the economy, it is natural to see the risk of a feedback loop.

From the global rating universe, it is extremely rare for banks to be rated above their sovereign. A quasi-totality of banks around the globe would be at risk of default if their sovereign defaults, which reflects not only direct exposure

but the credit risk in the economy, the funding liquidity, convertibility risks, reputation and confidence. Across countries the level of direct exposure is significant.

Across countries the level of direct exposure is significant. Quite often it is above 100% of common equity Tier 1 capital, and in multiple countries over 200%. Examples include China, Japan, France, Spain, Portugal and Italy. The list of these significant exposures is quite long, and there has been no material change in that exposure. In a few instances, there has been a decline, for example where countries have very negative yields or declining sovereign debts, but it has become a structural feature.

2.2. The risk of an adverse feedback loop is not the same among jurisdictions

A Central Bank official noted that Japan and high debt countries in Europe share a high level of government debt to GDP ratio, and banks and central banks hold a large quantity of government bonds. However, there are significant differences that can lead to a difference in the risk of an adverse feedback loop.

One difference concerns fiscal discipline. Some European countries increasingly face popular pressure to increase public spending, but in Japan the government continues to express the will to maintain fiscal discipline. Another difference is denomination risk. In some European countries, an increase in fiscal deficits led to the risk of an exit from the Eurozone and the resultant rise in long-term interest rates, whereas Japan does not have such risks.

The adverse feedback loop will not materialise in the foreseeable future in Japan, but there seems to be some worry about the possible emergence of it in Europe.

2.3. Some positive recent improvements in addressing the sovereign financial sector feedback loop

An industry representative indicated that there have been some positive developments with regard to the feedback loop risk. For Europe, there are improvements in banking system credit worthiness across multiple countries, which have had a positive impact on sovereign ratings. The build-up of bail-in-able buffers of minimum requirements for own funds and eligible liabilities (MREL) and total loss-absorbing capacity (TLAC) has reduced the contagion liability of sovereigns vis-à-vis the banking system, even if it is not believed that the resolution regimes will work in all scenarios.

Another factor is the improvement in sovereign ratings. Europe has had the highest proportion of sovereign rating upgrades and the vast majority of European sovereigns have stable or positive outlooks. The European resolution regimes and the build-up of bail-in-able buffers can also, to some extent, reduce senior unsecured creditors of systemically important banks and increase resilience to potential sovereign shocks.

The reasons there are not more examples currently are that many European sovereigns are strong and, more importantly, the build-up of bail-in-able buffers is still work in progress. With the resolution framework in Europe, in particular the Single Resolution Board (SRB) and the Single Resolution Fund (SRF), it is believed that the conditions to step in and protect senior unsecured creditors are difficult and surrounded by multiple uncertainties, which means not being able to ex ante the fact of a potential support for senior unsecured from the SRB.

2.4. Banks are more resilient but the home bias in sovereign bond holdings continues to be strong

A regulator confirmed that, thanks to the efforts of all stakeholders, there has been much progress regarding the stability of the EU financial system. By implementing the Banking Union, there are higher capital ratios in the banks and the volume of non-performing loans (NPLs) has reduced. MREL and bail-in rules have been implemented. There is also supervisory convergence throughout the banking union.

However, home bias remains a strong element of sovereign exposure. Indeed concentration risks in sovereign exposures remains a critical link in the sovereign-bank nexus. The home bias ranges from less than 3% to up to 91% of domestic sovereign bonds held by domestic banks. This is a main reason for why there is not a common understanding regarding the application of the resolution framework, especially when it comes to the public interest test.

The Chair asked an audience question regarding whether the EU has really committed to bank resolution. An industry representative replied that resolution is one tool. In the past there was a lack of potential systemic implications of some banks' defaults. There have been pragmatic approaches, which have avoided implementing the resolution as it was designed. A major obstacle to implementing the resolution is the build-up of bail-in buffers. When the problem becomes more systemic, resolution will not be a magic solution.

3. The way forward: different points of view but fiscal discipline and sound macroeconomic policies are essential

The regulatory treatment of sovereign exposures is a long-standing problem. With global efforts for an international standard stalling, Europe should start setting the right prudential incentives, develop an approach that is both effective and feasible and complete the Banking Union. A public decision maker stressed that each jurisdiction needs to judge whether it should introduce any measures that target sovereign exposure by banks while considering the risk of an adverse feedback loop and the economic and monetary situation within each jurisdiction. Fiscal discipline is vital notably to address the root cause of sovereign problems.

3.1. A longstanding problem

3.1.1. The regulatory treatment of sovereign exposures is not a new issue

An industry representative explained that 30 years ago, one of the issues the Basel Committee discussed, (in the aftermath of Basel I), was the treatment of sovereign exposures. The question at the time focused on how broad the zero-risk weight should be.

Ideas and proposals have been published that outline technical aspects for dealing with the sovereign-bank nexus. For example, the Basel Committee completed an exhaustive review and think tanks suggested how to calibrate concentrations to disincentivise the holding large sovereign exposures.

3.1.2. What is missing right now is urgency

The same industry representative noted that progress happens when there is urgency. Urgency often occurs when actors are under pressure. Currently, sovereigns are able to finance themselves at very attractive rates (i.e., low or negative rates), and banks are able to fund themselves because the financial system is awash with reserves. The traditional catalyst for action is missing, but this is a window of relative calm where there is an opportunity to do something. Policymakers should take advantage of this window.

3.1.3. The current negative yield environment may not persist. Policymakers should take advantage of it

There is $15-16 trillions' worth of government debt sporting negative yields. The four European peripheral countries that were in crisis just a few years ago – Greece, Portugal, Spain and Italy – all have 10 year yields that are below the US 10 year yield. The question is whether the

environment of negative interest rates and low interest rates will persist, and for how long. There should be readiness for a sudden shift back. If and when that shift does come, it is very likely to be rapid and disruptive, and there is likely to be a lurch upwards in interest rates. If this issue has not been dealt with, the sovereign bank nexus will arise in a very uncomfortable setting. The time to address the regulatory treatment of sovereign exposures is now.

3.2. A roadmap for completing the Banking Union

A regulator explained that to further reduce the link, there should be a move towards EDIS, but also steps towards a reasonable treatment of the sovereign exposures. This is highly political and controversial; therefore, a step-by-step approach is needed. Furthermore, according to this regulator, without EDIS and a reduction in the home bias, the Banking Union will not be complete. Only with these two cornerstones in place can the Banking Union 's initial mandate – untangling states and banks- be achieved.

3.3. Setting the right regulatory incentives in the Banking Union area

A first step could be to set incentives to reduce the home bias of sovereign risk in the bank's balance sheets and make them more European rather than national. Fewer home buyers and more European focus in the sovereign bond holdings is key. If the European banks were more European in their sovereign exposures, the effects of a sovereign bank crisis could be managed more effectively. The European way was chosen by the legislators when they decided to have a banking union with a Single Supervisory Mechanism (SSM) and the SRB.

Euro area banks should be incentivised to hold a well-diversified euro area sovereign portfolio. Rather than penalise the holding of sovereign debt, risk reduction through sufficient risk diversification should be incentivised. With such an incentive, zero risk weights could only be granted to well diversified sovereign portfolios. Overly concentrated portfolios would then be subject to own fund requirements for disproportionate exposures to any euro area member state.

The benchmark portfolio could be composed along the lines of the GDP shares of the eurozone countries. The share of Euro members in the Eurosystem could also be used.

Calculations for a representative and large part of SSM significant institutions, based on the assumption that the current sovereign bond portfolios remain unchanged – the banks hold roughly 2280 bn Euro area sovereign exposures -, and a risk weight of 20% for sovereign debt assumed, shows that the average impact would be moderate. The risk weighted assets would increase by 4.1% on average, and the CT1 would decrease by 57 basis points on average per bank.

For the average CET1 effect by member states, the impact would range from 38 basis points to 250 basis points in the large countries of the eurozone, and the effect throughout below 75 basis points. For the CT effect bank by bank, about 15% of outliers suffer a large impact because of their specialized business model. About 70% of the banks are affected by a decrease of less than 100 basis points.

However, given the incentive, the expectation is that banks will significantly diversify their portfolios and therefore be subject to substantially lower capital impacts. By diversifying their portfolios they can even avoid additional capital requirements. Other proposals and discussions regarding the treatment of sovereign bonds are focused on limiting overall levels of sovereign exposures.

This proposal would be for the eurozone, not the EU27 and not globally, due to the existence of the Banking Union.

The Chair asked an audience question relating to whether it is politically acceptable to explain to somebody who wants, for example, a Finnish mortgage that they must pay more because of investment in Italian sovereign bonds.

A regulator agrees that it is a highly political question. There is a significant home bias in the bank balance sheets and there has been discussion for 30 years about the risk weight for sovereign debt. There are other proposals in the same direction regarding the risk diversification as the first step.

An industry representative added that asking a bank in a country with high funding costs to pledge and put a large part of its liquid assets in government debt, and knowing that one main concern is profitability, could have other unintended consequences for the system. More systematic disclosures about the exposure might help to push the banks to adapt.

An industry representative believed that the suggestion is a pragmatic way forward, at least to begin the discussion. There has been progress in Europe on resolution. The establishment of the SRB is a significant step forward, as is the SSM.

3.4. Each jurisdiction needs to judge whether it should introduce any measures that target sovereign exposure by banks while taking into account the risk of an adverse feedback loop and the economic and monetary situation within each jurisdiction

A Central Bank official explained that everybody agrees on the importance of containing the emergence of an adverse feedback loop between sovereign and financial institutions. To address the sovereign-bank nexus from the perspective of policymakers, each jurisdiction needs to judge whether it should introduce any measures that target sovereign exposure by banks.

3.5. Sound macro economy policy is the appropriate solution

If there is a panacea for addressing the risk of the sovereign-bank nexus, it is sound macroeconomic policy, which no regulation can substitute for. However, it is also practically desirable that each jurisdiction should take into account the risk of the adverse feedback loop to assess the necessity of introducing regulatory treatment of sovereign exposure by banks. For Japan, it is not necessary to introduce any such regulation.

3.6. A sovereign default is possible

A participant suggested that while a pragmatic and step-by-step approach may be essential, one piece that is missing is the question of an insolvency law or regime for the states. If there was a real risk of a state going bankrupt, then risk managers would immediately say there needs to be capital for that risk. However, if there is no such risk then it does not make sense to have such a capital requirement.

The Chair asked whether a sovereign default is possible. An industry representative noted that even in Europe investors in sovereign debt have had some losses. The track record across the world demonstrates a large number of investors having losses on sovereign. It is unclear whether that would drive a change in capital. The banks, in their internal capital models, are also locating funds in front of sovereigns.

An industry representative added that Argentina occasionally acts as a reminder that countries can go bankrupt, default or restructure. Greece was a default of sorts because the maturity was re-profiled, so it even occurs within the eurozone.

The Chair noted that there is also the issue of whether every sovereign qualifies for a zero-capital weight, which is a different argument about whether they are all the same in terms of risk.

Cyber-security and cyber-resilience

1. Current industry practices and trends

1.1. Evolution of cyber-threats and risks

An industry representative explained that their company, an insurance firm, views the evolution of cyber risk through 20 years of cyber claim data and assessment of risks inside portfolios. Financial institutions have historically been the main target of cyberattacks, but as these companies have increased the robustness of their defences there has been a shift in attacks to other sectors. All financial institutions are likely to face at some point some form of cyber-attack. In 2018 the frequency of cyber-attacks grew with more cyber claims reported than in the previous two years combined. In addition, there has been a shift in the methods that cyber criminals use and also in the geographies targeted. In 2018 the three main methods used were business email compromise[1], ransomware and data breach.

Another industry representative stated that what most concerns them is the development of massive, well structured attacks such as WannaCry and Carbanak from large scale criminal organisations which go beyond the protection and measures that individual companies and banks can put in place. Regarding Carbanak for example, a few years ago, there was an enormous attack lasting two years from a large scale organisation across 30 countries. 130 banks were hit and the total loss was around €1 billion.

A third industry representative added that cyber-risk is a global problem with national implications. Effects in different parts of the world have the ability to create operational shocks in other countries, so it is a borderless issue. Considering market infrastructures for example, it is important to be able to respond to these potential cross-border impacts. Another characteristic of cyber risks is that they are intentional, unlike other operational risks.

An official summarised that cyber risks are on the rise and are changing rapidly. Risks are not idiosyncratic; they are pervasive and multifaceted, and as a result of the nature of the financial system they are cross border and system wide, specifically from a financial stability perspective. Attacks are becoming increasingly sophisticated and some are harming the financial system, as well as economic and political stability.

1.2. Main underlying factors of cyber-risks and challenges for the financial sector

An industry representative stated that there are several trends underlying cyber-attacks. The first is usually human error with employees or other individuals unintentionally opening the door to criminals or cyberattacks. The second is how companies respond after an attack. Having a robust response in the first 48 hours is critical as it helps to limit the size of the attack and its potential loss but also helps companies to get up and running much more quickly. This entails having a robust crisis management plan and bringing in the right forensic data experts and potentially public relations in order to mitigate reputational impacts and customer loss risks. Investment in response and recovery capacities after a cyber-attack are as important as the identification, protection and detection of cyber-risk prior to it.

Another industry representative felt that there are three primary sources of threat to the financial services sector. The first comes from increased criminal activity, whether from organised cyber-criminals or nation states. There has been an increase in the amount of cyber activity coming from those groups. The second is the increasing use of new technologies[2] in service offerings, which creates several challenges including the difficulty of understanding the gaps created when integrating new and old technology and the need to integrate technology quickly due to competitive pressure without fully understanding the risks and implications. And third, the growing outsourcing to fintechs and other third parties, which increases the potential surface and entry points for cyber-attacks.

These threats are exacerbated by the interconnectedness within the financial services sector and the complexity of financial markets, which makes cyber-risk a systemic issue. Cyber resilience indeed involves understanding how a product or service is accomplished from origination to delivery to the market and the underlying practices and disciplines. This requires qualified resources that are scarce.

A third industry representative agreed that increasing digitalisation and outsourcing (e.g. to cloud service providers) make cyber-resilience increasingly difficult. It is very difficult in particular to implement the specific requirements needed by individual financial institutions when dealing with global cloud service providers.

An official concurred with the different drivers of cyber-risk mentioned by the industry speakers, emphasizing that time to market pressure, which has increased with digitalisation and competition is pushing firms to move into new fields without always the adequate preparation for and protection against cyber risks. Another official noted that time to market pressure is relevant for example in the area of payments with developments related to instant payments tending to go as fast as possible.

1.3. Cyber-resilience and cyber-security actions undertaken by the financial industry

Speakers believed that progress is generally being made with considerable investments by financial institutions, although there is still room for improvement.

An industry representative suggested that three main steps are necessary to mitigate cyber-risk: realising the magnitude of a problem; investing in procedures to address cyber-risks; and taking the attackers' point of view. There is now a realisation of the magnitude of the threat in the financial sector and there is investment underway in framework practices. In addition ethical hacking exercises and bug bounty platforms[3] are used by many institutions to identify and tackle cyber-vulnerabilities.

A member of the audience was concerned by some industry players who still believe that cyber-risk can be tackled by taking an insurance or putting capital aside to fight a cyber-attack. An industry representative agreed that insurance is not the panacea to all cyber threats. Insurance companies help financial institutions to analyse their risks and cover some of them but they cannot insure all the cyber risks of a company, so it is definitely up to financial institutions to invest in their defences and employee training. Although there has generally been great progress within financial services in fighting cyber-risk, there is some bifurcation between larger corporations that have more resources available and smaller and medium sized companies. The smaller ones are sometimes not able to deploy the same network defences and information security sensors, so might rely on external vendors to increase the robustness of their defences, creating potential vulnerabilities.

2. Main areas of improvement in the financial services sector

2.1. Areas of improvement at an individual company level

An official believed that self discipline could be reinforced, particularly regarding cyber governance. In some cases, cyber strategy is still non existent or not operationalised and it is often not included in the global risk management strategy of financial institutions.

In addition, there is a need for the industry to adapt its cyber security approach and widen its scope from detection and protection to the ability to respond in the case of an attack. Scarcity of resources is a challenge in this perspective. Given the complexity of the financial sector, there is a need to set priorities on where and how to use these scarce resources. It is also essential to have a cross-jurisdictional and cross-sectoral coordinated action to address these challenges, which should involve both the financial industry, public authorities, security agencies and potentially other industry sectors concerned by cyberattacks.

Another official stressed that the industry should also consider expanding its thinking and actions beyond cyber risks to cover hybrid threats, which involves using broader risk scenarios in particular. This is one of the priorities of the Finnish EU Presidency.

2.2. Progress needed at sector level and information sharing

A public representative summarised that attacks are on the rise and have a potential systemic nature, so no organisations can defend themselves alone. A global, systemic and more organised line of defence is needed involving industry players and also supervisors, both at a global and European level. Information-sharing is also part of this.

An industry representative believed that firms need to understand how to be resilient to cyber-attacks throughout the whole supply chain, including third parties. Firms also need to work together as a sector to ensure cyber-resilience, considering the different intermediaries and suppliers used to deliver a given product or service, the current controls in place to manage cyber risks, and how the industry will respond if the risk materializes.

Another industry representative stated that in facing these threats a first step for companies is to strengthen their individual continuity plans and develop additional cyber resilience action plans. Training and change management can also help to reduce risks of human error. However, given the scale of organised criminal threat that financial institutions are facing individual company action is insufficient. It is also essential to increase the number, breadth and innovation of simulations in order to address the new challenges raised notably by digitalisation. Sector or industry level exercises, such as the one the G7 ran last June are a good example of this. Work is also underway at the industry-level to introduce new approaches. For example, several industry players are using cyber red teaming[4] to continuously test the vulnerability of the systems, instead of testing one given point.

An official explained that areas where the industry could work together have been identified and industry-led working groups are active in three main areas: data integrity (e.g. regarding how asset ownership can be recovered following an attack on a CSD), information sharing, and the verification of the level of security of third-party providers.. Constructive feedback has also been received from the industry regarding guidance defined by the BIS, especially on the two hour recovery time objective.

A member of the audience noted that some companies already have several years' experience in collecting operational risk data in the financial sector, including on cyber security risk, and that exchange of information about events is a well-rooted practice that should be used.

An official emphasized that although data collection is already happening, some issues remain to be tackled. Some of the data remains confidential. There are also consistency issues that require defining a common vocabulary and methodology for measuring the impact of incidents. This would help to qualify them better and in a more comparable way. An industry representative agreed that confidentiality issues are an obstacle to information sharing. If there was a reporting requirement to a regulatory body that would help to get a more complete information on cyber-breaches.

2.3. Improvement of the management of outsourcing arrangements

Outsourcing arrangements were mentioned as a potential driver of cyber-risk by several speakers.

An official emphasized that while it is right to outsource tasks, responsibility cannot be outsourced. One source of improvement would be for the industry to collaborate in the assessment of third-party providers and in the determination of those who are secure enough from a cyber-security perspective.

Another official felt that it is also important to check whether responsibilities are appropriately defined and that cyber security is being well handled by the service provider. The outsourcer also needs to be in a position to control risks posed by third parties. For example, it can be difficult for single financial institutions to oblige the very large cloud service providers to change their practices. Using safe contractual and functional arrangements is also essential to tackle the risks related to outsourcing, especially between market infrastructures and their providers.

A public representative agreed that the ability of the outsourcer to control risks and therefore to exert its responsibilities is an issue when financial institutions outsource to a larger company, which is often the case. A separate issue is when all financial institutions outsource to the same small group of companies. The concentration of services outsourced to a small number of providers poses financial stability risks and raises questions about how to control them. Control needs to be cross jurisdictional and cross sectoral and also requires a great deal of resources, which is challenging to put in place.

An industry representative suggested that the need for a regulation and supervision of third parties could also be considered in order to achieve resilience across the whole marketplace. A member of the audience wondered whether large global providers such as cloud service providers, who play a structural role for many institutions are open to scrutiny by the supervisors or by the industry regarding cyber-risks in particular. A public representative expected companies that provide outsourced services to be open to more scrutiny, especially those in very concentrated sectors. It is in their interest to be open to this type of assessment in order to mitigate the potential systemic risks this situation may pose.

3. Ongoing public sector initiatives at the EU and global levels

3.1. EU regulatory and supervisory approach to cyber-resilience

An official stated that attempts to promote cyber security have been taken by the public authorities, which have led to a number of initiatives globally, at the EU level and also nationally. The EU Fintech action plan proposed in March 2018 requests that the European supervisory authorities (ESAs) should provide the Commission with technical advice on how to develop a coherent cyber resilience testing framework and evaluate the related costs and benefits. Subsequently two pieces of joint-advice were published in April 2019[5].

The first one relates to legislative improvements. Several potential regulatory actions that could be taken have been identified including minimum requirements for ICT risk, security management at financial sector companies, the harmonisation of ICT incident reporting, the outsourcing of critical services and an appropriate oversight framework for monitoring the activities of third party providers.

The second piece of advice relates to the costs and benefits of developing a coherent cyber resilience testing framework. The ESAs concluded that red team testing is one tool in a broader toolkit for achieving cyber resilience, but on its own it is insufficient and requires a certain level of cyber maturity of the entities being tested. The authorities have also recognised that cyber risks are typically managed as part of financial institutions' traditional operational risk management framework, which is not sufficient.

The actions of the EU and ESAs are steps in the right direction but the official believed that further progress is needed, notably to tackle the mismatch between strong financial integration and limited security integration. The supervisory infrastructure has become more centralised, particularly with the Single Supervisory Mechanism and the ESAs, but there is no corresponding coordination of institutional collaboration at an industry-level. Improving information sharing and enhanced cooperation between the public authorities and the private sector is essential.

An industry representative also noted that the fragmentation of current rulemaking can be an obstacle to the improvement of cyber-resilience at the sector level. This would require the cross-border and cross-sectoral dimensions of cyber-resilience to be better taken into account by the public authorities in the regulation and supervision of financial services.

An official considered that at the EU level, the ESAs and the euro area authorities should consider holding cross border preparedness exercises regularly. The Nordic region is an example of cross border cooperation, as its banks are heavily interconnected, have similar funding structures and are exposed to similar risks. As part of that cooperation the Nordic countries have started to implement the TIBER-EU red team testing framework in a coordinated way. Cooperation in other areas, such as threat intelligence sharing and the consolidation of legal frameworks, should be the next steps. Going forward other industries need to be brought in as well, as it is not just a financial sector issue. An audience member noted that when annual crisis management exercises are conducted annually by the Dutch Central Bank in the Netherlands in the context of TIBER testing, the telecom and energy industries are included. The next step is to perform cyber resilience and operational resilience jointly, with a TIBER framework that is broader than just the financial sector.

3.2. Initiatives and cooperation at the global level

An official stated that at the global level cyberattacks are now considered one of the major risks facing the financial sector. Cyber resilience was a building block of the mandate of the G7 French Presidency and G7 jurisdictions agreed to deepen their engagement on this issue in three specific areas: (i) regulation while maintaining a balance with self-discipline at the industry level; (ii) information sharing with an improvement of the harmonisation and categorisation of incidents; and (iii) crisis management with the decision to conduct cross-border crisis management exercises at the G7 level[6].

Answering a question from the Chair about the possible need for additional guidance at the international level regarding cyber-resilience and information sharing, another official did not think that was necessary. Sufficient guidance already exists such as the one established by CPMI IOSCO and the industry now needs to cooperate in the implementation of those guidelines. This guidance is about protecting the core of the financial system, but CPMI is also working on securing the periphery with a strategy on how to secure endpoints in the payment system, particularly wholesale. Later this year CPMI will develop and publish an implementation toolkit for this strategy.

Answering a question about how to operationalise threat-sharing at the global level, an industry representative explained that it depends on the type of information concerned. Companies can share best practice information, but other types of threat information may have national security implications, which are much harder to share, especially across jurisdictions. There are also issues of trust and indemnification.

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[1] In a business email compromise attack, what typically happens is that criminals use credible looking spoof accounts to impersonate executives or potentially a crucial supplier or vendor to the company. They target employees who are authorised to transfer money or other valuable data. Those types of attacks can be greatly exacerbated by the use of embedded malware spreading things across the whole corporation. In the ransomware world, attacks have become increasingly targeted and malicious, leading to longer downtimes and more difficulty recovering data or restoring it from backups.

[2] With the development of artificial intelligence, machine learning, robotics and distributed ledger.

[3] A bug bounty program is a deal offered by organizations, websites and software developers by which individuals can receive recognition and compensation for reporting bugs, especially those pertaining to vulnerabilities.

[4] Cyber red teaming is the practice of using a team of experienced cyber individuals with knowledge of the techniques, tactics, and procedures of an adversary to test the plans, procedures, and responses of an organization in order to improve the organization's cyber posture.

[5] Joint Advice on the need for legislative improvements relating to Information and Communication Technology (ICT) risk management requirements in the European Union (EU) financial sector. Joint Advice on the costs and benefits of a coherent cyber resilience testing framework for significant market participants and infrastructures within the EU financial sector.

[6] A first exercise was conducted involving G7 financial authorities and the private sectors from France, Italy, Germany and Japan. The objective of the exercise was to enhance coordination among G7 financial authorities in responding to cyber incidents. The test was intended to cover certain questions. The first question was whether counterparts were able to communicate amongst themselves and exchange information, both inside the country and across borders, in a timely manner. The second question was whether counterparts could correctly assess the situation and collect relevant data to manage the crisis, and whether they had the appropriate mechanisms for a coordinated and timely response and recovery. The third question was how to communicate decisions in a coordinated manner and response to all stakeholders. Following this the G7 jurisdictions agreed to establish a programme of exercises in the coming years in order to improve operational procedures for response and recovery.

Medium-sized bank resolution

1. Medium-sized bank resolution: what is at stake?

The Chair introduced the topic of medium-sized bank resolution. The Financial Stability Institute has been conducting some work on this matter from both a global and a European perspective. He outlined three relevant singularities or peculiarities of the European Crisis Management Framework. First is the clear distinction between insolvency for less significant institutions, and resolution for significant or systemic institutions. The distinction does not exist in other jurisdictions. Second is the existence of the European Single Resolution Framework, administered or led by the Single Resolution Board (SRB), and the multiplicity of mostly cumbersome and ineffective national insolvency regimes. Third, it is quite a strict resolution framework for significant institutions with explicit minimum bail-in restrictions, and accordingly stringent minimum requirement for own funds and eligible liabilities (MREL) requirements.

Those are three important features to keep in mind. Experience shows that so far, these three important features generate several challenges for the effective operation of the European Crisis Management Framework. The panel will hear about issues concerning the application of the "no creditor worse off" principle in the context in which the loss reference for creditors of banks in resolution is set by the domestic insolvency regime. Other more general issues are related to the consistency between resolution and insolvency, as regards triggers, or the availability of public resources in one regime or another.

Yet the most important challenge has to do with the lack of an effective mechanism to deal with the failure of those banks that could be considered too large to be liquidated according to national insolvency procedures, but at the same time too small or too traditional to satisfy the stringent MREL requirements as requested by the resolution regime. The options for discussion are basically of three types. Firstly, the laissez-faire type of approach, letting banks adjust themselves to the regulatory requirements, the industry adjusting to them, and maybe accepting over time there could be a more concentrated structure of the industry with a smaller number of mid-sized institutions. The second possibility, more or less the approach taken by the European leaders and the Single Resolution Board as well, is to be a bit pragmatic and to adjust the MREL requirements a little downwards for mid-sized institutions, trying to reduce the stress faced by this type of institution to comply with MREL requirements. The third option, which is certainly much more ambitious, is to work in the direction of putting together a more comprehensive crisis management framework in Europe, a European crisis management framework that would be able to deal with crises of different types of banks, following different types of business models.

Options one and two have some relevant drawbacks. The laissez-faire option may imply over time a reduction in the diversity of the European financial industry. More importantly, that would trigger dynamics that could be quite destabilising in the short-term. Option two means to reducing MREL requirements for some institutions, would by definition involve more difficulties in applying the open bank bail-in tool to those institutions. These may generate additional challenges for the resolution of this type of institution. Option three would face plenty of political and technical obstacles but is likely to be the only on that could effectively address all identified challenges.

In that respect, some have supported using the Federal Deposit Insurance Corporation (FDIC) model as a reference for such a reform. This would entail three components. First is the convergence of national insolvency regimes to a common regime, administered by a European authority, typically a Single Resolution Board. The second feature would be that the SRB would have to deal with a crisis of both significant and non-significant institutions but using a different set of tools according to a public interest test, which probably would have to be defined in a more complete way. Third is the creation of a European deposit insurance mechanism. That European deposit insurance scheme or mechanism would actually be tasked not only to pay out cover deposits for failing banks, but also to fund actions taken by the Single Resolution Board to handle, typically through purchasing and assumption transactions, the failure of banks subject to insolvency while satisfying some restrictions in terms of state aid, and the least cost principle. This type of regime would remove the inconsistency between insolvency and resolution and would enlarge the sort of banks that can actually be subject to insolvency. That two-tier regime would help alleviate the middle-class problem.

This type of reform cannot actually be implemented overnight. It will require a smooth transition, probably starting by reforming the national insolvency regimes before these regimes converge in a common one at the European level.

2. Making the EU crisis management framework more flexible

A regulator supported the observation that the current European regime around resolution is very much characterised around a range of rather radical situations: black or white, yes or no, in or out. That is very much the nature of either being systemically relevant (and submitted to the EU resolution framework), or going straight to national insolvency, and so forth. More flexibility would be helpful. The difficulty is what exactly is meant by that. There are two basic principles: first, to technically improve the ability to resolve banks properly, in order not to be exposed to blackmailing situations; and second, to avoid unwanted bailout situations. Those principles have to be held up and should not be ignored. If flexibility means changing those basic principles through a backdoor, it should be opposed. The toolbox at present is too rough-cut in a way and needs to become more flexible. It is interesting as a source of information and inspiration to take a look at the so-called FDIC model. The basic principles must always be remembered.

The Chair noted that there has been some evolution in the policy approach. There is the BRRD tool, in which some of the parameters have been somewhat adjusted. Also, the SRB has now been more explicit about the criteria they are using when setting MREL requirements.

2.1. The recent banking package has already introduced some flexibility, but much must be done

A central bank official noted that the new banking package has introduced more flexibility. The big question is to what extent this is enough or not. It is probably not, and this is why rethinking is needed in order to improve the current situation in particular for mid-sized banks. It is very important that the general principles that led to

this regulation should be fulfilled. It will avoid a bailout taking place and public money being used when there is a problem with a bank. Introducing flexibility does not mean that this principle is changed.

2.1.1. A longer period of time to fulfil the MREL requirements

A central bank official noted that the new banking package has introduced some flexibility, which was already in the previous BRRD, but now it has gone a bit deeper. The true dimensions of this flexibility are well-known. First of all is the timeline. Currently there is a longer period to fulfil the MREL requirements, generally 2024 in most circumstances. Small and medium sized banks may need this longer period to build up the required MREL, without threatening their business model and profit generation. This is particularly important for these banks, also because they have never gone to the markets to get this money. They have no experience, and a relatively long period could help.

2.1.2. The level of MREL a bank needs is calibrated depending on the resolution tool to be used

A regulator noted that banks, for which in case of failure no resolution is foreseen, do not have to build up MREL on top of their supervisory capital requirements for a 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.

A Central Bank official noted that small and medium sized banks have to exploit, conveniently, the four resolution tools like that in the BRRD (bail-in instrument, sale of business, bridge institution and asset segregation) because depending on the size and the models, different tools can be used to make the resolution feasible. For example, the sale of business tool, which is an instrument which may be particularly useful for mid-sized banks, leads to lower MREL requirements. Again, this flexibility is particularly welcome for these mid-sized banks. Which is the level of MREL needed for a sale of business tool? In such cases, consideration should be given to the fact that the buyer will probably recapitalise the bank and 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 that the coverage of the recapitalisation amount is partially fulfilled by the buyer. Still, a safe margin for the recapitalisation amount should be covered by each bank with a transfer strategy. As a result, the resolution plan must develop a credible strategy for sale of business.

He added that there is an issue with the mid-sized banks as, because they are basically funded by retail depositors, they do not generally have experience to tap the market. And, even if they have experience, given the limited magnitude of the bonds they have to issue, they generally have to pay a liquidity premium higher than that of other banks. This is a very challenging environment, in particular when confronting these requirements with a low profitability environment. However, this flexibility cannot be done with the MREL requirements. The MREL requirements are there because they are needed, and there are general principles that have to be agreed by everybody. The only way is to have an optimal system of liquidation procedure. This is very difficult to achieve. The main worry is how to make the change in the system compatible with the requirements that are already there. There is a longer period to fulfil the MREL requirements, but it will still be challenging for mid-sized banks.

2.1.3. But the MREL requirements pose challenges for medium-sized banks with a retail business model and almost no practice to tap markets for capital or debt that absorbs losses

An industry representative noted that in Europe there is a very diversified banking landscape. There is quite a large number of small institutions, and more larger institutions that are actually acting cross-border. Anything that has to do with regulation must be structurally neutral, in order to avoid a situation of too high a number of too big to fail banks. That should be a principle in the regulation, but also in resolution.

In that respect, MREL plays a big role, and some flexibility has now been introduced. There is also a widening in the timeframe to find and issue MREL. Nevertheless, as long as the business model needs to build up MREL, or the size of the bank needs more MREL, this has to be done. It is an issue for all the banks to issue MREL in sufficient size. It will become more costly, and there have been many comments on the profitability of European banks. Additional MREL has to be issued, and then there is more capital coming from the implementation of Basel III. There are big numbers around, and that is probably what worries investors. Already, there is discussion about working on a framework that has not even been implemented yet. That does not sound, to investors, like stability. Mid-sized banks have to think about the cost of issuing the MREL, and to think about the type of MREL they want. As such, the SRB has the possibility to not only define the amount of MREL, but also the composition of the MREL. Obviously, it takes much time now to draw up the resolution plans. This is being done, and as such probably a little more time needs to be given, even though times are not easy, instead of doing the next step before the first has been implemented.

2.2. An assessment on the level of MREL

An industry representative noted that the quantity of MREL is a big piece of what is being discussed. Only around 20 banks of the five countries that received ESM support and were on an ESM programme receive any kind of support. Putting the numbers in terms of how much bail-in plus bailout they have received, it is something like 10% till off. For a 40% risk weighted asset density, this would come out with around 25% till off. Taking into account the 8% maximum that in theory can be done until the single resolution fund can get in, then there would be 20% MREL, which is a diplomatic way of saying that it is lower than the current numbers around. It is a relevant number also because the situation is not the same as previously in the crisis. There are already a Single Resolution Fund up which is being set up, and much time has been dedicated to the macroprudential policies that, in principle, should support the overall capacity of the system to cope and anticipate, and manage the crisis. On relative costs, there is clarity in terms of the direct relation between size and cost of MREL funding or issuance. This is observable for anyone in the markets. In this context, one can say again that there is a framework, in this case the resolution framework, which in a way is driving into the ecosystem of big banks, as they are the ones more able to cope with it, or at least cope more easily with it. There are also fixed costs which are very relevant in this equation. There is, therefore, a need to reflect on the implications which this ecosystem brings in terms of financial stability and competition in the system, and reasonably priced and diversified financial products.

3. 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

3.1. Operational challenges raised by the diversity of insolvency regimes

A regulator noted that in different member states they have different criteria to open the insolvency proceedings. They have different tools to tackle insolvency. They have different roles for administrative authorities in different member states. In some countries they can use state aid for liquidation, and in others they cannot. In the case, for example, of ABLV, the ECB triggered the Failing Or Likely To Fail of the parent company in Latvia and its subsidiary in Luxembourg. In Latvia the court decided to liquidate the bank and in Luxembourg the court did not. They thought that it did not comply with the accounting insolvency requirement so, as the bank was not insolvent, they did not open the proceeding for insolvency. Another example relates to the use of state aid with the Failing Or Likely To Fail of two mid-size Italian banks, and the SRB decided that there was no public interest in the resolution of these banks, and they went into liquidation. Finally, in this liquidation, there was state aid authorised by the Commission. Comparing the situation for creditors in a country with this possibility to a country without this possibility, it is very easy to understand the consequences. If it had been decided that these two banks could go to resolution, in that case the resolution framework is applied and all kinds of liabilities can be written down, including uncovered deposits, depositors, and senior bond holders.

A regulator noted that after a Failing Or Likely To Fail, the resolution authority has to decide if the bank has to go into resolution or liquidation according to the public interest assessment, determining if the preservation of a bank's critical functions is required to maintain financial stability. One key element of public interest is the analysis of the credibility of the insolvency proceedings in that country. It is quite challenging to compare 19 insolvency regimes with one single resolution framework. Imagining, for example, a cross-border institution, there is also the no creditor worse off principle. This element tries to make consistent the resolution framework and the liquidation framework, because one creditor cannot be worse off in resolution. This comparison is also quite challenging with a wide variety of insolvency frameworks.

3.2. Designing a package which is politically doable, sufficiently ambitious, and technically valid

A regulator noted that MREL is another motivation that was pointed to, with respect to medium-sized banks. It started with defining what exactly is considered to be a 'medium-sized' bank. Some of the challenges around providing enough MREL for smaller banks have been addressed already in the BRRD currently. It comes back to a huge project of harmonisation of insolvency rules. At the end of the day, a good package must be designed, which is politically doable. In theory, everyone would want a harmonised insolvency regime in the EU by next week, but it will not happen. That is, in itself, a 15-year project. Financial regulators are well-trained in acting within highly Europeanised environments. On the judicial side, and the judiciary ministries, it can be sensed very quickly that they are much less trained. A path should be taken which is politically more doable, and slightly less ambitious, but still makes a lot of mileage.

3.2.1. Defining the endgame scenario is not so complicated...

A regulator had less trouble in looking at the endgame scenario, which should be indeed a fully harmonised insolvency environment, and should be an integrated competency in a European setup, possibly comparable to the SSM logic, specifically the integrated approach of a European level and branches, or something like that on a national level. The combination of bail-in, and at least for bridge purposes access to public funding, are the key building blocks. That is plausible as an endgame scenario.

3.2.2. ...But the roadmap to achieve it is more challenging

A regulator noted that the part that is more of a struggle is the timing and how to get there. There is a very delicate question of what would be a prudent first, second or third step for the next two years, five years and so forth. Everyone is agreed that the basic principles set out when the whole journey started a couple of years ago should not be forgotten. Technically, there was just one bank that was resolved in the sense of BRRD, but in a broader world and in a non-technical sense many more banks have been resolved, and the real challenge is how to cope with banks in trouble. On the timing question, focus should probably be on best practices, as regards insolvency procedures and requirements, and trying to establish a European code and superimpose it on existing insolvency regimes. Second, a way has to be found to calibrate staying faithful to the no-bailout principle on the one hand and give access to some public money. It is being mobilised anyway if millions of voters in a particular country or region are under threat. Structures should be found to do that. EDIS would not be the right tool, because its purpose is as a guarantee system, which is very different to mobilising money for bridging purposes.

3.3. Making national insolvency regimes more efficient

A central bank official felt that the most interesting avenue is the possibility of reforming insolvency regimes to make them more efficient. If there were an efficient liquidation regime, then more medium and small banks could be incorporated into the strategy, and this would immediately diminish the umbrella requirements. Fixing what is meant by an efficient liquidation regime has a few elements which are particularly relevant. The first is the need for liquidation regimes that are bank specific. Some elements in the banking industry, in particular the loss value of the assets and the fact that the loss rate is very quick, make very clear the case for having a liquidation regime specifically for banks. Second, in those jurisdictions where this is the case, there is a need to move from court-based to administrative regimes for liquidating banks. Third, many of the tools currently in the resolution regime need to be incorporated into the liquidation regime, which is not currently the case in many of the European countries. Given the aim for a level playing field, it is important to have a homogenous liquidation regime for all jurisdictions. Given all these elements it is natural that there should be one administrative institution, and the SRB is the natural one to take this responsibility.

3.4. Defining a common application of the "public interest criteria" and designing a better proportionate resolution framework

An industry representative noted that the SRB has published a paper presenting the methodology and how the SRB assesses the criteria set out by EU law. There is more to be done on that, but it is a good basis for everyone

to re-read again what the principles are and how public interest assessments should work.

An industry representative noted that, from a general perspective, there is a need for better alignment between the resolvability of banks and MREL requirements. There is also a need for better alignment with the fact that banks with fewer and lesser systemic critical functions are more resolvable, and then this should have implications in terms of requirements, and better alignment also between MREL requirements and size.

3.5. There is no true Banking Union without EDIS

An industry representative noted that on EDIS one cannot lose ground in terms of how relevant it is to close the overall project of the banking union. There is not really a Banking Union. There is a banking friendship, but not a Banking Union. This will not be the case until one euro here is the same as one euro there; that is critical. If one looks at what happened in the worst financial crisis, with the MREL requirements plus all new requirements, EDIS is very cheap in terms of what it delivers in terms of financial integration, confidence with citizens, and at the same time is at the end in terms of the probability of being used, precisely because everything else is already in place. The establishment of EDIS that can provide the insurance of all covered deposits irrespective of location is a critical part of this resolution in this context.

3.6. Not to be too ambitious on EDIS

An industry representative noted that EDIS is not necessary for achieving a Banking Union. Much time has been lost because EDIS was overambitious when it was put on the table. The same things have been discussed for the last four years, and a restart is needed to find a way to embed all of this in a reasonable way that permits different sizes of banks to fulfil their tasks for the economy and for the scope of the clients that they see. Crisis management is always a very individual exercise. With all the rulebooks and all the principles being drawn up, there will always be the odd case that does not fit into it. A crisis is also something that cannot be treated with handbooks alone, but principle-guided treatment of crises of individual banks will be at hand.

4. Can the European system be inspired by the example of the FDIC?

4.1. Resolution under the Federal Deposit Insurance Act

An official noted that for the FDIC's Global Systemically Important Banks (G-SIBs), the very largest banks that are part of the Systemically Important Financial Institutions (SIFIs), the strategy worked on since the last crisis and the passage of Dodd-Frank is the single point of entry. A key feature is the requirement to have Total Loss-Absorbing Capacity (TLAC) to take on the losses so that other creditors and depositors do not have to, and operating subsidiaries can be kept going. That is for the very largest banks.

For the smallest, the community banks, approximately 500 of them failed in the last crisis. They are largely funded by insured deposits and, as a result, when they have problems there is more time to deal with them. They do not face the same liquidity pressures, so there is time to work with the supervisors for corrective actions, and if the situation worsens there is typically time to market the bank to other potential acquirers. Typically, this takes place over a few months or a few weeks, then the resolution weekend, where the bank is closed on a Friday, and an acquirer is usually found to take on the business of the bank, including in most cases all deposits, not just insured deposits. This is possible under the least cost test, because essentially the acquirer decides to bear the costs of covering the small amount of uninsured. Then the bank opens on Monday morning to depositors, and it is business as usual. 95% of those banks that failed in the last crisis were handled through a purchase and assumption (P&A) transaction with all deposits being transferred to the acquiring institution.

The medium-sized banks pose different challenges. Compared to the very largest banks, they do not have the single point of entry resolution strategy and they do not have the TLAC requirement, so there is not the same loss-absorbing resource. They rely much more on uninsured deposits for funding, and sometimes market sources of funding. They are larger and more complex, and the consequences are that when they face problems, there may be more liquidity pressures so there may not be as much time to act. Due to their size, it may be that there are fewer potential acquirers. It may be less likely that a purchase assumption can be done, so a bridge bank may be required, which poses operational challenges. The large amount of uninsured deposits makes it much less likely that a transaction can be done where uninsured depositors are covered, meaning two challenges are created. The first is operational. It is very difficult to sort over a weekend the insured from the uninsured deposits. The bank's systems are not built for that. Second, the disruption that would come from haircutting and imposing losses on large uninsured depositors in such a resolution has not really been faced to such a great extent, but many of these are corporate customers. In such circumstances, the FDIC would be tasked with continuing the failed bank's operations to avoid disruptions to depositors and to maximize value in the ultimate disposition of the bridge bank.

Those are some of the challenges. In terms of actual experience in the last crisis, there are two examples that bookend it. There was IndyMac, which was a $30 billion institution that failed quickly and had to be bridged. Then at the larger end there was WaMu, which was a $300 billion institution, which was able to be sold to JP Morgan Chase. It was interesting that a $30 billion bank was the most expensive bank failure ever, and cost approximately $12 billion. WaMu, the $300 billion bank, cost the deposit insurance fund zero. Finally, in the crisis in the 1980s, some medium-sized banks failed in Texas and New England, and that pushed pressure to have interstate acquisitions, so geographic diversification was a result.

4.2. Lessons to be drawn from the FDIC experience

A regulator noted that there was a lot of talk about flexibility, which can refer to tools and the absorption of losses. The key issue is the absorption of losses. If a model like the FDIC is imported, someone has to cover and absorb the losses. The liquidation of Vicenza and Veneto was reported in a Spanish newspaper as 'Spain 0, Italy 3'. This was wrong, because the taxpayer had paid the bill. In the current framework there is no flexibility. Creditors need to be used in the framework of resolution, the single resolution fund, and alternative financing arrangements can be made after the use of the Fund.

An industry representative noted that the FDIC model in Europe has been accepted as best practice. The problem consists of different insolvency laws in the different member states, and therefore the US model (there is a single liquidation in the US) cannot work in Europe. Also, liquidity support has not been touched upon, and the backup of the Treasury that exists in the

US for FDIC. The next point that should be worked on is a liquidity backstop for the SRF. Most of the institutions that got into trouble in the last crisis died of liquidity, not necessarily of capital. The next point is access to some public money: not an excessive amount, and not the typical bailout and things like that, but reasonable ways to use state aid to prevent worse situations.

An official noted that before the FDIC was created there were dozens of legislative proposals for a federal deposit insurance system, and they failed until the great depression. Even after that, state deposit insurance schemes coexisted alongside the federal system. Those schemes did not survive the 1980s crisis. Having one insolvency regime for insured banks, administered solely by the FDIC, is quite helpful, as is having an ex ante deposit insurance fund that is there to allow losses to be borne and liquidity provided.

CCPs: completing the post-crisis agenda

1. EMIR 2.2. implementation next steps

1.1. Progress made with the EMIR 2.2 legislation and next steps

The EMIR 2.2 legislation is now adopted and the main changes introduced concern third-country CCPs that are systemically important for the EU[1]. The focus is shifting to implementation; in particular with three delegated acts that the Commission has to put into place and on which ESMA has been mandated to provide advice. These concern the criteria for tiering, comparable compliance and fees. Three consultation papers were recently issued on these three topics. Following the advice provided by ESMA there will be opportunities for industry and others to give their point of view before the Commission publishes the delegated acts. ESMA will also further engage with stakeholders on what is needed to put the process into place (information needed, how to gather it…). EMIR 2.2 is expected to come into force late-October/early-November 2019.

An industry representative stated that more certainty is needed about the implementation timeframe, given that the transitional measures allowing UK-based CCPs to offer their services in the EU are due to end by March 2020.

An official also stressed that although the focus is now on Level 2 measures, there remain significant elements in the Level 1 text concerning third-country CCPs on which further clarity is needed to make the regime work. One is the requirement for the MoU to specify that third-country authorities will assure the enforcement of ESMA's decisions. It is not certain that third-country authorities will be in a position to sign that requirement from a legal perspective. Understanding is also needed of how the Central Bank of Issue (CBI)'s ability to place requirements directly on a third-country CCP in exceptional circumstances will work in practice and whether that will be acceptable to third-country authorities. Maintaining the high level of supervisory cooperation that currently exists between the Bank of England, ESMA and other European authorities will be essential to make these new arrangements work.

1.2. Main pending issues to be defined at Level 2

Regarding tiering criteria, a regulator noted that ESMA was asked to further specify the quantitative and qualitative criteria for identifying systemic CCPs. These indicators relate to the nature, size and complexity of the third-country CCP business and a number of other aspects including: the effect that a failure or disruption would have on EU markets, the membership structure and the existence of alternative clearing services. One issue is the extent to which this can be qualified through clear thresholds, given the variety of the criteria. In the US, they are proposing very clear thresholds around some of these criteria. ESMA is in the process of defining the criteria and their importance, but establishing thresholds seems more difficult under the legal provisions in the EU.

An official noted that it is important for the third-country CCPs concerned to prepare for the requirements that will be placed on them, and for third-country authorities to know how to prepare to engage with the EU authorities on this.

On comparable compliance, the question is how to avoid any unnecessary overlap of regulation, the regulator explained. ESMA needs to work very closely with the relevant home regulators of third-country CCPs that are systemically relevant to the EU in order to understand how their policies and procedures match up to the EMIR requirements. This will be looked at requirement by requirement but very much from an outcome-based perspective. ESMA also needs to get relevant information on the systemic third-country CCPs concerned.

An official considered that successful supervisory cooperation is based on third-country authorities deferring to the home supervisor, which is in line with G20 international standards. Comparable compliance is one way to achieve this, as the European authorities and Central Banks of Issue (CBIs) will rely on the rules and the supervision of the third-country supervisor, and look to that in the first instance to achieve their goals. With the ESMA consultation it is important that there should be clarity on how that will be applied in practice. The speaker was moreover curious to understand how an outcomes-based assessment can be performed on a requirement-by-requirement basis.

Concerning fees, the regulator noted that the co-legislators have decided that the supervised entities need to pay on a cost-recovery basis, like for other direct supervisory activity conducted at EU level. Third-country CCPs will only pay for the supervision of third-country CCPs, taking into account how much work ESMA will actually conduct in practice on the supervision. There is also a proposal to reduce fees when there is significant reliance on the home supervisor due to comparable compliance.

2. Brexit preparedness

2.1. Timing issues and the need for certainty

An official noted that many steps have been taken on the UK and EU sides to deal with a no deal situation. The UK Financial Policy Committee has published a Brexit checklist, and continuity and ability of EU and UK CCPs to provide clearing services in each other's jurisdictions was one of the major risks highlighted in that checklist. The Bank of England took action a couple of years ago announcing a temporary recognition regime, which gives EU CCPs the ability to provide services for

three years, during which a full recognition process will be conducted. This process is already well advanced although the temporary recognition regime has not commenced. On the EU side, temporary equivalence was given to the UK CCPs in December 2018. This gave certainty for 12 months, but this is already nearly six months through, and early clarity is needed on what will happen in March 2020. After this date UK CCPs will no longer be able to provide clearing services within the EU.

Another official considered that clarifying what will happen after March 2020 is difficult at a moment when it is still unknown how the UK will follow the EU line of regulation on CCPs, due to the current political uncertainty in the UK. Clarity by December would however help and by then the political uncertainty should have diminished in the UK.

The first official believed that monetary and financial stability need to be ensured regardless of the political environment. That is why the temporary recognition regime granted in the UK will last for three years starting the day the UK leaves the EU, which leaves sufficient time to provide for a full recognition and give long-term certainty to CCPs and users. It is hoped that the EU will approach this situation in the same way because there are £60 trillion of derivative contracts outstanding between UK CCPs and EU members and clients. That is a huge amount of business that would need to shift if legal uncertainty prevented UK CCPs from clearing them. The pipes may be ready for new business, but shifting that volume of historical business presents a financial stability risk that needs to be dealt with so that it does not crystallise.

An industry representative emphasized that IOSCO quantitative disclosure shows that 64% of the collateral posted by the two main UK-based CCPs is held in the UK and the US combined, with 31% of that 64% based in London and 16% is within the EU27. With that amount of business done in the UK and US, for everything to be completed in time for March 2020 is vastly optimistic. It is therefore urgent to find a solution to extend the temporary recognition regime of the EU.

2.2. Interaction with EMIR 2.2

An industry representative noted that the issue of continuity following the temporary recognition regime interacts with EMIR 2.2 because the initial aspiration was that EMIR 2.2 would be in place such that an extension would not be required. However, realistically that is not possible for March 2020 with all the assessments that are required of how the future UK regime measures up to EMIR 2.2 and how CCPs comply with this regime. It is a major task and the sooner the markets are given some certainty to move forward, the better for all concerned. In addition, a number of elements in EMIR 2.2 will be problematic for non-EU CCPs. Comparable compliance for example is too onerous for them and too big a challenge for ESMA. In a resource-constrained environment it is not clear if this is the right approach.

An official agreed that to have EMIR 2.2 ready for March 2020 is extremely challenging, which is why clarity is needed up front over what will replace the temporary recognition regime, whether EMIR 2.2 or an extension, since financial stability risks have not gone away.

A second industry representative felt that the level of preparedness of the industry is also important to consider in this perspective and it is much higher than 6 months ago. It is therefore really important to identify where the remaining financial stability concerns are, given these changes. Looking at the trading layer of the market where critically important benchmarks are run like fixed income benchmarks, six months ago 60% or so of the trading volume was emanating from members physically located in the UK. That number now is 40%, which is a significant level of adjustment to new objectives and realities. On the clearing side, equally, all the large international clearing members of UK based CCPs have set up EU 27 entities and there are visible changes in where margins are posted. On the end-client side it was a real concern that many of them had only one pipe into Europe. Their company – an EU based CCP - has however enabled the buy-side to build a second access.

A policy maker acknowledged the need for clarity expressed by the private sector, not just in terms of EMIR 2.2, but shorter-term measures. At the same time the Brexit process creates a legal fragmentation of the market that needs handling and a cliff-edge remains possible. Originally, a lengthy transition was foreseen, leaving enough time for negotiations about the longer-term relationship. The objective of the Commission has been to avoid financial stability risk from a cliff-edge in the short term. Understanding is needed that these cliff-edge measures are, for the Commission, steps to the discussions on the longer-term negotiations, but they cannot become the longer-term negotiation outcome themselves. In any case the Commission has shown in the past that it can move quickly when needed and a stability risk will absolutely not be allowed to take place.

3. CCP recovery and resolution (CCP R&R)

3.1. Need for and conditions of an effective EU CCP R&R regime

The Chair noted that the EU CCP recovery and resolution framework that was proposed some time ago has not yet been adopted and is back on the programme of the co-legislators now that EMIR 2.2 has been agreed.

An industry representative stated that two key themes should be focused on. Firstly, the EU CCP R&R framework must ensure that the incentive structure of the CCP is maintained to protect taxpayers' money. EMIR creates the right incentive structure with the way the framework for default management is set out based on the concept that the defaulter pays and then the risk mutualisation layer that exists below. The key point is that as participants to the CCP introduce risk they have to provide the funds to manage that risk through Initial Margin (IM) and default funds. Testing these mechanisms with all the stakeholders concerned is also essential. Secondly, the regime needs to be designed to deal with genuinely unpredictable market events, like a situation with potentially a multi-member default along with extreme market conditions that would make CCP existing recovery tools unable to be used. That type of event will also probably involve cross-border aspects. That is where the regulatory cooperation defined by EMIR 2.2 becomes key. The process also needs to be as predictable as possible, consistent across borders and across CCPs, and as much as possible the procedures and processes need to be known ex-ante.

An official emphasised the need to make sure that the EU regime can interact internationally. Regard is needed to the development of international standards, which are however going slower at the moment than the regulation in the EU. It is important that they should be reconciled eventually, given the international nature of many CCPs. An industry speaker believed that it is the case and that the EU framework as proposed fits well with the international standards that have been defined for CCP R&R.

3.2. A focus on recovery and avoiding resolution as far as possible

An industry speaker considered that a long way can be gone with well-designed recovery planning and regulatory cooperation, so there first needs to be understanding about how those tools are going to be applied before thinking about resolution. It is hard to define what is needed after. At that point it really becomes a cooperation issue between the authorities to decide the appropriate next steps. These will be unpredictable events by nature, so it is hard to legislate for every type of event.

A second industry representative agreed that most of the effort should be spent on recovery, since making this work may mean that resolution is not required. Moreover, it is an extraordinarily complex task to try and anticipate what a CCP going into resolution looks like and what is happening to the other actors in the financial market at that time. Anticipating this is helpful but it is difficult to put in legislation.

A third industry representative added that with EMIR the risk standards of CCPs are geared towards surviving the default of the two largest clients. Given that these large clearing members all have international client bases, this means that there is normally a long way to go before hitting the area where recovery and resolution rules become relevant.

Another industry representative suggested that the best way to avoid moving to the resolution phase is to go back to the fundamental principles of CCPs and make sure that benefits of clearing are preserved even in a crisis situation. Two main principles should persist. The first is the mutualisation of losses, because the broader the pain is shared, the smaller it is for everybody. This mutualisation principle needs to be maintained, so it means that very quickly all stakeholders should be involved to ensure that a matched book is restored when necessary. The second point is that the right incentives need to be in place. However, the speaker believed that it cannot be fully excluded that one day it may be necessary to move to a resolution phase which is why it is necessary to have these plans in place.

A policy-maker commented that the view of the EU authorities is that resolution planning is needed. An official felt that the focus should be on CCP resilience as well as on recovery. There may be situations where the recovery process promulgates risk in the system in an unacceptable way or it may be clear after a certain stage that the recovery plan is not going to work. The CCP will not be able to see that; only the authorities have the cross-market view across both the CCPs and their participants. There may therefore be a case for resolution authorities to step in before the end of the recovery plan and going into resolution if it is going to end up with a better solution.

A regulator felt that there should be a sufficient recovery period and process for the CCP to be able to try to manage the situation they are facing. This requires having the right incentives in place at the CCP and also the clearing members. There must also be sufficient preparation, because having worked through a few recovery scenarios beforehand is very helpful. However the recovery phase cannot be entirely relied on. If it ultimately fails, there needs to be a process in place that works into resolution.

3.3. The need for appropriate incentives and tools in the recovery phase

An industry representative emphasized three main incentives that are needed during the recovery phase and that need to be discussed during the upcoming negotiations on the EU framework. The first is a fair allocation of losses with a distinction between default and non-default losses that needs to be specified in the final text. The second is the size of the skin in the game, which must be commensurate with the amount of resources available in the rest of the waterfall. The third is the avoidance of IM haircutting on which there is a strong consensus. IM haircutting could indeed accelerate the exit of the CCP members and potentially have a pro cyclical and destabilising impact on the CCP ecosystem. There are also other more technical incentives, such as compensation claims by clearing members.

Another industry speaker believed that compensation is also an area where care is needed not to distort incentives. If there is a 'carrot of compensation' at the very end of the chain, then the fear would be that people will not be as incentivised to participate in the very first phases of solving a problem, i.e. during recovery.

A third industry representative considered that putting excessive liability on CCPs would be extremely pro-cyclical. The purpose of clearing is to ensure that the market can survive a default thanks to mutualisation and that firms can continue their business once that default has been tackled. It is in the market's interest to ensure the CCP continues. The people who bring the risk to the CCPs therefore need to have a very significant incentive to help unwind that risk in a situation where a participant has defaulted, together with the CCP that is on the other side of that risk. Who brings the risk back to the CCP and who benefits most from the ongoing continuity should be driving much of the thinking, rather than attempting to make a specific player pay. It is that balance that needs getting right. The industry speaker also emphasized that sufficient flexibility and a menu of tools must be available to the industry and authorities to deal with a recovery situation that cannot be fully war-gamed ex ante. It is difficult to anticipate what the exact scenario will be and how players in the ecosystem will be affected.

A policy-maker remarked that the people who bring risk on CCPs have been mandated to do so, hence the question about who should bear the losses. An official noted that when it comes to non-default related losses, a cash call is not the right approach. This is the sole responsibility of the CCP as an enterprise and as an operator. More equity may be needed to handle these risks. Moreover equity can only play a role in resolution if recovery tools have been exhausted and have not worked. The write down effect cannot be considered earlier.

3.4. The importance of cooperation and of a clear definition of responsibilities

An industry representative noted that recovery and resolution will lay bare who was actually responsible for a default and who from the public sector actually takes responsibility. In the context of multiple supervision, this may be tricky. In the end one person needs to be responsible, which is why this leads back to EMIR 2.2 and how systemically important CCPs are treated.

Given the international dimension of CCPs there needs to be close cooperation and clarity about who is in charge of the recovery and resolution phases, a regulator added, because of the need to take quick decisions that are clear and effective. In a resolution situation, it is also likely that there is a far bigger crisis going beyond the CCP and a few clearing members requiring broad cooperation within the market.

An official emphasized that organisational arrangements for resolution need to work effectively with the arrangements for supervision. It is necessary to

know who is in charge in a resolution; this needs to be the resolution authority and the home resolution authority.

Another official noted a link between supervision, resolution and recovery, which EMIR 2.2 acknowledges. One of the criteria to assess if a third-country CCP is systemically relevant is the impact that problems in a recovery or resolution scenario would have on EU financial market stability. In terms of governance there may be difficulties with joint decision making or binding mediation if the fiscal responsibility still rests with the jurisdiction of the home of the CCP, the official believed.

[1] There have been 47 third-country CCP applicants from 2013, and 32 which have been recognised following the relevant equivalence decisions by the Commission. For the majority of those third-country CCPs EMIR 2.2 does not change much. For systemically important third-country CCPs there will be a greater supervisory role for the CCP committee within ESMA and the need to comply with EMIR (or comparable) rules. Central Banks of Issue (CBIs) will also be involved in the supervision of these CCPs.

Insurance comprehensive risk framework

1. The expected contribution of the insurance sector to G20 priorities

1.1. G20 priorities

A regulator welcomed the panel and introduced the participants. There are many political and social objectives designed by political leaders in the G20 forum in which the insurance sector could play an important role, including filling the prudential gap, especially in the retirement field, supporting a sustainable economy by technology innovation, and stabilising the economy.

1.2. The stabilisation of economies, investing in infrastructure and addressing the challenges related to the ageing population are important and expected contributions from insurance undertakings

An industry representative felt that the insurance industry is naturally placed to tackle these challenges. It has supported economies and the public sector for a long time. Infrastructure investment is a promising asset class for insurance companies, especially in a low yield environment. In infrastructure investments on one hand are elongated cash flows, and on the other there is still some yield, which is attractive to customers and policyholders. Depending on the market, insurance is an important sector for providing people with long term security and safety.

An industry representative stated that Japan had the presidency of the G20 this year, and there had been a special insurance forum on 5 June. The two G20 priorities that are most relevant are a resilient economy and taking care of the needs of an ageing society. A number of positive steps have been taken on the former. Insurance can and historically has played a positive role on resilience, largely on the life side, because it has a natural desire to match long term liabilities with investments from infrastructure onwards. They can help in a market crisis, because companies can look to the cycle and be a natural stabiliser for economies. In general, both the International Association of Insurance Supervisors (IAIS) and the G20 have moved insurance into a place where it can help economies.

A policymaker agreed with what was said. The insurance sector can clearly make a positive contribution towards meeting G20 objectives and towards a strong, sustainable and inclusive society. More specific objectives are long term investments and investments into infrastructure, addressing an ageing population and developing sustainable finance to fight climate change. The sector has to try to leverage the long term nature of insurance companies' commitments to contribute to a sustainable economy and long term investments.

2. Impacts of the framework on the insurance sector

2.1. Possible impacts of the global framework on the ability of insurance companies to contribute to G20 objectives

A regulator felt the issue is the interplay between regulation and the actual contribution of the insurance sector to the G20 objectives. The first objective of the framework is to protect policyholders and contribute to financial stability, but other possible implications need to be focused on.

An industry representative stated that regulation plays an important role there. On resilience, the last financial crisis illustrated that insurance can be a stabilising force for markets. It is subject to regulation, which is not necessarily about enhancing, but more not hindering the natural role and business model that insurance companies have. However, changes have been seen in products and product mixes, partially in reaction to regulation. That is important to be discussed in detail.

2.2. The various aspects of the framework

A policymaker felt that the regulations should not be turned upside-down. Policyholder protection must remain the number one objective of the global regulatory framework, which Solvency II achieved in the EU.

However, it is important that the regulatory framework should not unnecessarily prevent meeting the G20 objectives that were set out.

Regarding long term investments, there are investments into equities, which are held for a long period, and into high quality infrastructure projects. The European Commission tried to look at its rulebook to see if it could be adapted to make sure it could help companies invest more in the long run, without compromising the prudential soundness of insurance companies. Steps have been taken in this direction, notably in the new category of long term (equity) investment, which benefits from a new capital charge of 22%. The Commission will have to see what the impact is, but it is not closed to the idea of going further. It has asked the European Insurance and Occupational Pensions Authority (EIOPA) to comprehensively look at the issue of long term investment, without being solely focused on the capital charge, but by taking a holistic view to see what could be done as part of the 2020 review.

2.3. IAIS targets improving the holistic framework to address emerging challenges

An official believed that that sector can contribute towards solving some of the mega trends and structural issues that are being looked at, including climate risk, inclusive societies and providing for older people. This is recognised in the IAIS strategy, which was agreed by the entire membership in June 2019.

A five year strategy starting from 2020 has been agreed, where the supervisory and regulatory perspectives to climate risk and sustainability, inclusion

and the digital economy will be at the heart of the work plan. Once the bulk of the post crisis agenda has been completed by the end of the year then the IAIS will be able to transition to those themes with the full force of its inclusive membership.

There are a number of initiatives in the area of climate risk and sustainability, because these are cross sectoral issues. The model is to partner with other agencies that are working on these issues and to offer the insurance perspective. On climate risk IAIS is working with the UN Sustainable Insurance Forum and has already produced useful material on the supervisory perspective to climate risks.

On inclusion, it is working with Access to Insurance. On other issues the IAIS focuses on insurers where it has a comparative advantage as a standard setting authority. It is doing special work on the risks around cyber underwriting, which only an insurance standard setter can do.

2.4. Making macroprudential surveillance effective

An industry representative felt that the holistic framework proposed by the IAIS in a document that came out in June is going in the right direction.

The holistic framework has a number of key parts, the most important of which is macroprudential surveillance. Monitoring for risks going forward is always the big challenge. The current Financial Stability Board (FSB) Chair, Randal Quarles, said that this is not an area where one can hire four or five experts to find systemic risk; everybody needs to be looking at all times. It is an inherently difficult challenge.

For the insurance sector, one of the most important things is to make sure that something is in place to look at the key risks as they grow over time. One of the key parts of the holistic framework is the liquidity risk assessment. A lot of work is being done on that in Europe.

There are four components to the macroprudential initiative: liquidity stress testing, capital stress testing, recovery and resolution, and counterparty exposure limits. 80% of the very intensive work has been on the liquidity stress framework to make sure that companies know what their top two or three liquidity risks are and make sure that they have enough highly liquid assets to meet short term demands. Surveillance will be key to address those risks.

2.5. The main building blocks of the framework and implementation challenges

An official explained that the holistic framework has four elements. The first is preventative measures which enhance ComFrame and the insurance core principles (ICPs) to address the sources and transmission mechanisms of systemic risk, including liquidity and counterparty risks. The second is preventative measures that enhance supervisory powers to make sure that they can intervene if problems crystallise. The third is the global monitoring framework. The fourth is surveillance risk assessments. The IAIS wants to be as forward looking as possible, as it is difficult to predict the next source of systemic risk. A well run insurance sector should be a stabilising factor rather than a source of risk.

As the global insurance standard setter, IAIS should be in a position to look at the data, examine whether risks are building up in the system, and try to prevent them. It should then challenge its own supervisory community about whether they are doing enough.

At its heart, the global monitoring framework is a sector wide activities based framework. But it is possible there could be significant and material companies that concentrate these risks on their balance sheets, which has happened in recent history. Private sector views on this are important.

One reason there are international standards in the first place is to maintain a minimum competitive level playing field. It is important to maintain implementation and consistency across policy measures, which why is there is an implementation programme and why the FSB is not going to remove the Global Systemically Important Insurer (G SII) status until it is satisfied that policy measures have been implemented in key jurisdictions.

3. G20 objectives and the global capital standard

3.1. IAIS's role and work in process to define the capital standard

An industry representative stated that insurance companies find the holistic framework quite useful and it is hitting the mark. Regarding the development process of the holistic framework, there was a new or newly perceived risk after the 2008 systemic financial crisis. Some ideas were drafted and the IAIS came forward with its initial approach. The industry was not enthusiastic about it, but what worked well at that time was cooperation and discussion between policymakers and supervisors in the industry in tackling this. That process needs to be used as a benchmark for what is done with new emerging risks going forward. When digital is discussed it refers to issues all the way from cyber risk underwriting to the potential systemic risk of cloud providers.

3.2. Challenges for appropriately finalising the Insurance Capital Standard (ICS)

An industry representative believed that the insurance sector has accompanied IAIS developments in recent years. It has participated in field testing and has come a long way. The interesting thing is what the final IAIS 2.0 will look like, which will be completed in November in Abu Dhabi. The uncertainty of what it will look like, illustrates the sector's concern that if there is such a late finalisation then the finer details will always be last minute.

An industry representative felt that the goals of the Kuala Lumpur agreement are good and well intentioned, but insurance companies think that there are still about a dozen outstanding design issues to tie the framework into the G20 goal to have a robust, resilient capital standard that will help protect ageing societies. Companies are concerned about several sources of non economic volatility. There is a need to have some data and an impact study to make sure insurance companies can continue to provide the kind of protections required by ageing populations.

An industry representative felt that the monitoring period of the IAIS and how it operates is in reality a natural extension of field testing. It is understood that it will be completed by 2025, and the sector has heard from IAIS that there will be another consultation, which is welcomed. What is needed however, is a quantitative impact study and comprehensive review of the framework some time in 2021 or 2022 when enough data has been collected, to take stock and establish that 99% of what will be entered into implementation in 2025 is appropriate or if some major tweaks are needed.

Regarding data collection, a speaker stressed that the colleges of supervisors are also important to have direct conversations with the chief risk officers (CROs) of insurance groups. When talking about systemic risk, insurance companies want to hear what is keeping the industry "awake at night". The Insurance Capital Standard (ICS) will be an important bearing point for systemic risk. A microprudential solvency measure is needed as well as a conversation about how it contributes to macro prudential

needs. Insurance companies need as much stability in microprudential measures as possible; whenever they have a framework that is a stable base, it becomes valuable and meaningful to put macro on top. But if there is a volatile micro baseline then supervisors will always be tempted to attribute such an instability to emerging systemic risk, even if there is none from the underlying economic risk perspective.

3.3. A monitoring period to addressing material unintended consequences

An official felt that there are now fewer concerns, which is why there will be a monitoring period. The IAIS would like a minimum prescribed capital requirement (PCR), in order to monitor the standard for IAIGs for a number of years with relative stability. It will be addressing all material unintended consequences during this period and there will be consulting. Impacts will be monitored and the IAIS will discuss the nature and timing of impact analysis. The IAIS is not monitoring the companies rather its monitoring the ICS and towards this purpose it wants to get the views of the group wide supervisors, as well as the technical groups within the IAIS. There are fewer than a dozen critical design issues currently on the agenda. There are going to be difficult technical policy discussions ahead of November, but the challenges are beginning to narrow, and the field-testing results are encouraging.

An industry representative felt that the interaction between policymakers, regulators and insurers works extremely well. If it is done for the upcoming risks in the IAIS then the industry will be successful for all its stakeholders.

3.4. Interplay between the holistic framework local regimes and implementation challenges for the EU

An industry representative stated that in the banking world big banks spend a great deal of time competing with each other but compete fiercely with small or medium sized companies complying with differing regimes. If the industry wants a truly level playing field, then it is not enough for the regime to encompass 40 or 50 IAIGs; it is about what is happening in local regimes because historically insurance has been much more locally regulated.

A policymaker thought that it may be too early to jump to Solvency II and how it might contribute to a macroprudential. There is much merit in developing this holistic framework for systemic risk. It can complement the judgment of micro supervisors and provide them, as well as to insurance companies and regulators with valuable information. The framework will be useful in the future, when stress tests are devised, to better define the economic shocks they will assess. In particular it provides common thresholds and definitions that would be applied to all IAIS members. It is important to benefit from a common definition for an internationally active insurance company.

At the EU level, the Commission has to find ways to minimise the data collection burden and that they can use existing data where possible but also the EC has to make sure that IAIS members apply a common language to make data comparable globally. Implementation is crucial. If certain policy measures are agreed, such as liquidity planning or ex ante recovery plans, then they need to be consistently implemented throughout jurisdictions.

A policymaker believed the first lesson drawn from Solvency II is that patience is needed when establishing standards across jurisdictions. Solvency II started development 20 years ago and was implemented 16 years after that, so patience is needed. It is important to do solid ex ante testing of Solvency II. Five quantitative impact studies have been done and the Commission welcomes the five year monitoring period of the IAIS. Excellent participation from the insurance companies is needed. The fora from the quantitative impact studies (QISs) will also be needed for the monitoring period, even if the burden is significant. Ultimately, it is in the interest of the companies to provide the right data.

Ex post evaluation is important, and the EU Commission has to be ready to adjust the standard when it sees problems. The intention is to preserve stability on the Solvency II framework and not make radical changes as part of the 2020 review. There needs to be a willingness on all sides to make political compromises to get to one standard and not one standard plus another, which may or not be comparable. The purpose is to ensure a level playing field and that there is trust in the system. That is best achieved by having only one standard.

SUSTAINABILITY AND LONG-TERM INVESTMENT

ESG agenda: EU priorities

1. EU action plan on financing sustainable growth

1.1. Main features of the action plan of the EU Commission and its progress

A public sector representative stated that sustainable finance is very close to the heart of the European Investment Bank (EIB). It was the first issuer of green bonds in 2007, and since then has issued over 20 billion green bonds.

The sustainable finance agenda is very ambitious and will be encouraged in the new EC. The UN Sustainable Development Goals (SDGs) and other environmental objectives will require trillions in private capital to be mobilised, which is well beyond the means of public financing. Investment in clean energy will have to more than double to almost over 400 billion per year over the course of the 2020s, and to 550 billion in the 2030s. The financial private sector is going to be part of a solution and part of a much broader agenda. President Elect von der Leyen has called on the EIB to position itself as the climate bank of the EU. The EIB's proposal is to phase out its financing of all fossil fuel related energy projects.

A policymaker stated that climate change consists of addressing a crisis. There is an urgent need to move the economy to a sustainable development path although the private sector will finance the transition to the extent that the transition delivers returns. This transition will have massive financing costs beyond what is possible from the public sector, so the industry needs to mobilise and facilitate private financing. One action plan was delivered by the Commission in March 2018, based on technical work done by experts. The experts' recommendations were embedded in the 10 point action plan to mainstream sustainability in the financial system. The objective is to create a framework that allows an investor to develop a preference for green and then to act on that preference. The three early proposals related to a taxonomy, improved disclosures in order to require the industry to display what they are doing in terms of green, and also sustainable benchmarks. The focus is on creating a taxonomy; the Commission expects to have it done by the end of 2019 or very early in 2020.

An industry representative felt that the action plan is an important part of the solution; having the same definitions, it gives a solider foundation in terms of how asset managers, banks and other players can act on this. The taxonomy needs to be dynamic and needs to take into account that there are multiple taxonomies that must converge over time.

A policymaker stated that the taxonomy has to be scientific in its basis, otherwise it is not credible. The legislation in the taxonomy is to do with the governance of the taxonomy. It is going to alter over time, so it is important to get the governance right.

The taxonomy has to be useable by the market and has to have a degree of political acceptance, otherwise it will not be possible to articulate a sustainable finance agenda with the broader economic agenda. Yet, clients are changing their preferences of their own accord; at some point there has to be another set of incentives built into the system. EC's now wider climate agenda – the new Green Deal strategy, will be announced over the next 100 days. Actions have been taken on climate in various parts of the Commission, and the plan is to bring it together into a coherent framework. Sustainable finance is going to be part of the solution and is part of a much broader effort which is bringing all together within the EU Commission 10 15 DGs, led by DG Climate, to work on the 2050 carbon neutrality target and the 2030 targets. This effort is ambitious and is going to have important implications for the way people live.

An IFI representative believed prices are going to be crucial, particularly on carbon pricing, but also on other forms of environmental pricing in terms of guiding investments into the right areas. Until there is adequate carbon pricing and other forms of environmental pricing, the sustainable finance agenda on the table is not facilitating investor choices.

An industry representative stated that the sustainable finance is very important to their bank and welcomes the Commission's action plan for financing sustainable growth. Indeed, it is trying to provide the agents in the market with incentives so that market driven results lead to the internalisation of (climate related negative) externalities. In an ideal world the price of carbon would play an important role however that market is still not sufficiently sophisticated, and from time to time will give the wrong signals to market players. An IFI representative felt that the industry's reaction to the proposals is a broad welcome since this is going to be helpful in facilitating investor preferences. Until there is an adequate price of carbon this is a helpful agenda.

The Commission is working to set up an international platform where it will bring together the regions of the world that wish to work together. It will start as a platform on which views, information and best practice can be exchanged; going forward it will be a forum in which the world can work together to come up with coherent taxonomies that do not lead to immediate fragmentation in the sustainable finance agenda at the international level.

1.2. Industry needs and reactions to the proposals and challenges

An industry representative felt that the role of the asset management industry in this is through engagement with the companies they invest in. If a company has 200 analysts who know the company intimately and are speaking to them every month then they are in a good position to challenge and scrutinise those companies on both their financial performance and their ESG performance. However, when a company does not have such information it is then unknown how it prepares itself for its ESG responsibility. In this respect the passive investment industry will say it fulfils its responsibilities under stewardship through voting, but what is specific here is engagement, not voting, however engagement cannot be done cheaply.

An industry representative acknowledged that active managers can do a great deal to promote sustainable investments, unfortunately a great deal of capital is

going into passive investments. Then one question is also whether even in passive investment more cannot be done to make sure that more of that capital is going into sustainable investments.

An industry representative noted that from an asset management perspective their financial group's investment advice has integrated questions around whether the customer wants to have a particular focus on environmental, social and governance (ESG) topics when selecting their investment portfolios. Asset managers will also see that they can channel much of their capital into the sustainable finance area because there is a customer demand there. The group also has separate responsible investment teams when it signed the UN Principles for Responsible Investment (PRI), but has also integrated it into portfolio management.

An IFI representative stated that the EIB Group aims to lead by example in managing its environmental performance and disclosing the impact of its operations. The Group has reported on the environmental impacts associated with its operational activities for over a decade. Last year saw a continued reduction in net emissions per employee, which has decreased by over 50% since 2007. There is a lot of confusion when institutions talk about the sustainable finance taxonomy and Paris alignment, and whether there is a difference, or they are the same. EIB approach builds around three pillars: (i) an increase in its own financing from current levels that stand at nearly 30% of EIB's new commitments worldwide dedicated to climate and environmental goals; (ii) a commitment to grow sustainable finance by working with EIB's public and private partners; and (iii) building on EIB 2015 Climate Strategy, alignment of all the EIB Group's financing activities with the principles and goals of the Paris Agreement. Alignment will determine a change in EIB Group's policies and actions, starting with a pledge to phase out energy projects that depend on fossil fuels.

It is useful that the general approach of the Commission has been to provide transparency through disclosures, benchmarks to players in the marketplace, and a list of the environmental damages or benefits that different technologies and sources of energy produce. The taxonomy provides comparability, which will allow for less greenwashing and will make more investment funds and investment decisions. There is a fear that these taxonomies could become excessively driven by technology preferences. The quality of the data does not allow for very careful incorporation of risk, but it should be part of the conversation with supervisory bodies that banks normally engage with. Pursuing ESG goals is beneficial, and htis has been shown empirically by both academic research and in research by the asset management industry.

A policymaker noted, however, that many institutions are working with inconsistent definitions. The EIB will not allocate its green bond funding to certain energy sectors such as gas or nuclear, but other institutions do. There is a lack of adequate disclosures, so it is not always clear from an investor perspective what exactly is being financed with their investments. These growing consumer and industry concerns have obviously prompted the European Commission and other public actors to set out the agenda, the action plan on financing sustainable growth.

An industry representative stated that in June 2018 their company decided to put its climate strategy totally in line with the Paris Agreement, which is very demanding. The question is whether to follow the sustainable trade or whether it is accelerated in the financial area. The company has governance at the top level of the bank and has also decided to be certified by external auditors. It has decided to assess all its clients in the way they are adapting their own business models with regard to climate change and has decided to adopt the same tool between investment and financing pots. Finally, it has decided to green the balance sheet of the company; this is very demanding because it requires a concrete financing and investing scenario to be adopted. The scenario the company has adopted is the Climate Analytics scenario, which asks it to disinvest coal in 2030 in the European Union, 2040 in China and 2050 in the rest of the world.

The taxonomy is a vital language that has to be adopted. It includes transitional activities and activities which are enabling the achievement of the transition towards the local bond economy, and this is an appropriate approach. However, the Technical Expert Group (TEG) high level report fails to explain clearly how banks could support their clients, because the taxonomy is quite static. In addition, Data is key in the climate transition; banks currently do not have enough data, so they have to persaude corporates to give their data and to be certified as well, because the question regards what it means to be green. Ultimately if the EDF has to state clearly whether they are 20% or 25% sustainable, banks have to take this data as it is.

The TEG proposes to exclude activities on the nuclear side from the taxonomy. A speaker expressed the opinion that this is an error, because the Climate Analytics scenario takes the nuclear to be a tool against climate change. The TEG stated that nuclear energy is outside the taxonomy, pending further scientific studies. The question is what 'scientific studies' means. For banks, this is totally inappropriate and questionable. The same thing is true regarding biogas; biogas is absent from the taxonomy because it is not significant enough to be eligible for the taxonomy. The decisions of the TEG can get very controversial. Nuclear is out and conventional gas is out although many people regard gas as a transition technology; it is better than coal but under the taxonomy it is out.

An industry representative added that their company is not waiting for a taxonomy. It is very important that the regulatory world and public authorities should realise that this market is moving very quickly. Clients are driving this change, not regulation. The active equity industry or the fixed income industry is under intense pressure from substitutions, and the only growth part of the active industry really is in the area of the ESG or sustainability. Five years ago, there may have been a situation where there was a small ESG team which was an addition to the investment process, but at present things are very different. The industry representative's company has close to 200 equity and fixed income analysts and has had to retrain them all. It has redesigned the nature of its investment reports, the questions that it poses to companies, and it has introduced its own proprietary ESG rating system.

It is a market driven agenda driven firstly by clients across Europe, particularly in the north, but it is not just a European phenomenon. Asia is moving quickly, particularly in Japan where the Government Pension Investment Fund (GPIF), has led the Japanese pension system in this direction. This is also taking place in Taiwan and elsewhere. The question therefore is not whether this is a regulatory driven agenda, but how regulation can facilitate this. If done properly, this is where the taxonomy can be of great assistance, because companies have much data at a corporate level on this matter but do not have standards and standardised data. A common language is needed which companies can work to in terms of their non financial disclosure.

1.3. Financial stability and prudential regulation challenges

A Central Bank official stated that regarding the expected impacts on the banking sector, client related issues are gaining a great deal of traction within the community of central banks and supervisors. More peers are convinced that climate related risks are a source of financial risk. The message that was conveyed in the 2018 progress report made it clear that action falls squarely within central bank mandates to ensure financial stability and that the financial system is resilient to this risk. The Network for Greening the Financial System (NGFS) was launched in December 2017, and its membership now consists of 42 members and eight observers. The network covers the five continents and is a coalition of the willing. The idea is to support the transition to a low carbon economy through its rule over the financial system.

The first comprehensive report was released in April 2019, with six high level recommendations. Four apply to the work of central banks and supervisors, while the last two give advice to policymakers. The recommendations are integrating climate risk into micro supervision; integrating sustainability factors into central banks' own portfolio management; bridging the data gaps; building awareness and intellectual capacity; supporting internationally consistent disclosure; and supporting a taxonomy of economic activities. Work remains to be done in order to equip the community with the appropriate tools and methodologies. The first two deliverables are to be released by the end of the first half of 2020, while the last will be hopefully released on the occasion of the IMF World Bank's annual meeting in October 2020.

The biggest challenge is good quality data, because different data providers will typically give very different answers. An important part of what this taxonomy will help with is improving the data. The question, however, is how companies are going to turn a 300 400 page taxonomy into something that enables equity analysts to pick stocks for investors depending on their sustainable finance preferences.

A Central Bank official believed that the sector is currently at the beginning of the process. If it wants to change the capital requirements, it needs to have a good basis for that, which means that it needs to check whether green assets are less risky than brown assets. The idea is not to act and change capital charges, but the sector would like to introduce new expectations from the supervisors in the way that banks manage these risks.

An industry representative stated that when their company started integrating sustainability into its asset management there was a belief that it would actually be positive for risk management but would hurt returns. Over time it has been empirically seen that returns have been even better from many of the products where this has been taken into account. Firms that will make the right choices will give great performance to the investments that they make for their unit holders. In that sense, being able to see who is good and who is not over the next couple of years will have a big impact on active returns.

An industry representative stated that asset managers are interested in value creation, which encompasses short term profitability. What dominates net present value are terminal values. Focus is needed on intangibles, otherwise terminal value will not be priced correctly. Whilst there may be a trade off between short term profitability and sustainability, there is not a long-term trade-off between value creation and sustainability because terminal values, by definition, are sustainable.

2. Further incentives toward an effective contribution of the frameworks to EU climate targets

A policymaker explained that the EU framework will be strategy and will not be executed from Brussels. Three things might need to be done; the price of carbon, environmentally harmful subsidies, and taxation. There is a need to have a sustainable finance agenda which is going to click into a shift in relative prices, because investors are not going to invest in technologies that do not have demand. And there has to be a return. The discussion is about a Green Deal which tries to shift relative prices, as well as to internalise the (negative) externalities. In that environment having a private sector financing arm will be very powerful because then the money will flow.

A market expert noted that it is important to fund the policy against climate change, but there first needs to be a significant flow of investment in the energy transition. To make it high enough, durable and rising, an appropriate level for the price of carbon is the best incentive, according to all economists, since it will trigger investment in clean energy and in all activities that emit less carbon. Since the last Eurofi (Bucharest) meeting there has been a European election which showed that the environment was at the forefront of the preoccupations of the citizens of Europe. Global warming is now high on the agenda everywhere, including the next Commission. Concerning the taskforce that was created, their organisation has taken the initiative, with a group of high level Chinese personalities, of promoting a convergent price of carbon between China and the European Union. They will convene in New York the following Sunday at the Climate Action Summit and will make public a joint declaration of their commitments for a significant price of carbon, both in China and the European Union.

Regarding the taskforce focused on Europe, the objective is to gather more and more people around this device to fight global warming. Progress is extremely rapid. A coalition of finance ministers for climate action, which includes the UK, France, Germany and a majority of finance ministers, signed a declaration in February 2019 the third commitment of which is 'To work towards measures that result in innovative carbon pricing.' In Germany the government is now looking at the domestic price of carbon. The sector is not covered by the Emissions Trading System (ETS), which are transportation and construction. It is clear that there is momentum for introducing a carbon pricing device in Europe.

A policymaker believed that Vice President Timmermans has the overall responsibility for the Green Deal and under him will be DG Climate, which will coordinate this. The Commission will remain responsible for the sustainable finance agenda, but the President Elect states that it will all be about teamwork.

A market expert stated that the new President of the European Commission made it clear that the environment and climate were a priority in her platform. It is clear that she is committed to act decisively in the new Green Deal. The price of carbon on the Emission Trading System (ETS) market is now €25 per tonne, a level which starts to be significant but is still very volatile. In 2008/09 and the recession, the price of carbon decreased from €30 per tonne to €3 per tonne in a matter of weeks. Another collapse of the price of carbon cannot be excluded; consequently, there needs to be a floor on the price of carbon at the current level of €25 per tonne. This measure is easy to implement as it is at the disposal of the Market Stability Reserve (MSR). There is no political cost. The current level of €25 per tonne does not raise any opposition, so nobody would dare to object to the

fact that the EC intends not to let this powerful price signal slip below this current level.

An IFI representative questioned whether there is a trade off between the agenda and a return on capital. An industry representative felt that there would not be in the long run, but a market expert felt that until environmental damage is properly priced unsustainable activities will inevitably be more profitable than sustainable activities. An industry representative is worried by this focus, as these types of decisions are going to imply huge changes in the landscape of the relative importance of different industries in various societies. The discussion has not incorporated the critical dimension, which is that this transition should take into account who wins and who loses. Losers have to be compensated and cannot be compensated with open ended schemes. Being neutral on technology has to be complemented with being careful about stigmatising certain industries which therefore enter into decline.

A market expert stated that there is no time for a trade off. The device, which is the price of carbon, needs to be put in place, which makes returns in terms of financial investment and real investment in accordance with the success of the energy transition. Returns have to be in accordance, and the only way to do that is the price of carbon. The implementation is complicated, but work has already started. There is a price of carbon in Europe, but the problem is that the European authorities do not want to target the price of carbon because they target the volume. Consequently; the price signal does not play its role, which is absurd. Countries have been in the direction of a price of carbon with much success, such as the UK and Sweden. The question is why it is not done at the European level. The start should be to put a floor on the price of carbon at the level it has to take, which is €25 per tonne, which would be a huge progress in terms of returns from good investments, while the banks and investors will realise that putting their money in coal may be problematic in the long run.

Fostering investment in sustainable projects

An International Financial Institution (IFI) representative stated several facts demonstrating the scale and scope of the challenge concerning climate change. There is no need to build a case for sustainable finance and environmental, social and governance (ESG) goals; the situation is clear. Europe has been at the forefront of initiatives in this direction for the last few years, including the Action Plan on Financing Sustainable Growth, A clean planet for all, and the recent comprehensive report by the Network for Greening the Financial System, A call for action. There has been progress on fostering sustainable finance, but there is the question of whether this is sufficient.

1.1. Sustainable Investment first requires disclosures and transparency

A policymaker stressed that disclosure is the mother of regulation. Without indicators and standardisation, it is impossible to make accurate comparisons, which precludes intelligent and transparent decision making. The regulation started as 'green only', i.e. it seeks to define what 'green' is. This initially seemed to place an excessive burden on the wrong parties, but much work has been done to get the process 'on the right track'. Now the regulation is not 'green only'; it is about the environmental and sustainability impact, and it includes a backstop. For example, the regulation makes it impossible to create solar panels using child labour or to combat climate change while significantly damaging biodiversity. Overall information must now be provided. Investee companies should also be obliged to report, but this is not included in the current regulation.

1.2. The financial industry considers that there is no alternative and continues to innovate

An industry representative felt that some of the most interesting successes are in the public sector. Under the Juncker Plan, several interesting projects were delivered in France. For example, 250 social housing energy efficiency retrofits were delivered.

Another industry representative felt that one of the main achievements in the past year has been that the industry now accepts that there is no alternative to sustainability.

An industry representative noted that the industry has focused on the green bond market. Bank of America for instance has issued four green bonds and one social bond totalling more than $4 billion. Bank of America is one of the original co authors of the Green Bond Principles that were passed to the International Capital Market Association (ICMA), which has done a brilliant job of making green bonds a global phenomenon.

Beyond 'use of proceeds' green bonds, which are bonds issued by companies carrying out a particular green activity alongside less green activities, banks continue to do innovative financings such as solar lease asset backed securities, electric vehicle lease asset backed securities, green commercial mortgage asset backed securities, bonds for Chinese pure plays focused on solar, wind and other forms of renewable energy, and project bonds for renewable energy farms in the EU and other parts of the world, as illustrated.

1.3. The size of the challenge is enormous: there is a need to do much more

1.3.1. Huge investment needs

An IFI representative outlined how the Organisation for Economic Co operation and Development (OECD) has estimated a need for a €7 trillion annual investment in sustainable infrastructure until 2030 to meet the two degree target in the Paris Agreement.

An industry representative felt that Europe faces challenges about delivering the climate and energy package. Following DG ENER, the High Level Expert Group (HLEG) on this subject estimated a need for a further €180 billion per year, which will only grow given the new European Green Deal and enhanced greenhouse gas target. To achieve the Commission's long term vision to 2050, energy investment in the EU must double from €200 billion to €400 billion.

A substantial amount of this funding gap is composed of work on energy efficiency, which is hard to accomplish because these projects are largely small scale and heterogeneous.

1.3.2. The Juncker plan, InvestEU and the role of development finance institutions

An IFI representative noted that the European Investment Bank (EIB) has been successfully involved in the implementation of the Juncker plan. From 2020

onwards, InvestEU will replace EFSI under the new MFF (Multiannual Financial Framework), and 25% of the EU guarantee will be made available to implementing partners besides EIB, such as for example EBRD. Environmental sustainability has been the core of the European Bank for Reconstruction and Development's (EBRD) activity since its inception. The EBRD has built a substantial body of knowledge, insight and instruments to work on issues such as energy efficiency and green cities. In the run up to COP21, the EBRD set the most ambitious target in green finance of any multilateral development bank: for 40% of its total investment to occur in sustainable finance. The EBRD is on track, having invested €30 billion in more than 1,600 green projects.

However, the industry must go further into the 'nuts and bolts' of how to deliver bottom up sustainable finance projects. There has been some progress, but more action is needed. Institutions must change their existing portfolios and invest in sustainable projects.

1.3.3. Private sector involvement

An IFI representative considered that private sector investments will be very important for the future of sustainable finance. 80% of all investments are private, so the private sector must be at the core of the strategy.

Additionally, it will be essential to leverage local banking systems. In some countries, it is extremely difficult to channel investment and finance to SMEs and local actors, which means it is important to work through a network and reach the end consumers and stakeholders who can enact change regarding sustainability practices at a local level.

An industry representative noted that the asset management industry is increasingly investing in sustainable assets: around 20% of assets are sustainable and there are more than 2,000 sustainable finance funds. Market participants can make significant contributions in terms of their stewardship of capital. It is possible to use ownership rights to engage with companies on their capital allocation strategies to deliver on sustainability. The industry representative's firm is currently doing pre engagement around land development with local authorities to ensure that additional public goods are included in property development. It is also essential for asset managers to 'get into the weeds' of sustainable finance to deliver additional impact.

2. Obstacles to securing greater sustainable finance in Europe

2.1. Involving both 'frontrunner' and 'followers'

A policymaker expressed his happiness with the Action Plan on Financing Sustainable Growth and the fact that the European Parliament and Council agree on the need for further work on sustainable finance. To secure more sustainable finance, it is essential to work with the 'frontrunners' in this area. Some MEPs worked hard to convince the European Parliament and the Council of the importance of this issue. MEPs worked with the 'frontrunners' from the Council – France, the Netherlands and Germany – to ensure the entire Council was on board. In Europe, there are frontrunners and followers.

There are differences between countries within the EU and differences with countries outside the EU. If Europe wants to lead, it must figure out how other countries and regions can follow it. A new European Green Deal could be very important. There are many elements in place in Europe to allow the EU to take the lead. The industry must create a credible strategy which involves both the frontrunners and these 'followers'.

The policymaker emphasised the need for a combination of different measures. The world is fragmented, and there is also a challenge regarding how to regulate access to the European market. There should be a discussion about carbon border adjustment, which will allow companies to invest in sustainability by reducing external undue pressure. There cannot be competition from the US, which has not signed up to the Paris Agreement. This is one reason why the world remains in a situation where energy taxes are low for companies and high for households while there are still subsidies on fossil fuels. Alongside work in the private sector, Europe will need public investment to tackle the remaining challenges.

A policymaker agreed that one obstacle to sustainability is that Europe must take the lead in a fragmented world. For example, the United States has not signed up to the Paris Agreement. Additionally, society is also fragmented. There is a clear need to abolish subsidies on fossil fuels but raising taxes on fossil fuels had serious consequences in France. An industry representative agreed that the protests in France are a serious matter. If the world phases out fossil fuel subsidies, there should be a high level commitment that this money is redeployed using a just transition approach, which will enable the political licence to facilitate this transition.

2.2. An accelerating change and a fast evolving paradigm require further political involvement

An IFI representative felt that moving insufficiently towards sustainable finance could lead to the emergence of physical and transition risk. There are questions regarding the levels of capital available in the market, the still excessive level of risk required to finance sustainable projects and the still insufficient degree to which European regulation is advanced and consistent. A policymaker expressed concern and excitement, noting several obstacles to sustainable finance. First, there is a need to address perverse public subsidies and budget spending. The world spends more on fossil fuel subsidies than health and social expenditure. Second, public procurement is a crucial lever here. The size of public procurement varies, but it is around 10 20% of GDP. In general, communities and states buy the cheapest energy they can although it should be compulsory to buy green energy, or to follow ESG targets. Politics is the biggest area of challenge. With the right support, politicians can make progress. The policymaker explained how national interests frequently contradict environmental standards. If politics are allowed to distort this subject, the EU will end up with a perverse taxonomy with the wrong incentives. Europe must remove politics from the details.

A policymaker outlined several new risks. The challenge Europe must pay attention to is that change is accelerating, and the paradigm of the system is evolving. The reaction from the authorities must happen in parallel.

An industry representative agreed that the continuation of public subsidies for fossil fuels is the most obvious issue. A political commitment to phase out these subsidies would be highly beneficial. Additionally, there is a challenge in moving projects from research and development to deployment. As an example, there is a substantial amount of money being spent on developing carbon capture and storage, but it is unclear in whose interest a large scale roll out of this will be. A policymaker acknowledged that underachievement in projects leads to sunk investment. When there are more sunk investments, organisations lose the time or money to reinvest. There is a need for dialogue on potential exit strategies between the national governments setting the policy frameworks and

the companies developing these new technologies. This would enable much more private capital to support these initiatives.

The policymaker emphasised, however, that the financial industry does have the required money. At present there is around €30 trillion in fossil dependent investments, which forms a substantial part of Europe's pension funds. Thus, the question for Europe is how to move such a large amount of money in a controlled manner. It is essential for Europe to move towards only financing sustainable investments. There must be a shift away from companies which refuse to change their policies. Within 10 years, everything should be green. The real challenge is how to accomplish this.

2.3. There are outstanding challenges related to Europe's regulatory framework

An IFI representative stressed the importance of destination when financing moves from brown to green investments. There is a question of transparency within the system in regard to how figures on green investment are accounted and disclosed, which means there is a need for harmonisation. Multilateral development banks such as the EIB and EBRD have sought to bring together development banks worldwide and find consensus on sustainable finance. The IFI representative informed the audience that there would be an announcement related to this at the upcoming climate summit in New York.

It is also essential to have more transparency and disclosure on the climate related risks of companies. The Task Force on Climate related Financial Disclosure and the Network for Greening the Financial System play important roles by leading central banks on these issues. Central banks are now taking climate related risks into account in their approaches to financial stability, using tools such as environmental stress testing.

Yet, both within Europe and outside it, policy frameworks have not yet been established to channel investments towards sustainable projects. Signals such as carbon pricing, incentivise the industry to shift away from unsustainable projects, but there must be a regulatory framework that incentivises private investment in sustainable finance.

2.4. Drivers to secure additional long term investment

An IFI representative noted the need for a long term view of projects, adding that both the EBRD and the EIB are long term lenders. This is a key factor in Europe's capacity to transform projects into being sustainable over the long term.

An industry representative felt it is important for banks to change the tenor of lending. There is a key challenge as to how money can be funnelled into equity and then remain there over the long term. There is also a contradiction between the need to incentivise short term money to be invested in projects and how long term investments are regarded in regulations. The desire to have more liquid equity in the finance sector tends to be a disincentive for long term investment.

The right balance has not yet been found at the political level. It is also essential for Europe to take a holistic approach rather than a short term vision. This is why the taxonomy is key. Europe must not treat long term investment in the same way as short term investment, even if it is riskier. It might be riskier, but it is safer for everybody in the long term.

An IFI representative noted that subsidies and the need for more equity had been mentioned. With the forthcoming InvestEU programme, there might be an opportunity to recommend a shift of emphasis towards equity tools and away from grants and subsidies. The IFI representative felt that this move has been happening for five or 10 years. In the European Union, EU structural funds are increasingly used as financial instruments. This is a positive way to use public money, because it can be reused. When public money is spent on grants or subsidies, it is expected to be lost.

Yet, when money is used as a financial instrument, there is a risk involved. In the private sector, such a loss is considered akin to an industrial accident. When there is a loss of public funds, however, the public make accusations about the misuse of money. This means it is still very difficult to use public money to take risk.

3. Concrete solutions

A policymaker expressed optimism on sustainable finance, because there are more opportunities than obstacles, although sustainability cannot simply become another topic in the financial sector; it must be a topic everywhere. The negative interest rate environment in Europe should drive new projects. Projects thought to be loss making now seem rather profitable. There is also increasingly more discussion of sustainability in Europe. When considering companies, sustainability is often discussed in terms of 'values versus value'. There is a change happening in terms of how corporate cultures consider the function of companies, even in the US.

3.1. Europe must implement a variety of measures in both the public and private sectors

An IFI representative felt that the public investment banks' role is to take a holistic approach by bringing together investment policy and technical assistance. InvestEU is an instrument which combines these dimensions. There must be high ambition on climate change action, but without an appropriate technical assistance the risk of the project might prove unacceptable to investors. In addition, InvestEU should lead to additional investment, not the crowding out of private sector investment.

3.2. Tax incentives could provide a vital impetus to investment in this area

A regulator suggested that there should also be tax incentives on green investments. Companies and market participants generally agree that tax incentives would facilitate sustainable investment. An industry representative noted that the tax incentives for wind and solar in the US have led Bank of America to dedicate tens of billions of dollars to equity investments in wind and solar energy farms in the US. Subsequently, Bank of America now understands the risks involved in these projects and recognises their excellent risk/reward metrics. It was necessary to develop a definition of 'green'.

However, the new draft EU taxonomy is a watershed event in terms of regulation. The taxonomy can now help firms with financing and risk evaluation.

3.3. An essential aspect is that investors must be able to access high quality and comparable data on sustainability

A regulator highlighted the impact of the lack of comparable data on sustainability. To increase capital flows to sustainable investments, investors must have data that is comparable, reliable and verifiable. There are several promising legislative and standardisation initiatives. The taxonomy will enable investors to understand how different economic activities comply with environmental objectives.

The disclosure regulation will oblige market participants to disclose how ESG factors have been integrated into their activities. In addition, the amendment

of the Benchmark Regulation will include two new benchmarks, the Paris aligned benchmark and the low carbon transition benchmark. Finally, while the Green Bond Standard will be advisory rather than mandatory, the criteria adopted within this standard are very positive.

There is a wide consensus on the need for regulation, but any regulation should be flexible and proportional.

Another obstacle which is factored in the Commission's action plan is the possibility of short term pressure in the market, which is why the Commission asked the European supervisory authorities (ESAs) to conduct an assessment of this risk.

An industry representative agreed on the need for higher quality, more comparable and consistent information. The disclosures agenda and the taxonomy are very important here. The taxonomy is structured in a way which enables investors to differentiate between 'green' and 'brown' activities in a quantitative way. If the taxonomy were deployed by national regulators and supervisors to make adjustments to capital requirements for 'brown' or 'green' activities, there would be an acceleration of the demand within banks for green finance products, which would be a 'game changer'

The industry representative also felt there is in addition a need for greater engagement with and responsibility from investors in public markets. There could be a European stewardship code, which could build on the reforms in the Shareholder Rights Directive.

3.3.1 Rating agencies play an important role

An IFI representative described how a prominent rating agency had stated that utility companies have been downgraded on average by three notches over the last 10 years due to a lack of visibility on their approach to the management of transition risk.

There are broad discussions about incentives, the use of public money and how to increase levels of equity, but rating agencies already embed into their assessments the kind of information that could incentivise corporates to adapt to the new paradigm. An industry representative agreed with these comments, suggesting that one rating agency has examined companies' environmental risk and established three key risk metrics: emerging technologies, shifts in demand and regulatory changes.

Another IFI representative agreed on the importance of the work of external ratings agencies, because this affects how investors apply pressure to the companies they invest in.

3.4. It is essential for there to be regulatory convergence within the EU and around the world regarding non-financial information

A regulator noted the need for convergence in the existing regulatory framework. There is more regulation coming on the taxonomy, disclosure and benchmarks, but Europe also has the directive on non financial information, which was approved in 2014. Large entities have been applying this directive since 2017, but the non financial information that is being provided is not comparable, because the information can be given in very different formats.

The industry must move towards a single framework in a similar way to how the accounting world moved to IFRS. A policymaker stressed the need for alignment, suggesting that industry should embed harmonised indicators and reporting in accounting and auditing rules. This should follow the globalised approach of IFRS. However, it is also important to review global and local regulation, including MiFID, Packaged Retail and PRIIPs.

Policies for addressing climate change risks

1. Large scale and global climate related actions are necessary

1.1. Climate change cannot be reversed and raises material transition and physical risks

A policymaker stressed that climate change is real, as evidenced by hotter summers, deteriorating weather patterns, and the fires in the Amazon Basin. The changes brought about cannot be reversed but can be slowed down and attempts made to prevent further climate change taking place. Movement to lower levels of greenhouse gas (GHG) emissions in the future is required, as is an eventual arrival at net zero emissions in the EU in the next 30 years.

The effects being brought about by climate change are twofold. First is the transition risk. Investing in an asset with a lifetime of 30 to 40 years, where adjustments need to be made in the next five years, those adjustments come about either through regulation or consumer preference. Assets invested in or which are secured against lending will see a deterioration, in a shorter term than their economic life. Second, there is also physical risk. Where an industrial process is reliant on water for cooling, a sudden drought will cause the business to suffer.

A central bank official noted that, on the physical side, 10% of the value of UK mortgages is on flood plains, and the annual loss rate on those properties is expected to double by 2050. On the insurance side, weather-related insurance loss events have tripled since the 1980s. On the transition side, it is estimated that the proportion of unburnable carbon in the ground is 80% for coal, 50% for oil and 40% for gas, in order to keep below 2 degrees Celsius. UK banks' exposures to high-carbon industries equates to 70% of their common equity base. On the insurance side, 12% of equity exposures and 80% of corporate bond exposures are to high-intensity carbon industries. It is not difficult to see how financial institutions can lose a lot of money in this space.

An industry representative stated that the impact on the real economy will feed back especially on corporate bonds and equity in the first step. Consideration is also needed in the second step of the potential impact on government bonds, where insurers are heavily invested. Indeed, consideration should be given to the impact if the real economy cannot pay taxes as before.

Thought is needed about how these two risks play into the financial industry, and also how they can be tackled.

They are not separate risks. If mitigation and regulation are currently not quick enough, acceleration is required. Both a 'too little, too late' and a 'too sudden, too late' situation need to be avoided, and therefore action needs to be taken now. The real economy needs to be brought along with the financial services industry, investors, bankers and insurers to make the change work.

1.2. Facing climate related challenges requires large-scale and global actions including capital flow ones

An industry representative agreed that climate change is real and progress is being made. A large part of this is down to the leadership from the European Union. EU leaders came out in June and reaffirmed the commitment to climate over the next five years. Many European countries Individual contributions are around a target of net zero.

It is important not to treat this as a European-only challenge. Climate, as Europe will experience it, will be determined not just by the actions taken by the EU, but in

the world more broadly. It requires large-scale and global transition. Climate physical and transitional risks do not respect individual regulatory borders or mandates. Action taken in Europe risks being drowned out by the emissions movement from other countries, particularly fast-growing ones in Asia. On a net global basis, action taken in Europe must not displace GHGs to other markets.

There are two other important points on the implications of the next steps of things like the EU taxonomy. Firstly, those likely to see the biggest impact from climate change have probably contributed the least. On a per capita basis, many of the countries that are now rapidly growing emissions are still well below the averages of the EU and others globally.

Finally, there is the role of EU banks, insurers and investors themselves. Europe is the centre of a huge amount of global capital flow. The regulatory framework implemented in the EU will inevitably impact on how capital flows are directed in the wider world. A global, coherent approach is very important.

Action now in the real economy is important, but financial services play a very key role. The representative's company has signed up to the Task Force on Climate-related Financial Disclosures (TCFD) and announced that it will no longer finance any new coal projects. Last year it made a commitment to measure, manage and ultimately reduce all its emissions, scope one, two and three[1], and the aggregate impact of lending and the emissions it led to, given the scale of this challenge.

1.3. Insurance companies are expected to play an important role in further optimising the transition

An industry representative noted that insurers look at the asset side of the balance sheet, but also at the liability side to address physical and transition risks. For insurers, it is about optimally using both sides of the balance sheet to encourage transition to a low-carbon economy, with a global view. To the extent that insurers have a carbon position, it is global, not European.

From the European Insurance and Occupational Pensions Authority's (EIOPA) perspective, it is very clear that insurers have a key role to play not only as important institutional investors but also in helping to provide coverage /services dealing with the risks. Insurers can potentially impact the transition risks with their investment behaviour. By taking climate risks into consideration in investment decisions, being active investors asking questions they can/ will impact change. Through their engagement with the economic actors they can play an important role in a gradual transition to a more sustainable and resilient economy. In the insurance market there is the knowledge to deal with the risks faced. This knowledge can also be of help when providing coverage and services to the economy.

In light of available evidence about the impact of climate change on the frequency and severity of extreme weather and climate-related events, affordability and insurability of natural catastrophe protection are likely to become an increasing issue. EIOPA is therefore actively working with natural catastrophe experts to better understand and monitor the protection gap for natural catastrophe. Recent evidence is clear that neither individuals nor the industry alone might be able to deal with these risks. The impact of a protection gap on households and business as well as the financial system could be systemic. There needs to be a concerted action by individuals, NGOs, industry and governments to see how to mitigate and adapt to climate change risks. As climate risk does not stop as borders a European solution should be envisaged maybe even going beyond climate risks and covering other risks such as terrorist risks as well.

On how to improve the sustainability approach in Solvency II, EIOPA has taken an approach where sustainability relates to all three pillars of the prudential framework: Quantitative, Governance & Risk Management, Reporting & Disclosure. It relates to both sides of the (re)insurers balance sheets: on the asset side the role as investor, on the liability side the role as risk carriers. In light of climate change a sustainable(re)insurance business model needs to be based on the principle of stewardship, both in its investment and in its underwriting activity. (Re) insurance should contribute to climate change adaptation and mitigation. The inclusion of (re)insurance activity in the EU taxonomy, which the TEG consulted on this summer, is an important signal in this direction.

1.4. Climate related actions required in both the financial sector and the real economy represent huge opportunities and strong coordination

An industry representative agreed that the challenge is interconnected in terms of risk types, and the solution requires a great deal of interconnectedness. One element less touched on is the opportunities that the transition presents. This requires action both within the financial sector and the real economy sector, but it is very important to take care to harness that opportunity and help use that learning to help advance the progress required globally.

2. Policies for an optimal transition

2.1. The role of the public sector

A clear transition pathway supported by policy signals is essential

Climate change is a systemic risk and, when looking at it from an investment perspective, it is very clear what needs to be done in terms of the net zero economy but getting there is not clear. Some of the scenario analysis work has shown distinct differences in terms of impacts on different economic sectors, depending on the technology path, timing, policy options, how coordinated or differentiated related policy is, and whether it is focused on energy efficiency, renewable energy, and so on. It is key to think about not just the policy and regulatory levers that need to be pulled, but when to pull them, and a transition pathway supported by policy signals for both the real economy and the financial sector that helps navigate it.

An industry expert noted that whilst climate and the transition is mainly not a finance issue, it is an issue that should be on the top of the agenda of heads of states, economic policy and industrial policy. This is where the lead should come from. Finance is mainly a service industry and will adapt. If there was the signal and ambition young people are asking for, it would not need to be discussed; much of the financial sector would follow. The financial sector often asks for fiscal policies and things like that to make their life easier and provide the certainty required.

A policymaker noted that Europe is in an extremely good place. GHG growth has been decoupled from GDP growth, which is very positive for the overall economy. Europe is also in a good starting place because very firm energy efficiency targets are in place for 2020, reducing GHG emissions and renewable energy. There is also legislation out to 2030 with much certainty as to reducing emissions, increasing renewable energy and improving energy efficiency. A policy paper looking out to 2050 and net zero emissions in the EU has now been published, based on modelling and a number of building blocks; energy efficiency and renewable energy will be part of that, though much of the low-hanging fruit in renewable energy

has already been gathered. Adjusting the bioeconomy, and looking more to transport, as well as really affecting the whole competitiveness of industry, is vital. Potential lifestyle changes which may come into effect have to be considered as well. This is why there has to be awareness of the aim. Everybody needs to be brought along, and the just transition invested in, whereby no person or region is left behind. The changes are huge, and there is not just one pathway.

The size of the necessary investments requires focusing public budgets on catalysing the involvement of the private sector

The costs of doing this are immense. To achieve the 2030 targets will mean an extra €180 billion per year investment in energy infrastructure. Going to 2050, those costs are even bigger; around 0.5% of GDP per annum. The whole financial community needs to be brought along. In the meantime, the European budget will do what it can; public budgets can be the catalyst but cannot pay for everything. Climate action needs to be mainstreamed into the future budget. 25% of the EU's budget will be spent on climate action. Research and innovation spending need to increase, which is happening through the International Platform on Sustainable Finance. Europe is responsible for 10% of global emissions and needs to influence everybody else.

A policymaker noted that sustainable finance by definition needs to follow other policies. Taxation plays a role in climate, as does product regulation; some cars have been banned both at the national and even city level. A plethora of policies exist, and sustainable finance takes those as given. Sustainable finance gives incentives to move money voluntarily towards re-orientating capital flows in a sustainable manner. The difficulty is looking at the estimations that have been made. People talk about €250 300 billion additional annual investments needed in Europe. At most EU and the national budgets can provide €40 50 billion. The remaining €200 250 billion must come voluntarily from the private sector.

Leveraging existing economic, civic and political impulses

The first advantage of this is a civic impulse; people in the street, particularly in Europe, are very alert to it. It is clear that there is a high level of civic attention. In 26 of 28 countries in Europe, people under 30 indicate climate as the number one risk. Secondly, there is the political impulse. As a consequence of politicians wanting to be re-elected, they tend to listen carefully to what the young people in the street say. The Commission issued three regulations. Two were adopted in about 10 months, which was unusually quick. Nobody says they are not advising their clients to put money into climate change. They have not become chairmen of charity institutions, but they have realised that they can make money by investing in this. They have understood the number one rule in finance: no risk, no return; lots of risk, lots of returns. The crucial point is that, because of this civic, political and economic pressure, this is clearly the crucial policy in Europe. Europe will get it right, but is only the third polluter in the world, and 10% of the pollution. The aim is to reduce the other 90%, which is done through cooperation, not in isolation. The international platform for sustainable finance has also been launched.

2.2. Conditions for an optimal involvement of the financial sector

Avoiding unintended disbenefits reversing existing impetus

An industry representative noted the benefit of all of the drivers moving in the same direction, but a real risk that if the transition presents disbenefits to swathes of society, the positive political momentum will start to reverse. Within Europe there is an opportunity to provide models on how that can work in a beneficial way across the economy. GHG emissions do not respect borders. The transition needs to take into account the broader impacts, and also the importance of diplomacy, learning, understanding the risks, setting policy in a way that is constructive, and importantly mobilising that capital. There are good opportunities connected with blended finance, specifically focusing on where capital is needed. The question is how to mobilise capital in other countries and regions where infrastructure is required to help mitigate and reduce emissions.

The distribution of benefits is important. It can be compared to the last two transformational events that Europe has witnessed in the last 25 years. One was the introduction of the single market, and a fundamental change in how the economies of Europe would deal with one another. The single market was accompanied by mitigating measures, such as structural funds and so on, to compensate for the winners and the losers. The second event was the enlargement in 2004. That was also accompanied by mitigating measures.

Customer pressure on the financial sector might help

An industry expert noted the need to distinguish between the two types of financial institutions. Some are mission-driven, such as a whole range of public finance institutions, development finance institutions, and so on. Then there are profit driven financial institutions. Their job and where they excel is looking for the optimal risk/return ratio. They should not be counted on to save the planet suddenly by themselves. However, despite not being equipped and not being at the centre of the governance model, they are making efforts and are moving.

In terms of what can move the private sector, which contributes the bulk of finance, customer pressure might help. There are reputation issues that can relate to that, but mainly it is the stability angle and the voice of central bankers or regulators, and the action plan from the Commission. The direction needs to come from outside, which is where the Network for Greening the Financial System (NGFS) should continue taking action and showing leadership.

Addressing the data and transparency challenge

An industry representative noted that there has been talk about bringing the real economy along, which in some respects is right to be encouraged. In other respects, if the goal is to incentivise customers to transition, one of the issues is whether enough information is coming out of the real economy to be able to assess transition risks with a greater degree of accuracy. The financial industry is doing its part in relation to taxonomy and disclosures, and that needs to be extended to the real economy.

Different industries and companies are at different stages of development. There is no doubt that broader disclosure would help that transition. The taxonomy is helpful, so everyone speaks the same language, but flexibility must be maintained.

An industry representative noted that the scale of the challenge and opportunity, and the investment shift required over the coming decades, are significant. It will need public action and the private sector. Information is important for the financial sector to take the next steps. A recent speech by Mark Carney declared that for markets to anticipate and smooth the transition requires the right information, proper risk management and a credible policy framework. The financial sector has done a great deal of analysis work. However, without the data from the real economy further analysis and thinking, not just through

the first reactions but second and third order reactions, are quite challenging. Collective action across both the public and private sectors to improve the availability of data from the real economy would enable consideration of the right policy choices.

A central bank official noted that the Bank of England has done a number of investigations into the UK financial sector, starting with insurance in 2016, and recently issued a supervisory statement. The Bank of England is committed to a quantitative climate stress test of the major banks in 2021. It is unclear what will be the best way to do this. There are a number of difficult questions to think about when doing a quantitative version, including, which of the various scenarios should be used, what kind of timelines should be used, whether to do a static or dynamic balance sheet, and how to deal with management actions. The most difficult question may be which assumptions firms should make about second and third order actions of real economy actors. This goes to the point of improving disclosure as well as awareness of the exposures.

2.3. Regulatory efforts made to improve the information flow in the economy

A policymaker noted that three regulations have been put out dealing with the three phases of the investment: before investment, once invested, and after investment. The first is the regulation on disclosure and financial advice, which takes onboard the recommendations of the TCFD, which many companies in the world have signed up to. The disclosure directive imposes the so-called double materiality around the effect of environmental change on the value of assets. Secondly, the taxonomy is in sustainable finance and giving incentives. It is not a compulsory tool, but an invitation for those who invest to contribute to the achievement of those results. The market will know whether a company has decided to finance or stop financing something. For the moment, all sustainable finance action is done in pillar 3, through the mechanism of market disclosure. The third regulation is the benchmarking regulation. The benchmarks are not Paris-aligned, which would be too demanding presently. There is also a benchmark for the transition. This operation is about ensuring all economy transitions move towards the sustainable.

For EIOPA as supervisory authority it is key to understand, assess and monitor risks and help to mitigate them. In view of this EIOPA is heavily involved in the NGFS, the Commission work to develop a taxonomy, having roundtables and workshops for developing our work to ensure strong engagement with industry, stakeholders and academia. It is key for supervisors and the industry to understand and assess the issues at hand. To better understand and assess these risks EIOPA included qualitative questions assessing environmental, social and government (ESG) factors in the pensions stress test and is developing a sensitivity analysis to assess the impact on transition risk on insurers portfolio together with the "2 degree investing initiative" and hopes to finalize the work by end 2020. EIOPA is also discussing how to enhance the assessment of ESG factors and scenario analysis in stress tests going forward and is actively working with natural catastrophe experts to better understand and monitor the protection gap for natural catastrophe. With its enhanced mandate under the revised ESAs regulation EIOPA will also continue providing technical advice to the EU institutions e.g. by providing an opinion on how to integrate sustainability within Solvency II.

The Commission has taken steps in the right direction with disclosure and benchmarking, but lack of underlying data limits the ability to act more quickly and strongly. On the protection gap, data is needed to assess the impact better. A taxonomy is required so that everyone can speak in one language. It will be a costly endeavour to go into that direction, but it is key to know and consider the underlying risks.

[1] Scope 1 emissions are direct emissions from owned or controlled sources. Scope 2 emissions are indirect emissions from the generation of purchased energy. Scope 3 emissions are all indirect upstream and downstream emissions (not included in scope 2) that occur in the value chain.

Tackling long-term investment disincentives

1. Europe must incentivise long-term investment

An official considers the subject of how to tackle long-term investment disincentives one of the 'most philosophical' subjects at Eurofi, because there are myriad answers to this question. However, long-term investment is extremely relevant for Europe. The official described the puzzle currently plaguing Europe, in which low interest rates should mean that companies are easily able to find and invest in projects with positive net present value, i.e. they are easily able 'to get rich'. However, this is not happening. An industry representative stressed that banks and insurance companies have an essential role to play in tackling long-term needs, particularly because the Capital Markets Union (CMU) is still unfinished. The official emphasised that more than 65% of the European economy is financed by banks.

1.1. Europe must be able to finance both the energy transition and digitalisation

An industry representative noted the broad agreement on the need for long-term investment. There are challenges around digitalisation, the environmental transition and the need to develop pension infrastructures. The cost of the environment transition was recently estimated at €175-250 billion per year over the next decade. Another industry representative agrees on the importance of global challenges such as the trend for greater digitalisation, the emergence of new players in the market and the environment transition. An official emphasised the substantial investment required for both climate change and digitalisation.

1.2 The ongoing macroeconomic climate is not conducive to long-term investment

An industry representative outlined several problems in the current environment, highlighting low interest rates. Some firms are using 'easily 25%' of their own funds to meet the increased market values of these liabilities; this demands a considerable amount of capital. When interest-rate liabilities absorb this level of funding, there are limited remaining opportunities to use capital to make long-term investment commitments. An official queried the cause of the present macroeconomic climate, what the low interest rate shows and why people assume the return on a discount is any bigger than zero. This zero is not an accurate reflection of the situation, but it illustrates that something is burdening the industry.

2. To what extent does Europe's regulatory framework cause long-term investment disincentives?

2.1 The impact of regulation on long-term investment

An industry representative considered that the financial crisis revealed excessive leverage, improper liquidity management and insufficient capitalisation in the banking industry, but this has been addressed and financial stability has been reinforced. However, post-crisis regulation and reform were implemented without a strategic consideration of their long-term economic impact.

2.1.1. There are strong regulatory disincentives to equity investment

An industry representative highlighted the impact of regulation on equity portfolios. Under Basel IV, equity risk weighting will increase significantly for banks applying the standardised approach: 75% for equity investment funds and 60% for equity investment. Financing technological innovation and sustainable development is generally done using equity investment; this increase could lead to banks reducing their holdings or even exiting these activities. Another industry representative agreed, describing how insurance firms are divesting from equities because this is the major adjustment available to insurers in an environment of declining regulatory ratios. An official viewed it as problematic that insurers are disinvesting from equity to meet their capital requirements. This means eliminating the prospect of higher returns for savers. Furthermore, in terms of financial stability, equity is a countercyclical buffer. If the insurance industry cannot invest in equities, it is unclear who will. Banks will not make these investments. Direct investment is possible, but savers do not want to over-invest directly in equity, which means financial intermediation is necessary.

2.1.2. In specialised lending, LGD input floors are of particular concern

An industry representative explained how the standardised approach for specialised lending in the latest Basel III reforms would impose probability of default (PD) and loss given default (LGD) input floors. This asset class has historically experienced a low level of default and a high recovery rate, but the new rules will have an estimated 30% increase in risk-weighted assets requirements. While a supporting factor was introduced into the regulation for safe and sound infrastructure, the EBA estimated that less than 3% of exposures would benefit from this. These capital constraints would more likely lead banks to revisit their strategy in specialised lending, which is paradoxical given the need for investment in this area. Banks would also be subject to a floor requirement on risk-weighted assets to enhance the comparability of risk-weighted capital ratios. This is a backstop which will further limit the investment capacity of banks using internal models.

A member of the audience highlighted the importance of specialised lending in financing the energy transition through its role in infrastructure project finance. The strong increase in risk-weighted assets (RWAs) experienced by banks implies a reduction in the volume of loans granted in this area. Banks in France and more widely in Europe expect an increase in RWAs of much more than 30%. The infrastructure-supporting factor with a 25% haircut does not compensate for this. In terms of infrastructure, the S&P study shows that over half of defaults have an LGD below 10%. Applying a 25% LGD input floor would make these transactions impossible to finance. The EBA should develop an adequate framework which is in line with the risk. Additionally, the criteria for infrastructure assets are too restrictive. It is important to develop criteria that can address the specificities between different projects.

2.1.3. Europe's regulatory capital requirements are excessive notably those related to securitisation

An industry representative considered the implementation of Basel III, known as Basel IV, will require a 25% increase in capital requirements, which adds to a capital requirement that has more than doubled since 2008. Considering the capital requirements under Solvency II, another industry representative provided a comparison of single-B capital requirements under Solvency I with AAA capital requirements under Solvency II for a senior tranche of a non-STS securitisation: the figures are 62.5% versus 38%. This makes it impossible for banks to securitise infrastructure loans or project-finance single-B loans and sell them to insurance companies, because the regulatory capital will be significantly higher. Additionally, regulatory capital for residential mortgages will be lower than the regulatory capital for the AAA tranche of that mortgage portfolio, which makes no sense for liquidity and credit.

An official wondered whether the primary law concerning capital requirements was not drafted incorrectly. The industry representative explained that many of these capital requirements were developed in silos. The requirements for covered bonds, the loan requirements, the requirements for corporates and the securitisation requirements were all developed separately, and their consistency and cumulative effect was not considered. The industry representative illustrated further such an inconsistency explaining that there would be a problematic effect caused by the banking regulation in terms of a maturity adjustment of risk weights. Moving from one year to five years increases the capital required between 30-50%, whereas in covered bonds or banks loans moving up to 20 years does not have this increase in capital.

An industry representative stressed the importance of securitisation. The EU's solution to securitisation was the adoption of simple, transparent and standardised (STS) securitisation. Securitisation could address a wide variety of issues, including liquidity, infrastructure finance and green finance. However, at the end of August there were 44 STS securitisations on the market, of which two were first-time issuers. The other 42 came from repeat issuers who use securitisation as part of their business models. Additionally, there was a long delay in the introduction of STS. The securitisation law came into force before the enabling regulations were ready. The reality is that many of the enabling regulations will not be ready until a full year after the securitisation law will have come into force. This creates uncertainty in the market. The industry representative suggested that the forthcoming review of Solvency II and the final adjustments to the securitisation regulatory technical standards could provide an improvement which would enable banks to use securitisation to address long-term funding issues. However, there is continued negativity around securitisation.

A policymaker considered securitisation the great low-hanging fruit of the 2015 CMU action plan. The fruit was low-hanging but very firmly attached to the tree, so it was possible to reach this fruit but not to pick it. Europe has to make these kinds of trade-offs. After the financial crisis, securitisation had 'enormous negative baggage'.

The Commission argued that the European experience was entirely different, but there was no traction because of the general sense that securitisation was responsible for the crisis. Bringing securitisation back in any sort of easy way was therefore not acceptable. Even the Commission's precisely calibrated and careful proposal was subject to further calibrations, and the result left nobody happy. The policymaker suggested that the Commission should look at this again, perhaps in a revamped CMU.

2.2. Other structural disincentives to long-term investment

2.2.1. Europe's approach to monetary policy negatively affects long-term investment

An industry representative felt that current monetary policy is a 'self-inflicted blow', considering it increasingly less understandable why central banks seek to increase the rate of inflation from current 1.2% to close or below 2%. The ECB's mandate is to ensure the stability of the euro and seeking ever-lower interest rates is moving into 'Alice in Wonderland territory'. Central banks must change their approach. An official agreed that any continued period of negative interest rates would create difficulties for the financial sector, adding that the ECB is well aware of this. Another official noted that Europe has been in this position for a long time, which means it is time to consider making structural adjustments rather than waiting for the situation to change and hoping there will be no adverse consequences.

2.2.2. High importance given to liquidity risk management in Europe

An industry representative noted the importance of liquidity risk management. Firms are using their own tools, some which are built on worst-case scenario's. If a company promises liquidity to customers, it must provide that liquidity while ensuring it has enough liquidity for itself. As it is logical for insurers to hold illiquid assets, there is a need to assess the possible liquidity risk in case of a worst case scenario. Given that consumers cannot buy back their insurance at the value carried on a balance sheet; there must be a deduction. The official suggested that this problem is different in different European markets. An industry representative agreed, emphasising that liquidity risk is magnified by fragmentation. Also, the help of national crisis legislations, in countries where these exist, which can prevent customers withdrawing their saving under crises can be an important protection tool against liquidity risk, an official suggested that liquidity is also a 'hot issue' in discussions about banks. Another industry representative described how their institution had never had a problem with liquidity before, but now it is over-liquid.

2.3 The challenge for the Commission: striking a balance between financial stability and incentivising long-term investment

A policymaker stressed that this is not the first time there has been a discussion on long-term investments and the obstacles created by regulation in a Eurofi panel. Long before the environmental, social and governance (ESG) agenda, there was a desire to promote long-term investment in the European Union. The crucial issue is to find a better balance between long-term investment maturity and the market's short-termism. This has always existed, and it demonstrates why Europe must reinforce the long-term growth potential of the economy. The European Commission is somewhat 'schizophrenic', because it is responsible for financial stability and other financial risks while also being responsible for developing policies that promote growth. The Commission's approach is based on the logic that even the most apparently substantial long-term investment is not sustainable if the system is not stable. Stability is the fundamental condition for sustainability. The Commission manages this by turning to its experts. The Commission asks the supervisory authorities to provide advice on how to strike this balance and whether it needs to recalibrate; it receives the advice and determines what to do, and sometimes it goes further than the advice it is given.

There are issues around financial regulation being an obstacle to long-term investment. However, when Europe has made adjustments, including a recalibration of capital charges, the elasticity of response to these has been very low. This recalibration has not produced a surge of institutional investment into infrastructure. There are two possibilities here. The first possibility is that there must be a much more substantial trade-off. This would suggest that the impact at the lower end of the curve is non-linear and there will be no reaction until there is a significant recalibration. This implies a much more pronounced trade-off within the conundrum concerning stability and growth. The second possibility is that regulation is less important than is often suggested. It is important to ask whether regulation should be the focus of this debate.

An official considered that the financial crisis demonstrated how important it is for financial entities to have sufficient balance sheets to absorb shocks. Such shocks can be absorbed by balance sheets with long-term liabilities and assets. This must be the first line of defence for private entities.

An official feared last Europe could shift too much to the public side on investment while protecting the use of public money in times of stress.

3. Looking forward: next steps for regulators and market participants

3.1. Are further regulatory changes required notably regarding equity investments?

An industry representative stated that the EBA could be given a mandate to consider how Europe can meet its objective of encouraging sustainable development, incentivising long-term investment within banks, while remaining in line with actual risks.

Another industry representative suggested that some regulatory changes are needed for insurance companies to ensure that firms would still be able to provide products with options and guarantees. An official felt that insurers are uniquely qualified to invest in equity, but there is a need for regulatory incentives for equity investment. Another official emphasised that the current position of equity on the balance sheets of financial intermediaries is unsatisfactory. The first official noted that the French and Dutch Treasuries have suggested tackling the disincentives concerning equity in the forthcoming Solvency II review. This review will be important. Supervisors must do their job, but Europe must take a longer-term perspective in its regulations. It is up to ministers to insist to the Commission that there must be a time horizon which is more relevant than one year. A policymaker described how the Commission accepted that insurers should hold equity portfolios but rotate individual equities over time by focusing on average duration rather than absolute duration.

An official suggested that the industry is aware that the public and private sectors can share the necessary long-term investment, which is connected to the next

phase of the CMU. If people are supposed to invest more, there must be assets for them to invest in. There must be prospects and there must be a future. This would trigger investment. Europe must clarify why it needs long-term investment, and private entities must be able to continue to make these long-term investments. Europe will eventually create near-term financial stability risks if its regulations are pro-cyclical or if they hinder long-term investment. There is a risk that Europe might create these near-term risks and destroy its capacity to invest in the long term. An industry representative agreed on the need for the CMU, suggesting that it is critical for insurance. The European capital markets are too small and too close to global cash flows. Currently in Europe there is more de-listing than listing, which is a negative development.

3.2. Regulators and supervisors must understand the limits of regulation: regulation can neither eliminate all risk nor solve all problems

An official felt that regulations should not shy away from risk-taking. The current problem of regulation is that regulators and supervisors seek to overachieve. The regulator sector seeks to achieve too much with very few pieces of regulation. The official described how Estonia possibly made a mistake in its compulsory pension system. The legislation sought to include all of the long-term and short-term benefits for the consumer, and the outcome has arguably been suboptimal. The official felt that the same happened in larger European regulations such the Markets in the Financial Instruments Directive (MiFID) or the regulation on the investment-fund: for example, seeking to preserve liquidity for retail investors should bring some benefits, but the market might lose something elsewhere. Another official agreed, describing how Austria has a similar pension product, which is supposed to provide excellent long-term returns, to have an excellent capital guarantee and promote the Austrian capital market. However, it does not produce yield because it cannot achieve several conflicting goals at once.

3.3. There must be an adequate balance of public and private investment

Another official felt that Europe must consider whether the funding for priorities such as the energy transition should be exclusively public or not. These issues create many challenges for member states, depending on their geography and historical situation.

An industry representative agreed on the importance of the private-public discussion. Indeed, institutional investors seek to invest in a variety of investment projects, but the political risk at the start of some private investment projects is something a company must be very cautious about. After this the investment project becomes more stable and has the potential to attract investors much better. New solutions could be done to solve this issue.

Revising Solvency II: main policy priorities

1. Need for change in Solvency II

The Solvency II directive has taken a very long time to be approved. In 2013 a long term package and a transition period were proposed, which have been questioned by market investors for some time. In the context of the 2020 review many questions have emerged about the fact that Solvency II has had to embed more than in the past, and that its main consequence could be a new set of complex, technical rules to better address how the regulation has had an effect on economies, specifically when talking about long term investment. A supervisor stated that the main task of a supervisor is to protect policyholders, however the regulation is interlinked with macroeconomic policies.

1.1. The low-for-long-era and challenges for insurers

Complexity is inherent to the insurance sector due to the duration of the liabilities, then the industry has to assess in which way the long term investment is correctly addressed by the prudential regulation.

Moreover, a supervisor stated that the low for long economic environment is a challenge for insurers, life insurance companies and pension funds as well as for supervisors.

In particular, a supervisor feels that it is currently a low (interest rates) era, but recently there has been talk of a negative era, which is different. It is thus of paramount importance that insurance undertakings should hold sufficient own funds to cover all their risks.

Indeed, the industry is now facing risks arising from the economic environment that have not been seen before. However, supervisory and supervisory activities should not be dictated by recent financial circumstances.

Indeed, negative interest rates are a fact of life and need to be dealt with in the system. The insurance system needs to take into account negative interest rates.

An industry representative struggled with the predictability of interest rates when reading research about the low for long scenario. Two years ago, the representative's company did an in-house study on interest rates in the 1960's, when Europe was coming out of the Second World War. Europe was heading for a crisis, with interest rates in the double digits. Conversely, now the whole idea of, 'It will stay as low as it is for a long period of time,' is a difficult one.

There are natural low points where people will not invest in negative interest rate securities. Companies will then put the money into a bank account, which might have a negative interest of 0.5%, or buy gold.

A supervisor feels that it is difficult to sync effectively. Indeed, while on the short-term, risk free interest rates (RFR) are decreasing, organisations have to assess their 30- or 40-year liabilities's solvency capital requirements (SCR); there the effect is sometimes very important. That was probably not thought about when the regulation was built, now the question is how to fix that.

Finally, instead of making short-term changes according to prevailing recent economic conditions the aim should be to keep the Solvency II regime fit for purpose, which is why the review process is ongoing. Yet, the prudential system should not be revolutionised, but rather tweaked to address possible blind spots. Any identified blind spots need to be corrected appropriately, such as the negative interest rate. The European Insurance

and Occupational Pensions Authority (EIOPA) made a proposal for that, which is now being fine-tuned.

An industry representative stated that Omnibus II was an instrumental milestone in allowing the applicability of Solvency II and has provided a workable valuation of the liabilities in the prudential balance sheet with measures and adjustments to the risk rate curve. Some fine tuning could still be done to the volatility adjustment. Further work is needed in SCR regarding dynamic volatility adjustment in order to provide a continuum with the prudential balance sheet and amendements to the criteria for the long-term equity investment portfolio are required to ensure its applicability .

1.2. Adjusting Omnibus II, keeping in mind a systemic risk perspective

An industry representative believes that changes to the volatility adjustment would be important in order to stabilise the whole system, which would free up capital capacity for longer-term real-economy investment. There is a question of whether it is desirable to increase the link between banks and insurers even further when looking from a systemic risk perspective. If this last liquid point is extending forward it will have massive implications for the whole valuation question and for the solvency ratios of the sector. The only way the sector can react if it wants to hedge that exposure is by buying swaps and/or swaptions from banks. The supervisory committee might not be satisfied by the transfer of the risk to the banking system, but it is a possibility for the industry.

1.3 Solvency II needs maintenance

A supervisor believes however, that the system has to be maintained. Maintenance of the framework is key; some essential refinements have already been done to Solvency II, with a more significant review in 2020.

Last year EIOPA offered the Commission some advice on changing and strengthening the sub-module on the downward interest rate risk because of market evidence.

The industry is possibly entering an era which is not low-for-long; if it is a negative era then that will hopefully be temporary. The framework may need to be adjusted, but not on a day by day basis since, Solvency II works and there is evidence for that.

2. Possible necessary evolutions of the Long term Guarantee package

2.1. Further addressing volatility would improve the regulatory framework

However, beyond the low-for-long context, an industry representative feels that the prudential system needs to be further stabilised to better reflect the actual underlying risks in the business model of insurance companies. At the moment the system is still reacting fairly directly to volatility in financial markets encouraging procyclical behaviours as well as overstating potential losses of own funds in volatile environments.

When long-term liabilities are examined, which are largely illiquid, then insurance companies do not necessarily have to sell assets when they are at a low point because of capital market changes, and liabilities are there for 20 to 30 years. Attention should be drawn on the important role played by the accumulations of own funds including free surplus, regarding the strengthening long-term stance and sustainability, and against volatility (avoidance of fire sales). This is notably the case in non-life undertakings and within the mutual sector where own funds can represent very large proportions of the liabilities of the balance sheet.

Changing the yield curve is the baseline for the valuation of liabilities and of the balance sheet. Adequate dynamic volatility adjustment should enable a company to adjust to its assumptions regarding future adverse scenarios. This makes sense, because the entire Solvency II framework is basically based on a future perspective.

If there was a more stable framework then there would be less risk from a solvency framework perspective, and companies could basically use these risk capacities that they free to further invest in real assets. Furthermore, if there is a system that adequately reflects the underlying risk and is reasonably stable, then adding on macroprudential measures, makes sense.

Conversely, if there is an unstable regulatory system whose risk assessment changes every month, ever suggesting that there is potentially systemic risk, then it would not actually reflect the business model and the real risks in insurance.

A supervisor, however, reminded the audience that there needs to be an evidence-based framework, and according to the evidence available, there is no reason to change the current framework. A supervisor explained that the idea is to make the long-term guarantee (LTG) measure cope with situations like long-term investment as well as the low interest rate level.

An annual report has been produced on the functioning of the long term guarantee (LTG) measures. Volatility adjustment is one of the areas that is being worked on, and there will be ideas, open questions and open options in the upcoming public consultation.

A consultation paper that will come out in the middle of October will provide a chance for the industry to comment. In addition, a holistic and accurate impact assessment will take place around March 2020, which will allow EIOPA to provide the Commission and the political authorities with an opinion in June.

2.2. Stabilising an appropriate definition of long-term nature of the insurance sector is still necessary

An industry representative noted that a clear understanding is needed of the features underpinning the long term nature of the business. There are tentative definitions to long term, but they are often too simplistic and are not comprehensive enough leading to distortions in the assessment of risks and potential losses of own funds.

Omnibus II has catered for improved long-term approaches to the valuations of fixed-income assets, though it still leaves room for improvement in order to achieve further realistic levels of the spread risk, which should require setting dynamic volatility adjustment mechanisms. Yet it has left aside of the long-term guarantees package, long-term equity investments strategies. However, in this respect the 2018 Solvency 2 Standard Formula review has taken the appropriate step towards an equity shock effectively reflective of long-term investment which are not submitted to forced sales. It is mainly very much a question regarding investing in listed equity, provided that listed equity challenge is about short term illiquidity.

Equity shares have always been a long-term investment vehicle with equity markets being among the most liquid markets, and providing essential accumulation of capital fostering sustainable growth and favouring thriving innovation. Even for non-life insurance companies, investments in equity shares is undertaken with long-term horizons despite the fact that most of the time they have short claim settlements inducing short durations of their technical provisions in the balance sheet all the more since future renewals are disregarded under

the contract boundaries definition. This does not give the full long-term view of their business model because their business is being continuously renewed.

For example, although medical expense businesses is thought of as very short-term, (less than one year claim settlement), those companies and notably mutual ones, can have own funds that represent 75% of their liabilities and have a long-term investment stance on the basis of their own funds. That is completely overlooked by the prudential regulation. The more own funds and free surplus a company has, the more it is penalised, because the regulation considers the market risks without acknowledging that financial robustness and liquidity provided given their ability to decide what and when to sell assets.

Long-term investors are often associated with buy and hold behaviours. Buy and hold has very much to do with what has been catered for with Omnibus II. If a company holds a fixed income security until maturity then the market value is not representative of its risk; it is a temporary picture of an economic loss, but it is not a realised loss, and if the company holds it until maturity then the loss will not be realised.

However, an appropriate asset and liability management (ALM) is not just achieved by buy and hold approaches. Another type of ALM, at the other end of the spectrum, would be the active management of assets. It is much more demanding, but it is rewarding because companies can capture risk premium and liquidity premium where they are. With equity active management companies can leverage their ability to hold against an adverse cycle. It is an ability ex-ante not to sell at worst times, and ex-post to make the most of financial markets with counter cyclical behaviours.

Finally, the time horizon for investing long-term is indefinite. Rather, long-term investment is the financial strategy which is only accessible to an operator holding stable resources, which both allow and require an asset allocation able to generate an economic return over time. There needs to be something that reconciles the two specificities of the business model that insurance companies have.

A distinction is needed between liquidity issues and solvency issues. In addition, marking to market is not something insurers dispute for evaluating the assets but evaluating technical provisions without thorough examination of the consistency of the approach with the asset valuation dynamics and implications poses a problem and distorts the view of own funds and potential losses.

2.3. Developing equity investment

An industry representative does not think the industry is especially well placed to pick up on the negative interest rate issues, as these issues are largely driven by the monetary policy led by the central bank. From an insurance company perspective, the low economic environment is mainly about unlocking corporate investment and developing equity markets, which is something achievable.

In the wake of the financial crisis a focus on short-term regulatory approaches has been put in place. Risks have been measured with short-term horizons that have tended to pose a problem for long-term investors. Long-term investments have declined since the financial crisis. A report submitted to the European Parliament Intergroup on long term investment in November 2018 by the French Long-Term Investment Task Force shows that long-term investments had not found their level before the crisis. Expressed as a percentage of GDP, 2% is still missing, which is around €4.5 trillion.

However, a supervisor stated that according to EIOPA data there has been no disaster, negativity or escape from long-term investment since Solvency II started. Investment in equity is quite stable, as previous investment from the insurance sector was not high before Solvency II. There is an evident difference in different member states in terms of the level of investment in equity, meaning the same framework does not necessarily lead to the same consequences in terms of disinvesting or investing.

An industry representative noted that the idea is not to start Solvency III; it is evolution, not revolution, and it is very important to have the volatility adjustment and the criteria for the long-term equity investment portfolio improved, provided that negative interest rates might be an additional reason to invest in equities.

However, a supervisor feels that the review of the framework should stay within the recent Solvency II regime. Much discussion could take place about whether the accounting regime and the market valuation are right or not, but that is not really the purpose of the Solvency II review. The Solvency II review should tackle some of the shortcomings within the existing framework.

There will be no long term investments if there is no appetite for insurers to enter any long term liabilities. Before discussing equity, it is important to think about whether the regime is robust enough to enable insurers to enter into any long-term liabilities.

2.4. The need for transitionals

A participant asked panellists if there is a need for transitionals, given that Europe is in a very difficult economic environment at the same time that it is trying to get a Solvency II review pack approved politically.

A supervisor feels that transitionals have worked very well up until now and should be kept in place. They are a matter of trust. Insurance companies should be able to trust inter-regulation. Everything that is being done should be fully assessed with a full impact assessment, taking the recent situation of companies into account as much as possible. A supervisor stated that the purpose of the transition is to facilitate a transition.

However, in a world with negative interest rates the question mark is how negative future interest rates could be. There should be a moment when the cost of keeping cash should enter in the next discussion on the risk free rate curve on Solvency II.

DIGITALISATION AND FINTECH

Implications of digitalisation for the EU financial sector

1. Opportunities and challenges of digitalisation

A speaker noted that technological innovation and digitalisation have had one of the most profound effects on the industry and it will become even stronger in the EU. Fortunately, it is one of the key overarching priorities of the new European Commission. The issues have sometimes been discussed in the EU from more siloed perspectives, which should be brought together to define which priorities Europe should adopt for the next five years.

1.1. Adapting to fintech agility and encouraging a cultural shift to catch the true opportunities

An industry representative explained that while technology is becoming easy of access for everybody, access to talent is becoming a challenge. Some of the biggest investors in the fintech revolution are the big US banks. Not all fintechs have developed their products fully, and there is a sudden shortage of capacity because the big institutions have decided that it is much easier and cheaper to use the fintechs. The cost-to-serve that the fintechs have brought the banks is very different, so the customer should be benefiting, but the labour cost itself is starting to increase as the same talent is needed. There is a run on talent and technical capacity.

A policymaker shares many of the sentiments concerning convincing FinTechs and BigTechs that moving into the mainstream is the right thing to do. But there is a need to act differently. 'Digital skills' are probably the real challenge for the financial services industry. Some of the talent is not staying in universities, because they can go out into the workplace very quickly and earn plenty of money, and probably not in the financial services sector. The other question to ask is what mix of skills is needed. More than ever in the past, what is needed now is people who can think outside the box and who have different backgrounds.

An industry representative noted that incumbents are trying to adapt. The cultural transformation is probably the most challenging aspect for banks. There is a new environment, with a much more diverse ecosystem and many different types of players. There will be very different types of relationships. It is a very rapidly changing landscape. There is a blurring of the boundaries between sectors. Competition used to be seen from a sectoral and national perspective, but what is happening now is cross-sectoral and cross-border.

An essential issue is the cultural mind-shift, particularly at board level. Boards have traditionally approached projects in a very linear fashion, which is not how fintechs work. Getting the boards to understand and adapt to an agile sprinting methodology is important. In this area, a framework like the UK Senior Managers Regime, is very effective at bringing focus to the board, and there is an opportunity for the regulators to provide an appropriate framework.

Finally, there is the question of managing the new suppliers themselves. Some of the Fintechs understand the new European Banking Authority (EBA) guidelines, but not all. Trying to contract with the fintechs when a banking licence is at risk can result in difficult conversations, notably with some of the big cloud providers.

It should be pointed out to boards that technology is everything now. There has been a great deal of talk about data and the cloud, but the now real thing to talk about now is artificial intelligence. The new president has issued a challenge for someone to come up with a regulatory framework for AI in the first 100 days of the next European Commission. This presents a blank sheet of paper, and help will be needed to get it right.

1.2. Policy priorities to address current challenges

A public sector representative asked what topics, other than cybersecurity, should be on the agenda of the next informal Economic and Financial Affairs Council (ECOFIN).

A policymaker noted that the regulatory framework needs to be fair. That means looking at the plumbing and the issues in terms of data. A more fundamental question refers to the market power of the Bigtech platforms. Over the last five years there has been tinkering with and amendments to the basic regulation that deals with online services, but the fundamental issue of network effects and competition in the market as a whole has not yet been addressed.

On artificial intelligence, there exists also the chance for detaching governance processes from the way that data builds information. Perhaps it is not people but data driving it and AI deciding what goes under which category. If there is a bias, the question is to identify how the system is becoming sociopathic rather than something else.

The current quickness comes from the idea the fintechs can ignore governments. However, governments do matter. Perhaps the new framework for data still requires protection and if everything else that governments do is taken away: it is the protection of citizens that is key. Nonetheless, because regulation is slow it will slow down things. The regulatory technology is also an extremely important aspect. It has to be developed in order to match the data development that is going on.

To make things more difficult, there are no vertical financial services anymore. They are completely horizontal. Perhaps EU governance structures are also challenged by this, because they too are in silos.

An official suggested that all of the topics raised by the panel would probably require several more years. There are many technical details and technical discussions about platforms, technologies and so on, which are extremely relevant, but one question to return to is what the framework is about. The monetary system was created to control the creation of money. There are now attempts to fit into this system the creation and usage of data. That may not work. There may be very fundamental questions

about how to develop or evolve existing entities into something completely different.

A Central Bank official added that central banks may, in the future, take over also roles somewhat apart from monetary policy. There could be the consideration of a central bank role as a trustee in establishing public data services, be it a registry for blockchains or a European cloud.

1.3. The systemic issues posed by new business as well as technological value chains

An industry representative noted that cloud adoption is becoming mainstream for financial institutions. They are coming to the cloud because they see it as a vehicle to innovate and co-innovate with cloud providers. The cloud is also seen as an opportunity to improve productivity and collaboration within organisations, and to improve security and system resilience.

The cloud has been enabling access to artificial intelligence and machine learning. Much of that technology is used to tackle financial crime and anti-money laundering. The Cloud is becoming a strategic imperative for banks.

Financial institutions were early adopters of private cloud, but the uptake of public cloud is still relatively low. Financial institutions are dealing with the complexity of their legacy infrastructures, and there are nuanced regulatory and compliance regimes. Even compared to other regulated verticals, there is much specificity in finance. On the cultural mind-shift and attitude of the boards and Senior Managers Regime, there are many senior decision makers who ultimately make assessments on the safety and security of cloud solutions, and muc trust and education is required to address perception issues. Even in the past few years there has been an increased understanding of the benefits and security capabilities of cloud. Cloud providers have improved and strengthened their compliance programmes. Regulators have also increased their understanding and issued guidance on the outsourcing.

A Central Bank official noted that it can be difficult to understand what should really happen in the industry, which is necessary in order to have the appropriate supervisory approach.

For central banks, as supervisors, supervised entities change quickly and in various respects business models are changing, and operating models are also changing, there are new entrants into the market and the challenge is to keep the risks in the financial sector are still under control in this new environment. The changes are so immense that it has to be a question of whether the supervisory and regulatory environments will have to be adapted to cover the risks in the future.

One example is the unbundling and fragmentation of the value chain. Supervisors might no longer grasp everything that happens in the banks, because elements of the value chain are outsourced to other entities. The outsourcing framework is the bridge which states that the banks cannot outsource their responsibility, but some participants see this as a kind of illusion. When a small bank outsources its core banking system to a cloud provider, they can be asked to have the outsourcing to the cloud provider under control by overseeing all risks and managing the outsourcing arrangement but in practice they may not.

An industry representative noted that fintechs are trying to unbundle the banking business and banks are trying to re-bundle. The eruption of Bigtechs is especially disruptive, because they tend to create digital ecosystems that have several special features. One is based on network effects. They play a gatekeeping role for the ecosystem.

The Financial Stability Board (FSB) and the Bank for International Settlements (BIS) have started to discuss the impact of this on market structure, competition and financial stability. Bigtechs are key providers of critical infrastructure. Cloud is critical; it is not an option but a necessity, and there is systemic implications from this reliance on a few providers of critical financial services.

A particular concern arise from data, because it is the basic element in all of this cross-sector and cross-border competition. There is an asymmetry in regulation, which is a concern. Europe has been the leader as regards privacy regulation, with the general data protection regulation (GDPR), and as regards open banking, with Payment System Directive 2 (PSD2). While PSD2 requires banks to open access to data to third party providers in standardised terms and real time, GDPR does not imply a similar obligation on the part of other players, including bigtechs. An extension of the open banking standard to other sectors is recommended. To offer value-added services to end users, this data sharing framework must work, and that means a much more ambitious, cross-sectoral and cross-border approach to data sharing.

1.4. Supervising technological risks in the new and ever-evolving environment

A Central Bank official explained that the situation is relatively new for banking supervision, which generally takes care of the financial soundness of a company. The technological risks become at least as important as the traditional financial risks, yet supervisory staff are often not yet IT experts.

There is growing interconnectedness between financial services, which is a risk. In addition to PSD2, APIs are an issue. The whole concept of the entity-based supervision, which is the rule in banking supervision, is questioned and challenged by some actors. Proposals to switch to activity-based supervision have been made.

Nonetheless, there are opportunities, and technology can make banks safer than before. From the European point of view, regulation and supervision should not be insurmountable obstacles for innovation. There is also an opportunity here to develop the process of supervision into a system of supervision, where financial stability can be monitored by the authorities with a kind of real-time monitoring.

1.5. Sustainability of new techs is an additional regulatory aspect to be considered

An industry representative noted that another big piece is sustainability, which is a critical part of the European agenda, and cloud has a role to play there. When financial institutions are considering their cloud strategies, they need to be looking at sustainability criteria as part of the selection process.

2. Key priorities for the political cycle

2.1. The importance of regulating data sharing in the new context of AI, contrasting GDPR and PSD2

An industry representative stated that the asymmetry regarding data availability needs to be fixed. The desire is to offer what customers are demanding, which is more and better services. They are used to having things that are immediate, real-time, sometimes free and very user friendly wherever they are. If banks want to provide that then they need to have access to data. Of course, that must be with the consent of the client. Clients should be at the core of all of this. The expectations of GDPR did not realise such a framework.

This idea of extending something inspired along the PSD2 framework, with standardised access to data based on APIs and real-time, to a cross-sectoral framework with users allowing companies to have a complete picture to offer better services is what is needed to improve the insight companies have and the trust of the customer in the services offered. The European Commission is doing a great job on this. There is a regulation of the free flow of data, for example, but there are elements still missing.

It is no doubt not possible to go all the way at once. A more gradual approach is likely needed and more realistic objectives, perhaps focusing on some type of data or some sectors where standardisation is easier to implement.

A policymaker added that GDPR is probably not enough. GDPR has been difficult in practice. The point about business to business data is the right one. The European Commission is onto that. The incoming President's speech talks about AI and then about using big data and how to approach that. Part of it will be linked to AI, because for a cloud it is important to have data quality and data interoperability for AI to succeed, and that will be facilitated through the cloud in terms of data storage.

The challenge is going to be about the extent businesses should be obliged to share data or be encouraged to share data. Out of the box thinking is needed. Telcos had significant market power as incumbents, and then asymmetric regulation was imposed on them to rebalance the market. In terms of ex ante regulation, it must be done, and competition rules must be used. Commissioner Vestager now has a mandate to look again at the competition rules. The real issue is what is happening upstream because, by definition, the competition rules will remain rather case focused, so there is a need to look ex ante at what needs to be done.

It is provocative to say to banks that they have to get their acts together on payments. The regulatory framework is challenging for them; it takes them longer to get their products approved. There may be a need to look at some of the rules again, such as the e-money directive. There is work to identify what needs to be done to make the playing field fairer in that respect.

A Central Bank official noted, regarding the existing legislation, that things are moving very quickly and the initial ideas for GDPR and PSD2 are from an age before big data. Some elements of the financial regulation might not take into account the new needs for the banks, so there should be a review of all of the legislation under the perspective of digital readiness.

On setting standards, the world is looking to Europe's regulatory measures and initiatives. They are expecting Europe to take the lead to a certain extent, because they might not fully trust the Chinese or American systems in this regard.

An industry representative stated that it ultimately comes down to trust, addressing the skills gap and addressing issues around responsibility. It is a very different topic when talking about AI frameworks, but cloud underpins much AI innovation. A great deal of effort has been invested into developing a responsible framework for an ethical development of AI, and the European Commission has been worked with closely to share some of that work.

A policymaker noted that the AI piece has to come quickly as it is part of the 100 first days of the new EU Commission. It really will be a question of analysing markets. The digital platforms are restructuring the whole economy, so how to frame that has to be queried. It will not be possible to deal with all of the issues, but there can be better framing and then a check of what it means in practice. There is pressure on the big platforms asking what data they will provide. They have data that can stop epidemics, and one question is whether public authorities should have access to that data to be able to do their job of protecting citizens.

The role of governments also appears in the President-Elect's speech on democratic legitimacy. Young people do not believe in going out to vote in the same way the previous generation did. Many people were mobilised for the European Parliament elections, so there is now a reasonably good situation, albeit probably a fairly difficult and unpredictable European Parliament for the next five years.

2.2. The need for an effective openness in the ecosystem in the global context

An industry representative explained that from a cloud perspective there are already many debates about the upcoming regulation. Very different models are being discussed at the pan-European level of direct oversight as part of the fintech action plan, and at the global level where FSB is looking at a potentially critical infrastructure designation type of regulation. There are conversations at the national levels with the regulators and central banks. There should be a very practical debate with all of the stakeholders on what is workable and what would not only mitigate the risk but would also lead to innovation in the markets and encourage competition.

The key focus areas need to be concerned with the openness of the ecosystem. Vendor lock-in is a real problem. Build for open source and for different multi-cloud strategies. The European Commission has been doing fantastic work on the portability code of conduct for cloud providers, but that is probably only an initial step. Much more needs to be done to protect the open ecosystem and to build for a multi-cloud at the policy and legislative level.

An industry representative added that there is also an issue regarding global governance. The case of digital identity in India is very interesting. The programme being pointed to affects many different types of authorities, so it is not only about financial stability. The FSB is doing a great job, but the Japanese G20 presidency suggested that the World Trade Organisation (WTO) should have a role. The Organisation for Economic Co-operation and Development (OECD) also did something in the past. A forum where all of these issues can be looked at together is required.

2.3. Catching up with BigTechs, keeping pace with the rest of the world while preserving the EU's technological sovereignty raise essential and urgent regulatory and supervisory topics

An industry representative suggested that what is needed is the sharing of information and a meeting of minds. There are other parts of the world that are very far ahead, and there is a need to perceive what is happening.

A policymaker explained that the answer that the European Commission is giving to the issue of keeping pace with elsewhere is under the idea of technological sovereignty. There is a strategic realisation, which can be seen very acutely in the 5G space in relation to Huawei and what is done in terms of security measures.

A collective European response is being worked on. The new Commission has said that there will be a new industrial policy strategy, and part of that will be about technological sovereignty. The question will be what technological sovereignty means in practice, and also how to be open. It is the big geopolitical challenge currently,

especially given what is happening in the rest of the world and the polarisation between the US and China.

An official noted that data has to be opened up and made available to companies in order for them to catch up with BigTechs and the world development, but at the same time there must be caution regarding security. With geopolitics, the hope is to remain open to the extent that technologies can be developed and benefited from. The industrial policy should be about securing things, making sure that consumers are safe, that money is not laundered, terrorism is not financed and that the financial system is stable. Once that is figured out through the institutional changes, then there can be focused thought about how the data is freed and how to get benefits from it.

In this context, the competition policy is very interesting. Those difficult in-between areas should be approached on a free flow of data, scale economies for banks and other entities, and made secure. However, there is the question of how to do that, and the governance on the public side of how to manage that. If the scale of economies is destroyed for the BigTechs, the question is whether that would not also apply to financial institutions. Control should not be lost to AI. For entities, regulation will remain, but activities will have to be figured out very quickly on how to regulate them.

A representative if the industry stressed in this respect, that digitalisation challenges are permanently evolving. In this area there is a huge threat for financial institutions, that adds to the various challenges faced. In such a context finally, the urgent need is for regulation and legislation to catch up quickly, since at the speed the tech industry works at, it will leave regulation behind.

For instance, some recent regulation on payments will soon be superseded. Libra is a wakeup call for the financial services industry, in terms of what is happening on payments. Most of the time, disruptive innovators are trying to serve the market. Consumers are becoming fed up with not having facilities. Consumers want choice, but if they have one way of doing things, and if it is very easy and they can plug everything together, then that is what they are going to opt for. For central bankers, crypto currencies are very challenging, but they need to react quickly, because otherwise the market will try to provide them.

The Chair asked an audience question querying what banks are intending to do with their customers' data coming from Bigtech platforms, since they do not seem to be able to use their proprietary data properly at present. An industry representative answered confirming that the banks are trying to improve the way they do things. Thus, in this challenging environment, banks that try to do their homework should have to opportunity to do things better and compete in this difficult ecosystem. This requires a level playing field. Otherwise, even banks that do their homework will have difficulties competing. What is being asked by financial institutions is to have the opportunity.

However, in addition, the magnitude of the potential financial stability problems stemming from digitalisation, will depend on the extent to which there is an effective level playing field. That is also an issue for regulators.

Digitalisation and new technologies in the retail space

This session discussed the impacts of digitalisation on the retail financial services sector, with the exception of payments that was addressed by another panel during the Eurofi Helsinki Forum.

1. Potential customer benefits provided by technology in retail finance

1.1. Improved services

An industry representative explained that the principal benefits of digitalisation for consumers are reduced friction in their interactions with financial-services providers (e.g. easier access, quicker decision-making), greater choice and personalisation. Technology is helping financial institutions to exploit the opportunities offered for example by micro insurance for 'gig-economy' workers or micro-loans for firms in need of working capital for extremely short durations. Looking at developments happening in China in companies such as Tencent and Alibaba, digitalisation helps to broaden the range of services offered e.g. into new areas such as healthcare. Technology also allows financial institutions to make personalised service offerings at the point of need. For example, institutions can use predictive technology based on artificial intelligence (AI) to assess when customers might go overdrawn or need a mortgage.

Another industry representative emphasised that efficient data storage and sharing is another important aspect of digitalisation. With a customer's consent, digitalisation enables data sharing with partner institutions. The industry representative's firm allows small business users to digitise, categorise and share their business transaction data with accountants, for example, which speeds up their end-of month bookkeeping dramatically.

1.2. Easier access and greater financial inclusion

An official stated that digitalisation does not change the product per se but it does change the mode of delivery and the availability of the service, allowing institutions to reach efficiently customers at anytime and anywhere and also to service previously unreachable customers and parts of the world. Lowering barriers to supply and also to entry into the market is its true advantage. Most developments are taking place in the payments space at present, but other areas will be concerned.

Another official added that the increase in the financial inclusion of the un- or under-banked and the greater access to credit supported by technology is a globally relevant subject. AI and data analytics can allow financial institutions to access additional data points and create more robust credit profiles for individuals or smaller businesses that may not currently have access to credit. The unbundling of services that goes with digitalisation is also unlocking increased efficiency which allows them to reduce the cost of certain products. Finally financial health firms that have emerged notably in the US using data analytics can help families that do not have sufficient literacy to manage their financials.

An industry representative agreed on the importance of providing access to finance for SMEs and noted that

technology allows their company to offer services to this customer segment across Europe in an efficient way.

A third official emphasized that technology could also play an important role in capital markets, which is an area where retail engagement is notoriously insufficient in Europe. This can be explained by limited financial literacy and the perception that investment is complex and risky. From an economic perspective, with a decreasing share of labour income in Europe, it is essential for households to invest more in capital market instruments. Technology could provide effective tools to encourage savers to do so and the industry should propose ways of further standardising capital market instruments in this perspective.

Two speakers also stressed the risk of financial exclusion for the part of the population that is unable to use digital services. It is important for financial institutions to consider how to help these clients. In addition, not everyone is capable of understanding the risks and benefits associated with financial products, which is essential when using digital channels with no support from advisors. There is therefore a link between digitalisation and financial education that needs to be considered.

2. Changes in market structure and in the operating model of financial institutions

An industry representative explained the key trend towards ecosystems and marketplaces. Many incumbent retail institutions are faced with challenges concerning cost-income ratios. To alleviate cost pressures they need to find new revenue generating opportunities that are cheap and fast to develop, while supporting existing customers and products in a more efficient way. Platforms leveraging cloud, AI and machine learning can help them to do this. These platforms can help them to build a broader financial ecosystem e.g. with fintechs and explore new revenue-generating opportunities. Harnessing data will be critical for taking advantage of these opportunities because this is not just about being able to develop new products; it is also about being able to apply them at the point of need. The institutions able to leverage these technologies to offer these more personalised services will win trust from customers and be able to maintain long-term relationship with them. This approach should also help retail financial institutions to optimise their back-office operations. Many of these are relatively undifferentiated and the IT platforms they currently use present many similarities. There could be greater convergence and harmonisation in this area with progress in the use of utility services based e.g. on cloud services. Doing this would allow financial institutions to reduce their costs and focus more resources on providing value-added services.

Another industry representative highlighted the revolutionary nature of change happening in the retail financial industry with digitalisation. First, there is a cultural revolution taking place inside banks with an increasing proportion of employees with tech backgrounds. In the speaker's institution, a large bank, 49% of new employees have a tech background, compared with 14% five years ago. This changes how a bank operates internally and the mind-set of its staff. Second, there is a revolution in customer processes. The industry representative's bank has taken the first few thousand mortgages through a fully digital process with no human involvement. 85% of customers now apply for mortgages through a digital channel and the use of mobile devices is increasing. Thirdly, there is a revolution in cooperation between banks and fintechs through APIs and also between banks and public authorities for example with on-line access to property registers or tax information in the context of mortgage applications. Finally, there is a revolution within the competitive landscape of financial services with the implementation of Open Banking concepts in particular. New entrants could challenge the current structure of the financial sector and require changes in the regulatory and supervisory approaches. A regulator added that it is likely that bigtechs will at some point enter the retail services market.

The speaker also stressed that a key challenge for banks with physical branch networks is to manage the costs of the associated physical processes while also investing in digital innovation. Managing these two investments in parallel will hurt their profitability. Since it will be impossible for large banks to survive in the future without being digital and being both digital and non-digital will become increasingly difficult as this will ruin their cost-income ratio, the trend towards digitalisation is due to continue.

An official underlined that new technologies are enabling the 'platformification' of financial services notably in insurance. Co-insurance initiatives such as the one the Bank of Lithuania is engaging with, should develop. Instead of there being an insurance company responsible for the insurance framework or services moving to the platform of an existing service provider there is a platform that connects the different insured entities.

3. Current policy approach

3.1. Technology neutrality

A regulator highlighted the importance of supporting innovation and the development of new retail services while mitigating risk, noting the European Commission's release of its FinTech Action Plan in March 2018.

An official stated that the current EU regulatory framework facilitates the development of digital finance with a technology-neutral approach. Europe embraced Open Banking in 2015 with the second Payment Services Directive (PSD2), which is one of the best examples of technology neutral regulation. This is an important concept, because a payment is a payment, whether it happens through a bank or a third-party provider. The official added that linked to the Fintech action plan, the Commission has also launched a FinTech Lab to support digitalisation.

Another official agreed on the need for regulators to remain technology neutral and also mentioned that the US advocates a functional approach to regulation, i.e. regulation based on economic activity rather than entities. If a new technology based on AI or data analytics performs the same function as an existing service, it should be regulated similarly. This will allow regulation to adapt to different business models and not remain tied to institution-specific considerations.

3.2. Sandboxes and innovation hubs

An official mentioned the Commission's European Forum for Innovation Facilitators (EFIF), which is a platform aiming to improve cooperation and coordination in support of the application of new technological developments in the EU financial sector and to exchange best practices on innovation hubs and sandboxes. The Commission is not constructing a European sandbox; rather, it is ensuring that different national sandboxes, which are places to conduct testing in a safe way, talk amongst themselves.

A regulator felt that many new entrants to the market do not understand the function of sandboxes; they

simply want to avoid unnecessary regulation. Answering a question about possible issues with the cross border export of services from sandboxes with lighter licences, the official stated that testing procedures are converging in the EU after an initial flourishing of differences. This is why the Commission considers it useful to foster regular discussions on the development of sandboxes among European supervisors.

4. The role of technology in further integrating EU retail financial markets and existing barriers

4.1. The issues posed by regulatory fragmentation across the EU

An official emphasised that technology in itself cannot solve the current fragmentation of EU retail financial markets because it does not change the underlying services and the rules attached to them; this would require a unified framework for retail financial services at the EU level. It is also important to understand the drivers of fragmentation. There is a large degree of fragmentation in the debt market, for example, which is partially caused by issues around financial infrastructure making it very difficult for retail customers to participate in cross-border debt markets.

Another official agreed that regulatory fragmentation hinders the capacity of technology to further integrate the EU retail financial services market. Digital services are by nature cross border, but if the rules do not change, the digital cross-border experience will be even more frustrating than the physical one because the barriers will seem entirely artificial. Customers will be asked for their nationality and depending on that will be offered different products or services for example. Fragmentation is mainly due to restrictions or specificities imposed by Member States. For example some UCITS funds are not distributed in all EU countries because authorisation channels differ across Member States and since separate authorisations are needed in all countries, many investment managers do not bother to apply in all countries.

An industry representative predicted that there will be no European single market in retail financial services despite digitalisation except in payments, because these services and products are strongly linked to banks, which still operate nationally because of differences in regulation and supervision across EU countries. This means that there will be differences in how banks respond to market trends such as digitalisation and changes in customer demand, leading to increased differences between business models and further fragmentation at market level. An official queried whether there are technical impediments causing this fragmentation, for example differences in the internet usage across the EU. The industry representative agreed that this could be a factor, but only a secondary one.

The first official stressed the importance of developing standards at the EU level. The SSM has unified the supervision of the largest banks but customer-related rules such as consumer protection, product frameworks, issuance rules or marketing rules are still largely national. The implementation of EU legislation also differs across EU countries. This significantly increases the administrative and sales workload for banks and thus their costs. The industry must push for hard European standards otherwise Europe will fail to compete effectively with the US or China. At present US banks are profiting from this fragmentation with a competitive advantage in each individual EU country. In the area of technology, Europe is focusing on 'niche' markets that cannot compete with US or Chinese bigtechs.

A third official mentioned that the US faces similar fragmentation issues to the EU regarding retail regulations especially those concerning consumer protection because these are regulated at a State level. AML however is largely managed at the federal level.

4.2. Know Your Customer (KYC) and customer-identification issues

An official felt that KYC is a second major factor limiting the capacity of technology to support the further integration of EU retail finance markets. There should be a single place in the EU for storing information about customers, because a customer is the same no matter where he or she banks in the European Union. As mentioned in another session of the Eurofi Forum DLT based platforms could be used to streamline this process. An industry representative emphasised the importance of a proper management of customer onboarding and KYC when customers engage with multiple institutions across the European financial ecosystem.

Another industry representative stressed that smaller institutions have the same anti money laundering (AML) requirements for payments as larger ones. The industry representative's firm, a small growth company, uses technology to manage issues such as transaction monitoring and fraud management at scale and with less up-front investment. This enables their business to scale faster, more securely and with greater customer benefits. An issue however is that KYC practices, which should be quite straight-forward, differ across EU countries (e.g. Germany requires video KYC, the UK allows a driver's licence as ID which Finland does not...). This makes being a cross border player extremely difficult in Europe. The official however remarked that this is not Europe's fault but is caused by different member states' implementations of the relevant directive.

A third industry representative believed that although customer-related rules will continue to differ, it is hoped that back-office processes such as KYC, which are causing increasing operating cost and 'hassle' for customers, can eventually further converge thanks to technology and with greater cooperation between banks and other financial institutions. There are several cooperative KYC initiatives being established around the world, including one example in the Nordic countries with 6 Nordic banks cooperating.

Another official noted the existence of 19 frameworks for electronic identification in the EU. Each country notifies the others of its framework for identity and asks them to ensure that it works. There is a substantial amount of infrastructure behind this, meaning that each country has its platform and that financial institutions only accept the identification system of their home country e.g. if a Finnish or British customer wants to use a Finnish ID or UK driver's licence at a German bank that will not be possible.

5. Challenges and risks associated with digitalisation in the retail space

The cyber-risks and operational risks associated with digitalisation were highlighted by several panellists. An official noted that these risks are not new, because the sector is constantly integrating new technologies into existing and legacy systems. However the pace and scale at which this is happening is increasing, which may pose greater risk for individual institutions and also potential systematic risks.

Other more specific issues related to the use of AI or to data sharing were also stressed.

5.1. 'Black box' effect

An industry representative mentioned how their institution has learned that technology is a 'good servant but not a good master'. While algorithms mine data for different purposes, humans must also interact with these tools and ensure they are operating correctly. People tend to think these technologies are smarter than they are, but they still require human supervision and training.

An official agreed that there is a need for 'human primacy' in the use of AI tools in particular, in order to provide regulators and supervisors with sufficient transparency, auditability and accountability and avoid the so called 'AI black box' risk. This is particularly relevant as decisions are made by increasingly complex algorithms in areas such as credit, portfolio management and quantitative funds. From a technology neutral perspective, institutions must be able to explain decisions to regulators and supervisors. For example, a credit decision must comply with the same fair credit reporting obligation in the US, regardless of whether AI was used to make it.

Another industry representative described how their company, a major cloud service provider, is investing a great deal of resources in research, products and technologies to alleviate the 'black box' effect with AI and data analytics. Investment is made in open source technology available free of charge to the public to address the concerns around the possible bias of machine-learning models and the way they are trained, particularly for credit scoring and lending applications. A fintech looking for a credit scoring algorithm will be able to literally download it from a marketplace and should be able to understand how this algorithm was built and trained. The speaker's company is also seeking to facilitate the access to and inspection of the algorithms and data sets used.

Another industry player felt that there is a need for further regulation on the use of AI and customer data in order to create trust from society and customers.

5.2. Data privacy and data-sharing issues

An official stated that while the new methods of delivering financial services based on technology are beneficial, the risks potentially posed to consumers and the financial system also need considering. The industry must ensure that consumers are well informed about the choices they are making notably with regard to the access they are providing to their data. For example in the case of financial health firms, consumers need to understand that they are giving these service providers access to their account login information in many instances. This is because of the way these services are being delivered, which is different from traditional banking services. Ensuring permissioned access and informed consent is one important aspect of the risk mitigation needed.

An industry representative agreed that data privacy and data sharing issues are important to consider, particularly in Europe, because the open approach that is necessary to realise the benefits of an ecosystem model supported by technology discussed previously has profound implications in terms of data sharing between institutions. There must be transparency from technology providers around how data is stored, accessed and shared, and the financial industry must leverage open source technology and define open standards as much as possible.

Another industry representative felt that PSD2 and the EU Open Banking approach do not provide a fair enough and broad enough access to data needed to reap all the benefits of digitalisation and AI in the financial sector. PSD2 allows authorized third-party providers to access bank customer data via APIs with account holder consent, but there is much more customer data available (e.g. on merchant websites or social media) that could safely be used for providing financial services and that financial institutions do not have access to. Opening up access to this broader set of data in an anonymised form would help financial institutions and particularly the smaller players to scale up machine learning and AI, which is limited at present by the range of data they have access to. Another industry speaker agreed, emphasizing that Open Banking regulations are forcing banks to share their data with other players, but the reverse is not true.

In addition smaller financial companies and fintechs rarely have the resource to complete complex integrations with different government registries that are needed for processing credit applications for example and PSD2 does not help in this regard. At present, only the larger banks get access to these registries through proprietary links. European regulation should mandate more open and fair access to different government registries for all players.

Responding to a question from the audience on the impact of GDPR on data sharing, an official stated that GDPR facilitates data sharing because it clearly sets out the two necessary preconditions: one, that the data is the property of the data subject; two, that the data can only be given out with the owner's consent. The official then addressed a second question from the audience on the role of the European Commission in developing digital financial services across the EU and whether the CMU and Fintech action plans are sufficient. The official suggested that the next Commission will need to consider Capital Markets Union (CMU) intensively and digitalisation will be part of this. As digital finance develops, the artificial barriers created by national regulations will seem increasingly inappropriate. One solution could be to move all financial legislations based on directives to regulations. That may create some difficulties, but the official believed that the time has come to make such a change.

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Reaping the benefits of DLT and cloud

1. Lessons learned from DLT applications in the financial sector

1.1. Ongoing developments based on DLT in the financial sector

An official noted that there are two main types of impact from new technologies such as Distributed Ledger Technology (DLT). One is existing players trying to integrate these new technologies. Another is the technology enabling new business models.

A regulator explained that developments involving DLT have been monitored by their authority at the international and European levels, for the past three years. There are some very interesting projects underway, such as the European Central Bank (ECB) / Bank of Japan Stella Project looking at DLT with regard to settlement systems; the Monetary Authority of Singapore's Ubin Project aiming to issue Central Bank digital money

using DLT; and one by the World Bank together with the Commonwealth Bank of Australia whereby they would issue bonds on DLT. There are also investment firms under MiFID II looking into DLT as a possible technology to offer derivatives through smart contracts.

Initiatives are also being conducted leveraging on DLT platforms in relation to anti-money laundering (AML), combatting the financing of terrorism (CFT) and know your customer (KYC) requirements. KYC apps based on blockchain ecosystems that act as an interface between the customer and banks are being developed, whereby the customer uploads information onto the platform and then banks can get access to it with the customer's consent. Such a system simplifies the process for clients who only have to provide information once and then update it. Clients also may remain the owners of the data throughout the process. This type of platform providing a common database with information on individuals who have caused difficulty to banks in different jurisdictions could also potentially be used by EU policymakers to integrate and strengthen AML/CFT in Europe.

DLT could also be used to simplify and streamline some supervisory processes and improve supervisory convergence in the EU, the regulator suggested. For instance, application processes for a licence under European directives or notification processes could be conducted on a DLT platform developed by the European supervisory authorities (ESAs) that could provide the various authorities concerned with the necessary information.

An industry representative referred to a new asset servicing and reporting platform for credit default swaps developed by their company using DLT and supported by cloud services. A distributed ledger is used for the data storage component, which happens after the processing phase is completed. The original project was to use smart contract software for the processing part of the service but this was not possible in the end, because of the amount of computing power needed to support the smart contract code and the risk of disrupting the existing service. Another issue is that the smart contract technology being used was proprietary code and would have required a relatively complex support ecosystem.

1.2. Benefits and challenges associated with DLT

An industry representative considered that the full benefits of the DLT technology have not yet been realised. It has not really delivered on cost savings or provided significant efficiencies so far. Actual maturity and improvement in the technology itself is needed, which is partly an issue for the vendors involved. There also has to be a network because there is a need for multiple players willing to be meaningful members of the network and host nodes. Until there is a critical mass of nodes, the full benefits of this technology cannot be obtained. One other potential benefit of DLT is resiliency, because there is a multi-nodal network where many of the same operations are taking place and the same data is being kept. However, when considering how to comply with recovery times, for example, we are still far from the standards needed for Systemically Important Financial Market Utilities (SIFMU) and securities processing firms e.g. in the US. In addition, for anyone embarking on a journey to implement DLT, an early operational stress testing of the software is essential to check performance and capabilities.

An official noted a calming down of the excitement around DLT, somewhat mirroring what has happened in the past with many other financial or technical innovations. In the end many of these have turned out to be incremental changes that fully integrated into the existing financial ecosystem. This is in part due to the specific market structure and regulatory environment of financial services. Experimentation, including at the Central Bank level, has shown that the technology still has room to mature.

Another official expected more fundamental changes coming from DLT. Although it is still an emerging technology, the fact that some Central Banks such as the Bank of England are considering to use it in their high-value payment system for example is an indication that it could be an important part of financial services in the future. Various other experiments have been conducted by the Bank to evaluate how DLT business models could be integrated into their central bank infrastructure.

Besides the maturity of the technology, an industry representative noted that privacy and how it relates to the governance of the network is a major issue for DLT. Decisions have to be made about what takes place on each particular node being hosted by a network participant. The relevant organisation, their internal policies and procedures, and the applicable laws for the firm's jurisdiction all dictate what can take place on the hosted node. That raises many questions that need to be answered. A paper setting out the key components of an effective governance model for DLT networks has recently been released by their organisation. It suggests in particular that there has to be an identifiable governing body in charge of operating the network.

Convergence or interoperability of blockchain codes is a further challenge that does not appear likely to be solved soon, given that there are still very few significant DLT projects actually in production, the industry speaker believed. At some point, if there is significant adoption of DLT by many firms and they are using these different platforms and languages, it could be a major consideration.

Concerning data privacy another official stated that Europe is in a leading position. GDPR was initially considered as a partly unnecessary constraint, now it is being copied by other jurisdictions such as California. The reality is simply that Europe is ahead in this field and many other jurisdictions are expected to follow.

2. Lessons learned from the use of cloud computing services in the financial sector

2.1. Benefits of cloud services

The benefits of using cloud services go beyond savings, an industry representative explained. Cloud allows for the digital transformation of financial services firms with a significant reduction of the investment needed to build IT infrastructure and of the time and money for running it, as well as increased scalability and accelerated go-to-market to satisfy new customers' demands, hence enriching customer experiences and increasing security. Cloud service providers offer standard building blocks that firms can leverage in a standard way for their services in a pay-as-you-go way. There is no longer a need to spend millions of pounds of capex-intensive investment to just test an idea. If the idea works, an organisation can productionise it quickly. Over the last 10 years, it has been observed that over 90% of start-ups no longer build their own on-premise infrastructure, and in the last 7 or 8 years many different financial institutions have also been attracted to that way

of operating. The speaker mentioned a large sovereign wealth fund that recently moved from an outsourced environment and established its own cloud services unit. That helped them to improve their agility through self-provisioning of elastic resources, increased performance and a higher pace of innovation.

An official believed that cloud is becoming a strategic and commercial imperative that company management needs to consider because of the flexibility and agility it offers, the ability to adapt business models in real time and the potential to react to customers' needs as they evolve. This is true in a number of sectors including financial services. Cloud helps to improve significantly time to market, and makes financial services markets much more competitive and healthier. Cloud that uses best-in-class technologies also offers significant resilience benefits for institutions struggling to maintain ageing legacy systems, which can pose challenges for operational resilience. Cloud may also offer effective cyber defences.

An industry representative agreed that resiliency benefits are important when considering how to leverage cloud providers. This is true for financial institutions but also for market infrastructures that are starting to move forward with their cloud strategy.

2.2. Implementation process

An industry representative explained that the approach for implementing cloud services is similar for retail and wholesale financial services. The baseline is security, followed by durability, then availability and then speed of the service. The journey is somewhat different for every financial organisation but there are some common characteristics. Many firms start with non-critical services and just want to test an idea. If that idea works, they then productionise it in a very secure and available way.

This is a major change from the traditional way of delivering projects based on a waterfall delivery model. Traditional projects often involved hundreds of people in siloed technology areas and took months if not years to deliver, going through a process of handing product and work units from one team to another. There is now a shift to small technical teams that have all the skills they need within the team, a practice which is widely known as development and operations (devops). It enables the team to take an idea and programmatically configure everything that is needed to test that idea and to then bring it to market. That does require an operating model change, and thoughtfulness of segregation of duty within the team and how to oversee it.

2.3. Market concentration issues

An industry representative mentioned that in conversations with financial organisations, the question is no longer about whether cloud is necessary but how to implement it. Gartner published a study last year stating that by 2020, 40% of financial institutions around the world will be using cloud.

An official agreed that moving towards the cloud seems inevitable economically, but raised the question of how the high concentration in the cloud service sector should be addressed by the public authorities. One question is whether the legal view of outsourcing tasks and not responsibilities used in traditional outsourcing arrangements remains relevant with such a concentrated cloud sector. Another is whether this concentration can be dealt with only using regulatory tools or if competitive tools should be deployed.

Another official considered that from a financial stability perspective, the fact that the cloud market is extremely concentrated cannot be ignored. The top four providers account for about 65% of the EU market, which speaks to the fundamental economics of cloud provision, which are that it is a scale business. Such market structures however raise financial stability concerns that have to be thought through, and financial services firms and cloud service providers must be worked with collaboratively to consider how to capture the benefits of cloud whilst also protecting the economy and society from the potential risks. In addition, given the very persuasive benefits of cloud technology, a very wide adoption can be anticipated, not just in financial services but in every area of the economy, which may require a cross-sector approach.

Regarding the use of competition tools, central banks such as the Bank of England are not competition authorities. Its first and foremost responsibility is to protect the safety and soundness of the financial institutions supervised and financial stability in the markets. It does have a secondary objective to promote competition in the markets it oversees, but in doing so its tools are less competition than financial supervision tools. These latter tools involve a close monitoring of changes in market structures and their implications for financial stability to avoid markets being locked into certain critical providers. Secondly, supervisors interact with firms using cloud and conduct on-site inspections of cloud service providers, which requires changing both the supervisory mindset and skill set.

The current approach of supervisors is to put the responsibility of cloud arrangements on regulated financial institutions, the official confirmed, as for other outsourced services. This situation is being further investigated by the authorities and specific guidelines have been published by the European Banking Authority (EBA)[1] on the use of cloud and outsourcing arrangements, but no threshold has been defined yet for policy intervention. In June 2019 the Bank of England issued a commitment to update its policy on critical outsourcing arrangements, particularly cloud. It will include clear expectations for financial firms about how they can use the cloud and expectations around risk management, incorporating the EBA guidelines on the use of such arrangements. Ways to promote and participate in international collaborations should also be considered, to make sure that cloud can be used in a resilient and safe way across borders and to avoid fragmentation, given that many financial institutions and cloud service providers are international.

Answering a question about whether cloud providers should be considered as critical infrastructures, an official was not sure that a conclusive answer could be provided at this juncture. Cloud services are only one aspect of critical services that need to be assessed more broadly. Another official considered that there needs to be supervisory metrics to assess the level of concentration and these do exist. The degree of criticality goes together with the benefits that cloud provides and that is being watched closely. However, any policy response should strive to harness those benefits rather than stifling innovation.

3. Regulatory and supervisory approach to DLT and cloud services

3.1. More specifically related to DLT

An official noted that regarding technology the role of financial regulators is notably to avoid the emergence of risks and maintain a level playing field. The impact of innovations should not come to the detriment of

markets and speed-to-market should not be pursued ignoring risks. This may require some specificities in the supervisory or oversight approach.

When assessing new business models, for example those that may emerge with DLT, it appears that some are designed in a way that is fully compatible with the existing regulatory framework and others try to test the boundaries of existing regulation. Addressing this from a regulatory standpoint requires technology neutrality. For example if an arrangement is designed to perform transfers of values it is likely a payment system and should be regulated as such, irrespective of whether it uses DLT or tokens, or some other innovative feature. A more functional approach to regulation should be considered, going beyond the traditional prudential focus on entities. These are already long-established concepts in central bank oversight that looks at particular services, schemes, arrangements and operators.

In terms of rules and standards, the European Commission is assessing whether the existing financial acquis is posing obstacles to the implementation of new technologies in the financial sector, as part of the fintech action plan. Attention is notably given to privacy and data management issues in this context. At the international level a review of the global principles for financial market infrastructures (PFMIs issued by CPMI-IOSCO) has concluded that they are technology neutral, with perhaps the exception of the need to have a central responsible entity within a DLT network. The combined result of work conducted at International and European levels should allow for the provision of a technology neutral and risk sensitive regulatory environment to foster and support innovation based on new technologies.

Interoperability concerns still need addressing, the official considered. Otherwise there will be silos and fragmentation in the implementation of DLT, resulting in frictions and costs, that will then take much time to overcome. There is a particular role to be played jointly by the industry and the regulators in this respect to ensure a sufficient harmonisation of rules and technical standards.

3.2. More specifically related to cloud services

An official explained that there needs to be continual adaptation of how technology applications are supervised in order to ensure operational resilience. Supervisors are already assessing this thoroughly, but they need to address those questions in a more specific way and become quicker at resolving some of the concerns.

Another official agreed that supervision needs to evolve with the increasing use of technology. The starting point in the central bank oversight domain is perhaps easier to adapt to cloud services than for prudential supervisory frameworks, because it already uses the notion of critical service provision in addition to outsourcing. Due to the emergence of a number of new services, a very intensive mapping exercise has been undertaken across the European infrastructure to evaluate the degree of critical service provision in the financial sector. Numerous critical service providers were identified, with different degrees of criticality, showing that Europe is a very complex picture when it comes to infrastructures.

The existing oversight policy framework for critical service providers is being reviewed in the Eurosystem. A first question is the degree of provision of critical services by a single provider that may constitute systemic relevance and what this may imply for the user of the critical services. A second point relates to the way evidence of compliance with regulatory requirements is provided by the users of critical services, given that many infrastructures and institutions rely on the same critical service providers. Each individual institution may provide some evidence, or there could perhaps be a more streamlined and collective process. A third aspect relates to the extent to which an institution or infrastructure relies exclusively on cloud service provisions, and whether there is a need to have alternative, non-cloud based mechanism in the case of emergencies. A last point concerns the implications of cyber-resilience. In the Eurosystem, cyber-resilience oversight expectations have recently been issued, which impose increasingly stringent standards on overseen entities. When the overseen entities rely on third parties, there is a question of how to ensure that there is sufficient compliance with these requirements and how supervisors can be provided with evidence of this.

A regulator believed that supervisory approaches should evolve in a digital environment. More money should perhaps go into supervisory technology that could allow more automated approaches for checks. The cloud and related analytical tools provided by cloud service providers could also potentially be used more by financial supervisors to access the data of licensed entities and carry out checks.

An industry representative concluded that it is crucial that the right balance be found to ensure that risks are mitigated while encouraging innovation and growth. This notably requires taking into account the needs and concerns of market participants.

[1] https://eba.europa.eu/documents/10180/2170125/Recommendations+on+Cloud+Outsourcing+%28EBA-Rec-2017-03%29_EN.pdf

EU electronic payment strategy

1. The digital payments landscape

1.1. The digitalisation of payments offers wide-ranging opportunities

The digitalisation of payments offers wide ranging opportunities to make payments easier and faster, better integrated into daily routines and safer. As the provision of payment services is a network business, some tech players taking advantage of global economies of scale could gain a substantial market share. A number of fintechs have emerged as new competitors but, for the time being, are still dealing with the challenge of reaching critical mass. At the same time, open banking may be a game changer in Europe. People are asking who will win and who will lose, and if it will all end up in a competitive single European market.

A Central Bank official stated that regulators and supervisors need to make sure, in a coordinated fashion, that risks associated with these developments, such as

operational (including cyber) risks, legal risks, financial risks, as well as concentration and systemic risks) are addressed. Adequate governance arrangements and effective oversight must be ensured. The objective should be to safeguard a competitive and innovative European market for secure, efficient and user friendly payment solutions to blossom.

1.2. In the EU single market traditional, sometimes domestic, payment channels cohabit with emerging technologies

Another Central Bank official described this as an intriguing moment and potential game changer, as opposed to the more incremental evolutions seen in the past. A wider range of new business models and technologies offer undisputable benefits. New services are being contemplated for efficiency and user convenience, though some envisaage similar results from enhancing traditional payment channels.

A Central Bank official sees three forces shaping payment markets in Europe: new service providers, new products and new legislation. The tech giants have taken their first steps into European payment markets, bringing new payment applications with them, while the underlying systems have remained more or less the same. Most payment applications still use traditional card payments or credit transfers. However, this central banker disagreed with an earlier panel that emphasised the coming revolution; their feeling was it is more likely to be an evolution. Payment habits are traditional and have been slow to change in Europe.

New payment applications have demonstrated a trend for integrating payments seamlessly into the underlying economic transaction. Taking ridesharing companies as example, there is no need for the user to pay any attention to the payment act. This could be a good thing, but might also lead to overconsumption. The Finnish Payments Council has been worried about the levels of financial literacy and education in this changing landscape and has made some effort to encourage consumers to pay closer attention to the potential dangers of new payment applications.

1.3. Regulators target innovation, undue fragmentation, pan-European reach and trust

A central banker argued that the regulatory approach must remain technology neutral and provide a level playing field for incumbents and newcomers.

One critical aspect that needs to be closely followed is the potential both for fragmentation and concentration. This is not a contradiction. In European payments, one still often witnesses a dominance of national players and no EU-wide provision of services. Any new solutions being developed should adopt a pan European reach from the outset and leverage harmonised standards. Besides the fintechs, the tech giants could also cause disruption by locking users into existing platforms. This would exacerbate the fragmentation just mentioned. The attention of regulators is clearly needed here.

Another central banker described payments as a business of trust. It can take a long time to build up trust, but it can be lost very quickly. Central banks want payments that are secure, reliable and efficient – in that order. An industry representative is concerned that the narrative of recent months appears to position regulation as the assassin of innovation, which is a crude and inaccurate reduction. The industry welcomes regulation: it builds standards, creates clarity, sets rules and establishes trust.

This industry representative related how the Libra announcement precipitated a great deal of debate and put a spotlight on access and financial inclusion. It remains the view of some in the industry that there is no reality to an unregulated global payments rail. Much of the discussion of Libra has focused on the enabling technology, which is unfortunate, because it is really about the use case; the technology has been around for years. Regulation needs to be adaptive to keep pace with the threats and opportunities posed by technology and ensure it ultimately benefits consumers, who are becoming increasingly choosy about the services they use. There is a move away from networks with many consumer connections and towards value-exchange mechanisms – if not Libra, something like it. There is nothing like a seism to galvanise the various stakeholders into action.

An industry representative asked how to ensure that consumers are at the heart of every decision when a new payments concept is being built. It is important to take a step back sometimes and talk to consumers. A significant change is occurring in people's financial behaviours, and it is important for everybody to keep pace with it, whether they are part of a bank or regulated institution. The industry has to move fast, but also needs support from regulators and supervisors to ensure those in the payment business are being controlled fairly. Larger incumbents can only innovate faster if the focus of regulators will be on activities rather than on entities. Banks cannot innovate a product if treated like a core banking product.

Most banks are in favour of making international payments easier. Having an available, instant, trustworthy and safe service is key. For people using payment services every day, there is a need to cater for what is natural. It is not natural for an 18 year-old today to be searching for an IBAN, swift code, account number or bank address. Sending money should be as simple as sending an email. These types of leaps forward are necessary and possible.

1.4 Financial inclusion should also remain a priority

There are compelling reasons to move away from cash and into digital payments, but care should be taken to ensure that the benefits do not outweigh the societal costs of excluding the economically vulnerable. Globally, about 1.7 million adults do not have access to a bank account. While innovation can address the needs of consumers, it should do so regardless of their place on the financial spectrum. The industry must be mindful of this as the pace of innovation increases.

2. How the architecture of payments is evolving in the EU

2.1. Open banking should further level the playing field notably making all the sources of data available

There has been much debate about the benefits of open banking. It is clear to one industry representative, from talking to customers, that other sources besides banking data make a difference. If one applies for a loan, bank transactions and statements form only part of the decision. There are many other crucial sources out there. Consequently, it is important to apply this same lens to non-financial data and focus on making these sources available. Open banking is one piece of the pie; there is much more needed.

Another industry representative is excited about the potential of open banking to change the payment landscape, encourage more competition and spur innovation. It is the most dramatic shakeup of the

industry in years. Some good has happened already, as well as some unintended consequences. Costs have certainly come down, but unevenly. Large merchants have benefited most. Small merchants are seeing some reductions, but these are being offset by scheme fees and annual charges. There are barriers at the point of sale, where the regulations have been implemented unevenly. This creates an un-level playing field, lack of transparency and a bad customer experience. This industry representative therefore does not believe the goal to increase competition has been accomplished. There are no meaningful new players in the region and the small players are struggling to achieve scale.

Open banking regulation ought to be focused on levelling the playing field. This can be a great platform for Europe to be more advanced than any other region of the world but, so far, the pace of change has been slower than expected. To encourage choice and competition and allow market forces to take hold, the system needs stakeholders, merchants and consumers to have better visibility of what they are paying for. A complete surcharging ban would create a good customer experience at the point of sale and drive adoption of payments, so it is critical, in this industry representative's view. Smaller players would be more encouraged to enter the field if they knew they would be able to scale up, while traditional financial institutions would need to sharpen their focus more on the customer experience.

2.2. In the payment applications area fragmentation is increasing

One central banker argued that the payment market is becoming more fragmented, at least in the diversity of applications. Choosing which application to use when hundreds of alternatives exist appears impossible, so there needs to be convergence. Whether that comes from the tech giants, new efforts by the banks or the fintechs remains to be seen.

2.3. The evolutions expected in the EU card market

A central banker reminisced on the critical moment when the first Payment Services and Directive (PSD) and Single Euro Payments Area (SEPA) projects were initiated. The number of transactions supported by these two pan European initiatives is growing fast, even across borders, but the SEPA Card project was not a success. Card payments are still highly fragmented in Europe and national schemes cannot be used in other countries. European citizens can only use their debit cards abroad thanks to co-badging with international schemes.

The service-level offered by international card schemes does not appears poor at all. Cards are accepted everywhere – physically, electronically and globally. The business case for change is not appealing to European communities, given the low number of cross-border transactions.

However, there is more concern for the card payments market in the longer-term. When domestic card schemes are replaced by international variants, competition may gradually reduce, concentrating powers in the hands of a few entities. European intermediaries and institutions would have little control over the development of the market. There are advantages from increasing the cross border acceptance of national schemes or developing a new pan-European scheme.

An industry representative compared trends in consumer card payments to those for digital payments. Some dramatic developments have already been seen and more are likely over the next few years. By 2020, there will be over 20 billion connected devices, and the story about paying at point of sale will no longer be true. Almost everybody now has a smartphone or drives a high tech car able to make payments. There is increased access to cheaper technology and a consumer appetite to make this a market opportunity worthy of development. However, the secret ingredient to ensure the rise of digital payments will still be trust. Consumers need to retain control and will get what they are paying for.

All panel members were asked how long people might continue using plastic cards to make payments. Two central bank officials and one industry representative anticipate plastic only having a few years left, while another central banker thinks the answer depends on the type of payment. One industry representative noted that their card is not plastic anyway. Plastic is just a form factor. Others commented that consumer behaviour should be allowed to decide the answer, and these vary depending on the jurisdiction. More relevant is what lies behind the plastic, which is a powerful, global, secure service able to cross borders.

McKinsey recently carried out a study that predicted the volume of digital payments will rise to €750 billion worldwide. Some 55% of this will be outside the traditional rails, meaning neither the banking nor card sectors. The regulators need to make sure that they are looking at the right landscape, whether at incumbents or disruptors. Some big traditional players are already working with the smaller innovators to provide new capabilities across their existing networks.

2.4. Instant payment volume is still limited

Some commentators are speculating that cards might diminish in relevance given instant payment opportunities. On the other hand, contactless payments themselves seem to have spurred electronic payments.

Given that SEPA instant credit transfer is by design a pan-European payment scheme, the volume of transactions still seems lower than expected, which may be related to banks' need to bear the burden of adapting to the second PSD (PSD2). In any case, the industry can revert to the traditional SEPA instruments. A central bank official highlighted two specific areas on which the industry and regulators can act: first, user friendly solutions should be available at the point of interaction; and, second, a clear legal framework must be established that protects consumers. The possibility of instant credit transfer in the c2c domain calls for improved protection measures to reassure the user. These could come either at the contractual level, in refund arrangements, or through regulatory initiatives. A balance between the two has to be found in this basic framework.

3. The policy priorities for a future payments area

3.1. The success factors for defining an efficient regulatory framework for payments in the EU

An industry representative urges caution with respect to consumer protection. Over the next five years, any legislation in place in Europe should be consolidated and be shown to have demonstrated its effects before being amended. PSD2 is a complex and ambitious project that still needs to be tested. In addition, regulators have to employ principle-based legislation that understands the needs of consumers, the industry and the market, and reacts to them. Finally, the regulators should act to prevent fragmentation, which also means avoiding data localisation.

Another industry representative welcomed the increasing trend towards harmonisation in the Commission's anti money laundering (AML) packages.

The landscape is fragmented and this creates challenges in operating across borders. It is important to address cyber -security risk in the context of consumer protection and fraud. Increased international cooperation is needed within a defined legal framework that permits the exchange of relevant information. This area needs improved focus over time, as it is currently being hamstrung by the prevailing legislation.

A further industry representative explained that, ultimately, costs from the current regulation have come down, but better transparency is also needed so that the entire market can have free choice. This representative also felt that some fragmentation is needed so that smaller players can break through, fostering competition. One- size-fits-all regulation fails to encourage new entrants that might offer customers a better experience at the point of sale.

A central banker argued for regulation to adapt to new situations. It must be activity and not entity-based and, if possible, technology-neutral. There should be competition and cooperation at the same time to find out which payment solutions are socially optimal, available and easily usable. This can be discussed by payment system users, providers and the relevant authorities at other established bodies, such as the Euro Retail Payment Board.

A Central Bank official reported that authorities already cooperate closely on payment services. They can leverage their experiences of regulatory measures in the field, such as the PSD or, to a minor extent, the E-Money Directive, in moving this forward. There is also a case for regulators and central banks to be more innovative in their approaches towards regulation, such as taking a more functional approach. These discussions have outlined how a functional approach may allow existing regulation or oversight to extend to a new arrangement, such as Libra.

With this in mind, The EuroSytem is undertaking a review of its oversight approach towards framework for payment instruments, schemes, and arrangements. In this context the current oversight frameworks such as credit transfers, card payments, direct debits and e-money schemes are being reviewed, taking into consideration new developments. The aim is to develop a more holistic, agile and future-proof oversight framework for payment instruments, schemes, and arrangements.

3.2. Meeting operational and cyber resilience challenges

With the advent of global players, there is also a need for even closer global cooperation across authorities and central banks. They can promote a framework that addresses the risks and challenges being posed to a safe payment ecosystem. The industry is investing massively in cyber and operational resilience, which are even more essential when the payment is untethered from the point of sale.

There can be no compromise on this if payments are to remain simple, secure and speedy. Operational resilience is key. The bad guys are working globally, and companies too have to share their data to anticipate fraud patterns, which tend to repeat across different regions. Regulators were told to think twice before implementing an initiative on data localisation.

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Data challenges associated with AI

An official noted that the panel would be discussing the advance of artificial intelligence (AI) and technological innovation in the financial sector in connection with data and data protection. AI is about empowering machines to make decisions by using large amounts of data. This subject is not theoretical, however. AI already plays a very important role not only in the financial sector but also more generally in society.

1. AI creates both challenges and opportunities in the financial sector

1.1. The use of AI and other technologies offers perspectives and challenges to the financial industry

An industry representative feels this is an extremely interesting topic. SMEs are dealing with many of the realities of AI in the financial industry, but there are two main challenges for the industry. First, there are challenges around customer data. There is a certain amount of modesty about what the financial services industry feels comfortable doing with customer data. AI is often considered as an opportunity for things such as know your customer (KYC) and anti-money laundering (AML), but in the financial industry there is an opportunity to create new products, be more innovative and access more customers. AI does not just have to help prevent fines; AI can assist the development of new products and give access to more customers. Additionally, there is an opportunity to be more transparent with customer data than Google or Facebook. It is time to 'brainstorm' the kinds of products that customers feel comfortable buying after providing their data. There is a potential for revenue here but accessing this revenue would require substantial investment.

Secondly, the industry representative observed that many market participants see poor returns from investing in AI, which is partially caused by a lack of data standards. There is a requirement for better data standards that are not merely legislative but also machine-readable, i.e. they are accessible so that developers can use them to help make better technology. It will become necessary to use much of the detailed data that is currently being used to create AI. This suggests that there is a huge opportunity for the industry to collaborate and to collate data sets which can teach machines to work much more effectively.

Another industry speaker praised the fact that ideas like 'machine learning' and 'AI' are now household terms. This serves to remove the fear around AI. Turning to a concrete example the industry representative described, which is a flight-delay insurance product developed by Swiss Re's, which uses similar methods to Amazon's dynamic pricing.

A third industry representative agreed that technology offers huge opportunities, noting however that Europe is somewhat side-lined. The companies most actively using data in their businesses are the platform companies like Google and Amazon or WeChat, Tencent and Alibaba in China. 70% of the global market capitalisation of these companies is owned by seven out of eight of these companies. Europe owns around 2% of it. Europe has enough ambition, but they are in competition with institutions which are 'ahead of the game'. The

industry representative does not fear competition, but these companies are significantly ahead.

A Central Bank official noted that AI is also of use to supervisors. De Nederlandsche Bank is experimenting with machine learning, because it possesses a substantial amount of data. The Central Bank official feels that regulators could also improve the data being put into AI models. AI has become possible because of the huge amounts of available data, but the quality of this data is extremely important in ensuring reliable outcomes.

1.2. There is a desire for explicability, but this creates several difficulties

An industry representative suggested that the four levers to serving customers well, are transparency, explicability, independence and ethics. Transparency and explicability are positive traits, but it is very difficult to explain how AI is being used. This activity is very complex and algorithm-based. It is impossible to release algorithms on the market to explain what a company does, and the company itself might not fully understand itself what it is doing. Additionally, there are limitations to transparency. Transparency is always good, because companies should explain to their customers how they are using their data, but it is impossible for regulators to rule flatly that everything must be transparent. In particular, it would be inadvisable to be transparent about AML procedures, because criminals will take advantage.

A Central Bank official felt it is important to consider what explicability means. Regulators should not set out exactly what is being sought. Defining the criteria of explicability will be very complicated in certain cases, due to the nature of AI. The Central Bank official noted that only 1% of money laundering is identified and wondered whether Europe would accept an algorithm which increased this number by a factor of 10 but was not entirely explicable. Explicability must also depend on the purpose of the model.

An industry representative agreed on the importance of explicability. Airlines have used 'dynamic pricing' since the 1950s. Passengers pay a different price for the same service, and often the only difference is when a passenger bought his or her ticket. In the insurance space, the methodologies used for pricing and rating insurance products have more or less stuck to generalised linear models. The reason for this is explicability. Insurers seek to explain to both regulators and consumers how factors such as age effect changes to the ultimate rate for a target cohort. Some firms are using approaches involving less explicable methodologies such as deep learning, but these methods only form part of the process. If there is a methodology that is much more accurate for assessing underwriting risk but not explicable, the industry will have to decide whether or not to use it.

1.3. Regulation and practices are fragmented between different industries and across jurisdictions

An industry representative described that in principle, many products in insurance and banking have been data-driven for a long time. However, the technology behind them is not as developed as the technology used in bigtechs like Google and Amazon. The challenge for banking and insurance concerns how to access cutting edge technologies notably because their activity is much more highly regulated than other industries. For example, Amazon engages in 'dynamic pricing' by predicting demand and adapting its prices accordingly. Consumers and regulation in the insurance and banking industries would not be happy to see these practices being used.

A Central Bank official suggested that the purpose of introducing a regulation was to achieve a Europe-wide implementation of these principles. There were good intentions, but this is clearly insufficient. The point of regulation was to ensure a level playing-field, but the rules are not applied identically across member states.

1.4. There is a clear need for more education on the topic of AI and technology across the industry and among regulatory and supervisory authorities

An industry representative highlighted the importance of education. Poor results from investments in AI are often caused by huge misunderstandings about how to use data scientists. AI is often mistaken for machine learning, which is somewhat simpler and more accessible. The industry representative wants Europe to take charge of educating and upskilling its workforce – both in the financial industry and at the regulatory level – with a detailed understanding of technologies such as AI, algorithms and the cloud. This will facilitate the development of a legislative agenda that makes sense for innovation, developers and technology.

Otherwise, firms will continue to implement things in their own way and at some point, the legislation will catch up, which is when fines and legislation happen. Europe must anticipate this and install an efficient system of welfare around its legislation on the implementation of AI and algorithms.

Another industry representative agreed on the need to demystify technology. This is not only a task for regulators; it applies to workforces in companies of all sizes. The industry must demystify machine learning and AI. When there is better understanding, fear will subside and innovation will be enabled. A Central Bank official noted that their number one objective is to increase knowledge about these subjects.

2. Regulatory intelligence: how regulation interacts with the development of new technologies

A Central Bank official is 'tickled' by the expression that AI is a highly regulated area. The technology exists now and it is already shaping the preferences of the public. One of the problems with AI is that it is supposed to exist outside the regulatory remit.

A regulator described how several global multinational tech companies are seeing the consequences of misusing AI. These companies are the 'guinea pigs' in AI regulation: they have huge amounts of data, vast resource centres, large resources in relation to employees and finance, and they are innovators and disruptors. They want to be part of the financial sector not only by creating cryptocurrencies but by developing technology for KYC and ID verification purposes. The regulator summarised the recent regulatory fines imposed on Google, Facebook and Amazon. Google were fined $170 million by the FTC (Federal Trade Commission) for their failure to protect children from an excess of advertising when using YouTube. Similarly, Facebook knowingly kept insecure the details of 50 million customers, and did not declare it for some time. They were also recently fined $5 billion due to a similar issue. Beyond the issue that most companies do not have an annual budget of $5 billion for the payment of fines, there is a wider problem. In rectifying these issues, the industry has lost consumer trust. Finally, Apple was fined for its Siri devices, which use AI processing, having been found collecting confidential and highly sensitive information from their customers. Apple used these data to develop how Siri interacts with customers, but

this data was not anonymised. While Apple have realised their mistake, the regulator feels that they will have 'a hell of a job' to rectify related consequences, beyond the fact that the case will likely become a matter for the European Data Protection Board (EDPB).

2.1. Existing principle-based regulation is an enabler of innovation

A regulator suggested that the EU data protection regulation (GDPR) does not prevent the use of technology or AI; it simply requires firms to think about what they are doing, the purpose for which they are using AI and the outcomes they wish to achieve. Data protection also means that firms must consider the benefits a technology will have for the firm, its regulatory implications and the benefits that will accrue to consumers.

A regulator considered that data-protection legislation enables innovative development by providing a framework for balancing data subjects' rights with innovative developments. When developments occur in a regulatory framework, it is assumed that there are sufficient safeguards for data subjects' rights.

A Central Bank official observed that regarding AI, De Nederlandsche Bank has recently published a discussion paper which defined six important principles, spelling 'SAFEST': Soundness, Accountability, Fairness, Ethics, Skills and Transparency. The Central Bank official suggested that there is no need for further regulation in the field of AI. In addition to existing high-level regulation (GDPR), as in other areas, the ESAs could provide further advice in the form of guidance like the SAFEST principles.

However, an industry representative noted that GDPR is still being interpreted in many different ways across different member states. This creates difficulties. For instance, the privacy authority in the Netherlands considers the use of a TIN or a social-security number as a matter of privacy, and this then cannot be used by a bank. This is one of the only ways to make sure somebody exists. While the month of a person's birth is usable, their day of birth is not. A more Europe-wide approach to explaining these principles would be welcome.

2.2. Regulation cannot offer the industry complete ex ante guidance

A regulator opined that regulators 'would love' to give further guidance to the industry, but they must be informed about problems first. Firms must identify what their risks are. If these issues cannot be solved, supervisory authorities can discuss this with firms in a 'friendly manner' and determine what can be done. Only data controllers can identify the problem. The regulator reminded the panel of the mandatory requirement to have a data-protection officer.

A Central Bank official considered that regulators and supervisors should not provide firms with guidance on ethics. Companies should decide these things themselves. While the early involvement of supervisors can be very positive, there is a tendency for the industry to seek explicit guidance on exactly what is permitted and what is not permitted. This is not the task of a regulator or supervisor, because it is a box-ticking approach.

An industry representative considered that regulation is based on laws that everyone accepts, but it can eventually create dilemmas. Financial institutions struggle with fairness and bias in their application of AI. In consumer lending, some use instant-lending techniques. If a consumer files an application after midnight in a bar there can be a bias against that person, because the system concludes something about the liability connected with that person. Although the system looks at all kinds of other data to make this decision, the decision may ultimately be completely unjustified. In the past, there has been postcode and race-based underwriting in certain jurisdictions, for which there was a technical explanation but which was also completely unfair. It was rightly regulated away and punished. As a bank, there are challenges here.

2.3. The industry view: regulation stifles the development of innovation

An industry representative suggested that much of the legislation that has been introduced has had an impact on the level of innovation being brought into the industry by AI. A Central Bank official felt there is a dilemma around fostering innovation in the financial sector. If regulators prohibit something too quickly, the potential for innovation is destroyed. The pace of change in AI is very fast. It is important not to take a definitive stance, because technologies continue to evolve. Cloud computing is an instructive example here. Five or 10 years ago, supervisors were firmly against cloud computing, but now they are in favour of it because of developments in the technology. The technology is a moving target, which means that supervisors should keep their minds open.

Another industry representative felt that guidance from supervisors is also capable of preventing innovation, considering what has happened to the fintechs and SMEs which have implemented the General Data Protection Regulation (GDPR). Conversely, although many large tech companies have been eventually fined, in practice they have largely benefited from years of managing data and building models with limited regulation.

2.4. Regulators do not understand the technology to a sufficient degree

An industry representative felt there is a need to educate legislators and regulators. They must understand in much more detail how AI is implemented. While algorithms are supposed to be 'explainable', this very quickly becomes extremely complicated. There will be large amounts of documentation that is inexplicable to anyone unless they are skilled enough to understand how algorithms work.

A Central Bank official noted that the people who understand new technologies are the people working in these companies, not regulators or supervisors. The industry should accept responsibility for ongoing issues and work on them. Supervisors have their own perspectives but work in these areas should not begin with regulations and detailed guidelines, especially with regard to issues such as AI.

An industry representative stressed the importance of understanding the detail of these technologies. This is why education is so important in this area. If very high-level regulations are implemented, they will have a serious impact on smaller companies, fintechs and innovators rather than the larger companies.

3. Understanding the impact of GDPR

3.1. GDPR is a solid framework for balancing data subjects' rights and technological innovation

A regulator outlined how one part of GDPR is an AI toolkit, which allows public or private sector entities to carry out a Data-Protection Impact Assessment (DPIA) when they are processing personal data using a huge customer database and big-data processing. The toolkit enables a firm to assess what it seeks to achieve and determine how it is going to manage the problems

which arise from this. If the problems identified are high risk and cannot be mitigated, the firm can consult the supervisory authority in any member state. There can be a problem if a data subject objects to the automatic processing of his or her data. In DPIAs touching on this, it is essential to demonstrate very clearly the evidential requirements being used to justify the use of AI and how it will benefit consumers.

Another regulator noted that the importance of the tools provided by GDPR, became clear to the wider public, notably following the Cambridge Analytica scandal. Indeed, the DPIA is supposed to be conducted at a very early point in the development in order to take account of the rights of data subjects. GDPR provides a good toolkit for managing these challenges. One of the main challenges of AI is ensuring clarity and transparency for data subjects on how data is collected and when and how decisions are taken based on that data. However, while in some cases – such as 'cookie boxes' on the internet – this is relatively clear, this is not always the case. Sometimes it is challenging for a data controller to identify the situation in which personal data is being collected, which means it is also not clear for the data subject.

3.2. The GDPR is not sufficiently detailed

An industry representative cited the Swiss Re's internal digital governance framework, which is used to evaluate everything in the data and analytics space. Such a framework could prove to be too burdensome to use for smaller players, however. However, it is essential to ensure that the regulation of AI is better in Europe than in other jurisdictions and that it does not prevent innovation. The only way to get this balance right is to go into detail. The industry representative considered finally that any further regulation of AI is unnecessary.

Another industry representative noted that GDPR is a Europe-wide regulation, which should represent an opportunity for collaboration and the sharing of data sets in a context where Europe is competing with China and the US in AI. These issues should be at the top of the agenda.

A regulator suggested that a code of conduct could be implemented. If the industry has a problem with AML or any other issue, there could be a rulebook with 'dos' and 'do nots' which could indicate how personal data can be processed in specific situations. Both the European Data Protection Board and member states' national authorities would be open to such discussions. An industry representative felt that a lack of guidance and a lack of detail prevents machine learning from taking place. There is a lack of detailed understanding about aggregated, combined or statistical data.

3.3. Is the GDPR sufficient? There are different views on the need for further regulation or further guidance

An industry representative felt the intentions behind GDPR are very positive. GDPR is a great example of collaboration across different countries to develop a piece of legislation across Europe. However, it is somewhat of a missed opportunity in terms of what it could have been. Hopefully, there will be better and more pragmatic guidance on how to implement it. The industry representative felt that the GDPR is very high level and there is poor guidance on implementation. Another industry representative noted in particular that it is sometimes difficult to understand which data is owned by whom, even when it is anonymised. In principle, GDPR is well regarded in the insurance industry, but there are questions about data lineage and what happens to data in the value chain where data is processed. The industry representative noted that in particular there are cases where it is unclear whether an institution is a data processor or not and hence must take responsibility for customer data. The guidance on GDPR does not take account of the fact that rogue developers in financial institutions could overwrite a log to place blame for a problem on an external company rather than an internal process. GDPR is not bad per se, but it is not sufficiently detailed to avoid having an impact on innovation.

A regulator felt that GDPR established the basic framework for the development and application of AI. Given that GDPR itself is comprehensive and creates a multi-layered legal framework, it is important to assess carefully whether there is any need for additional legislation.

An official considered that financial regulation in Europe is better equipped to manage innovation than GDPR. This is not due to the substance of GDPR but the way it is structured, because it becomes excessively detailed. The official pleaded against any further regulation. Another official observed that this is an area where the regulators consider further regulation is necessary, while the industry seeks further detail. Each side should consider the other's views.

DEVELOPING EU CAPITAL MARKETS

CMU way forward: IMF proposal for a new action plan

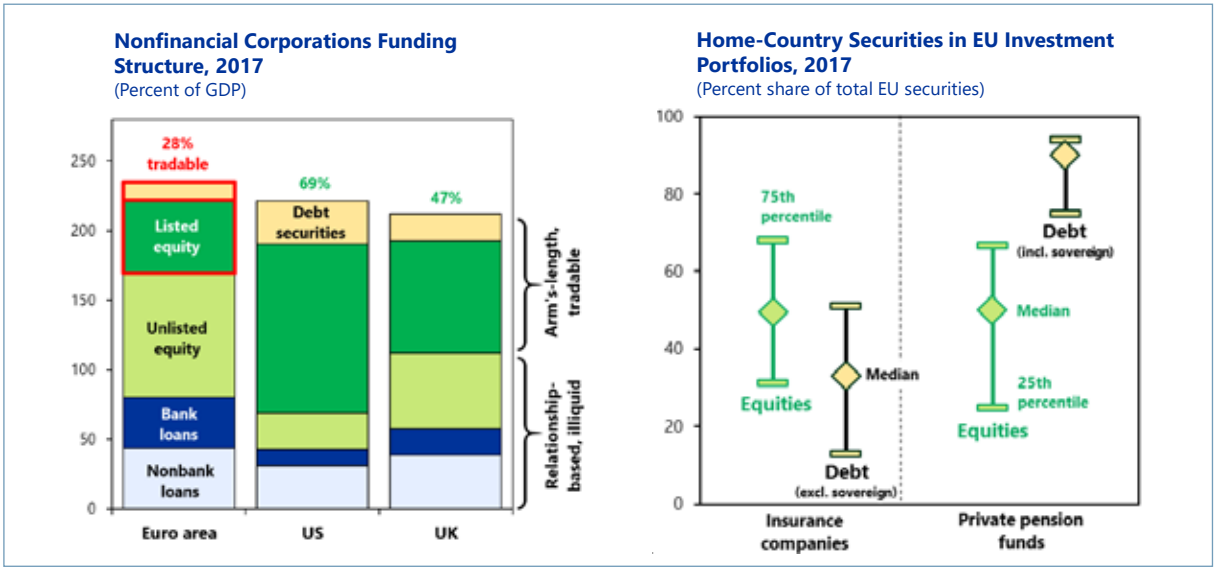
The Chair introduced the objective of the session which was to discuss the staff discussion note recently published by the IMF on the CMU: *A Capital Market Union for Europe*[1]. This paper focuses on recommendations to move the CMU forward, now that a large part of the Commission's CMU Action Plan has been adopted. The IMF has been involved in the work on CMU in Europe for a while, including on topics such as high-quality securitisation.

An IMF representative presented the key findings and recommendations of the paper.

Assessment of EU capital markets

The first piece of analysis relates to the level of development of capital markets with a snapshot of how non-financial corporations fund themselves in the euro-area compared to the US and the UK. Arm's-length tradable financing – bonds and listed equity – was separated out from relationship-based financing – unlisted equity and loans. This shows that the euro-area's share of traded finance - at 28% - is much smaller than in the US or in the UK. Although relationship-based financing has its advocates who speak of its stability benefits, arm's-length financing is characterised by its efficiencies. Given this starting point in Europe, there is plenty of room for Europe to develop its tradable financing. In terms of EU market integration, insurance companies and private pension funds in Europe are heavily concentrated in their home-country securities, on both the equity and debt side.

Low reliance on traded instruments; Pervasive home bias



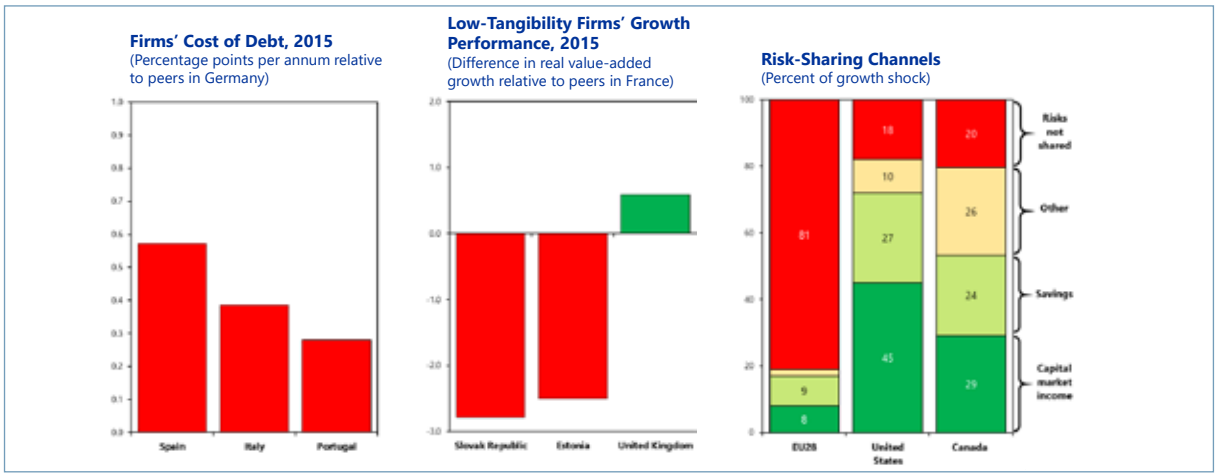
The second area of assessment of the paper relates to the costs of European fragmentation. In order to assess these costs, firm-specific data was analysed to weed out factors such as firm size and profitability and to try to distil the effect of where a firm is incorporated. The results show that fragmentation makes a material difference. A typical non-financial corporate in Spain for example will pay 60 basis points more on debt funding than its peer in Germany and in Italy 40 basis points more, which is quite significant in an era of zero interest rates.

The growth performance of low-tangibility firms in different Member States relative to their peers in France was also considered. These can be thought of as typical IT start-ups. The basic notion is that a firm of this type in a jurisdiction where capital markets are less developed will have a harder time reaching out to venture capital (VC), so will go to banks. This means that it may be rationed out of funding because these firms, by their nature, do not have much by way of plant and machinery to post as collateral. This risk – in certain European countries – of holding back innovation is a second cost of capital-market fragmentation.

Thirdly, risk-sharing channels were also assessed, comparing the EU with the US and Canada. The idea behind private cross-border risk-sharing applied to equity markets is the following: if a firm based in Country X has equity owned by investors in Country Y, when Country X is hit by a local shock and the share price falls, the valuation hit is taken in Country Y. This will contribute to reducing the impact of local shocks on Country X's consumption. Data shows that the macroeconomic smoothing of a local shock is four-times lower in the EU than in the US, meaning less resilience to shocks.

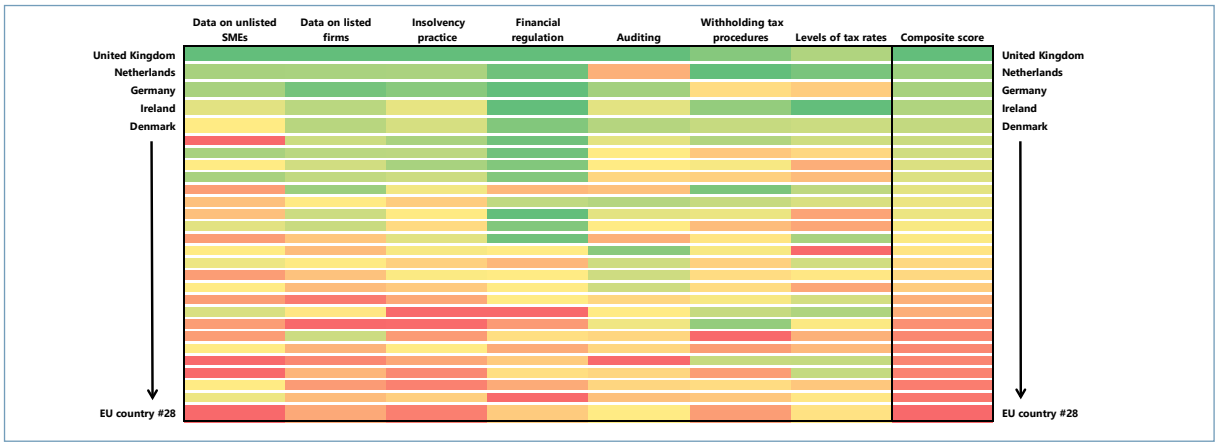
The evidence therefore shows that capital-market fragmentation has different impacts on funding costs, growth potential and resilience.

Uneven corporate funding costs, restraints on innovation, limited risk sharing



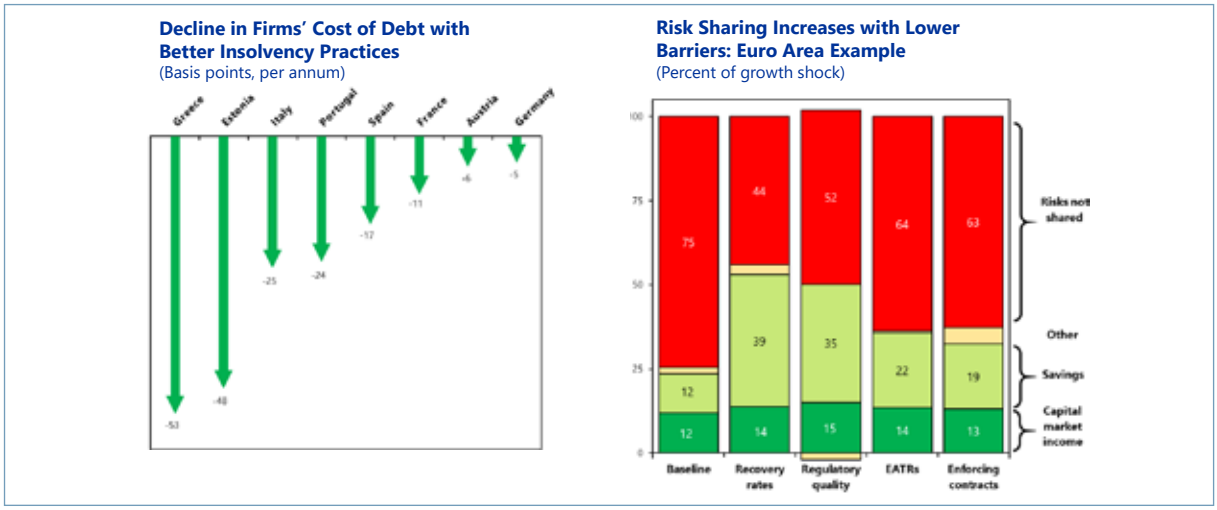
The next stage of the analysis was based on a survey of the potential areas of concern regarding capital markets in each Member State. Respondents to the survey included European and national capital market regulators and also some of the largest institutional investors in Europe. Although the survey results revealed significant differences across countries, common areas of concern appeared relating to data availability on both listed and unlisted firms, insolvency practices and capital market regulation. The UK is generally viewed as the best performing capital market jurisdiction in Europe by survey respondents.

Survey responses flag data gaps, insolvency, regulation



The results of this survey were then corroborated with empirical work. To assess the funding cost savings that firms could gain if their countries were able to improve their insolvency regimes to best-in-class standards, the quality of a country's insolvency regime was proxied by the recovery rate of a secured creditor using so-called third-party time-series data. This analysis showed that if Italy for example could improve its insolvency regime to be closer to the UK's standard, its firms would save around 25 basis points on funding, which is a significant amount. The analysis also showed that risk-sharing channels in the euro-area can improve with better recovery rates and better regulatory quality in particular.

Better insolvency regimes and regulatory oversight can lower firms' cost of debt and increase macroeconomic smoothing



Recommendations for moving the CMU forward

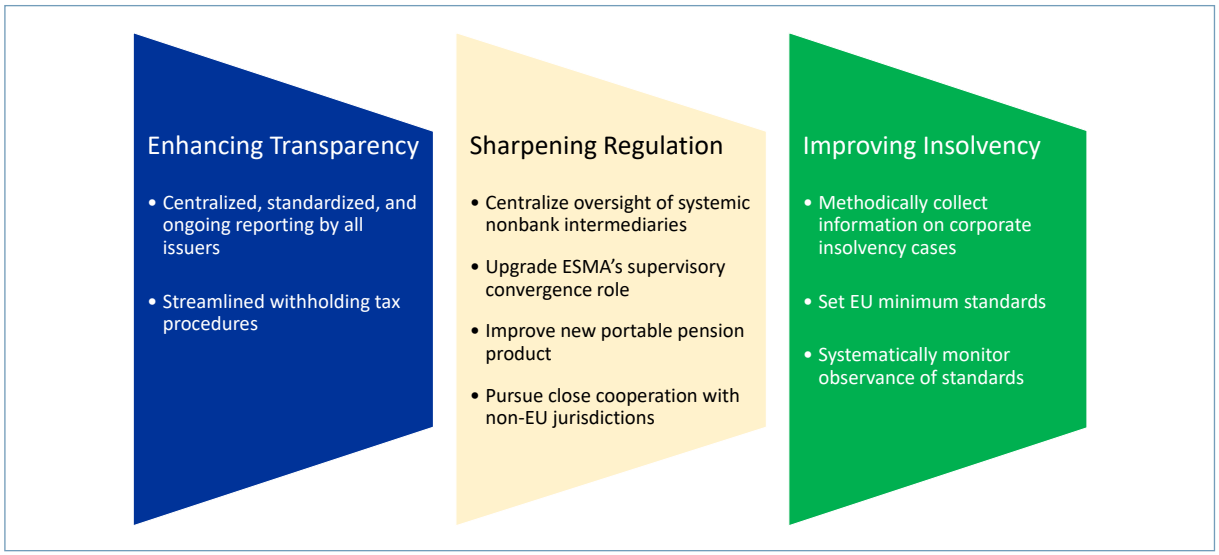
Based on this evidence, recommendations were put forward in three main areas: transparency, regulation and insolvency. Although the assessment shows that the EU's CMU Action Plan is generally well thought-out and covers most, if not all, of the basic elements necessary to develop capital markets further, there is a need to 'reboot the project' in order to achieve significant progress.

The foremost recommendation is possibly on transparency because arm's-length tradeable finance hinges on publicly available information. The first proposal in this area is for the EU to introduce standardised, centralised electronic reporting for all issuers on an ongoing basis. This would be a major change to the current reporting framework in Europe and would replicate what already exists in the US and Canada. In the US for example, anyone can access the Securities and Exchange Commission's Electronic Data Gathering, Analysis and Retrieval (EDGAR) database via its website and retrieve, for free, prospectuses and the 10-K and 10-Q annual and quarterly financial statements, standardised for all issuers, irrespective of size. Yet this cannot be replicated in Europe by decree; it is a multi-stage process, ultimately involving work on accounting standards. Digital technology could also be harnessed to improve transparency in cross-border withholding-tax procedures.

Secondly, a more tailored approach is required on regulation. Empirical work indeed shows that improvements in individual jurisdictions tend to attract more capital. The full energies of hands-on, day-to-day prudential supervision must be focussed on a few systemic entities; namely, large investment firms and central clearing counterparties (CCPs). On investment firms, this is in train; for euro-area CCPs, a direct role is needed for the European Securities and Markets Authority (ESMA), jointly with the European Central Bank (ECB), going beyond what has been adopted so far. The paper also supports stronger supervisory-convergence powers for ESMA to ensure uniform investor protection across the EU.

Finally, insolvency is a difficult area that cuts to the heart of national sovereignty, but an essential one. A soft and pragmatic approach is proposed, based on best-practice standards and a monitoring of how countries progress toward observing them. This sort of 'name and shame' approach has been effective in other areas such as the Basel Core Principles for Effective Banking Supervision.

Three obstacles, three policy priorities



Comments and reactions

The Chair then asked the other members of the panel to react to these conclusions and proposals.

An official agreed that it is necessary to think about how to move the CMU forward now that the initial CMU action plan is essentially completed. This reflection started at the Eurofi meeting and at a special session of the ECOFIN in Bucharest in April 2019 and will be a key priority of the forthcoming Commission. All the "non-revolutionary" proposals to develop capital markets have been included in the existing CMU action plan. This is a good starting point, but the more far-reaching areas of transparency, insolvency and market infrastructure must now be further reviewed. The CMU action plan must also take more account of the current dominance of banks in Europe, which is different from the US. Capital markets in the US represent three-quarters of a total amount of financing of € 62 trillion compared to one-third in Europe of a total of € 51 trillion[2]. This shows that there is a high potential for improvement.

The official however considered that one may have expected the IMF, given its relative freedom on the subject, to go further and make proposals also in more controversial areas like the area of supervision at the EU level, which is obviously a crucial issue. In Paragraph 86 the note states that it 'does not call for a Single Supervisory Mechanism (SSM) for the capital market' because, 'it is considered neither desirable nor practicable, given the diversity of the capital markets and the core role of national law enforcement'. This justification does not seem relevant because the EU is precisely about changing national law.

The second point that one may have expected to see more strongly emphasized relates to the comparison with the US in terms of exposure. One of the strengths of the US is that exposure to the dollar and to the US is easy to obtain, via a bond or another instrument. Exposure to Europe is less easy, for many different reasons. A third point is about the strong position that Europe has in sustainable finance. How sustainable

finance could contribute to a rebooting of the CMU should be further assessed.

Another official broadly agreed with the conclusions and recommendations of the IMF report that strike a good balance between ambition and prudence.

The critical point tackled by the IMF paper is the question of what else needs to be done to move the CMU forward. The official agreed with the proposal on transparency and information dissemination, which is particularly relevant for equity markets. Insolvency procedures are also of crucial importance and it is worth going for "the long haul" that is probably required in this area. It is a difficult area where a step-by-step approach is needed. This approach should focus on areas where agreement is possible and use research and indicators of the differential performance of Europe on insolvency procedures as a basis. The emphasis on harmonising the ranking of claims on the liabilities side is right, to which should be added improving reorganisation proceedings, creditor participation, SME procedures and early warnings. Some countries have made progress with SME procedures and are examples that more progress can be achieved. The possibility of a 28th insolvency regime is not mentioned in the IMF paper, but would be an interesting option to further assess also.

Seriously developing equity markets in Europe would normally require a holistic approach, cutting across different areas including funding science, financial education and ensuring competitive product markets. One specific and important improvement in this regard that is not captured in the paper and needs to be further emphasized, the official suggested, is the role of financial literacy, for example because demographic developments make individual pension savings increasingly relevant. Evidence shows that there is quite a diverse level of financial literacy across euro-area countries and if literacy was increased to the level of the best performing countries this would be conducive to a higher level of equity holdings. A particularly effective way of of improving financial literacy is through the secondary schooling system. The G20 together with the OECD had a priority on financial education under the German presidency, which needs pursuing. Many countries have some form of strategy towards improving their level of financial literacy and this needs revisiting to identify where further progress is most needed in Europe.

In addition there is one conclusion of the paper on which the official had some doubts, which is the recommendation to consider re-bundling research costs and execution fees under MiFID II. Before doing so, the official would like to see evidence that this will not discourage investment and that the access to finance of SMEs would improve as a result of re-bundling.

Reacting to the previous speakers' remarks and suggestions, the IMF representative responded that the project had focused on picking those proposals that appeared to be the most actionable, and on avoiding roadblocks that may be very challenging to tackle. Not pushing for an SSM was deliberate also because the supervision of major banks is very different from that of market activities and the diverse entities that operate in the capital markets, which range from pension funds to mutual funds and CCPs, and where there is often a heavy focus on ex post enforcement through the justice system.

Regarding MiFID II, the IMF paper is not suggesting a re-bundling of research and trade execution service fees, the speaker clarified, but simply that a study should be conducted in order to decide objectively what should be the next course of action. There are many market anecdotes on the implications of unbundling for SME markets in particular, so it is essential to objectively assess these potential impacts. Financial literacy is an important issue also, the IMF official agreed, but other actions also need considering, such as the further development of private pension schemes.

[1] IMF staff discussion note «A Capital Market Union for Europe» - September 2019. Authors: Ashok Vir Bhatia, Srobona Mitra, Anke Weber et al. This working paper has been seen by the IMF Board, but is not an IMF board-endorsed policy.

[2] See Figure 4 page 6 of the IMF paper.

Refocusing CMU: key policy priorities

1. Progress made and challenges faced by the CMU initiative

1.1. Limited progress made in the effective development of EU capital markets

A policymaker indicated that the Capital Markets Union (CMU) action plan launched in 2015 is now nearing full implementation.

An industry representative was frustrated by the limited tangible progress made with the CMU in the growth of EU capital markets despite all the efforts of the Commission. Eight years ago 70% of the total funding in Europe came through banks and 30% through capital markets, and vice-versa in the US. The percentages are still the same. Another industry representative emphasized the gap that exists between the ambitions and the delivery of the CMU despite all the efforts made to implement it. This is because of the continued fragmentation of the EU capital market. The focus has mainly been on technicalities thus the overall perspective of the project, which was to put in place what is needed to unite EU capital markets, was lost.

A regulator was less pessimistic about what has been achieved. In some areas there has been much progress, even though some key others remain to be tackled. The asset management sector for example has been developing very strongly, growing into a truly European asset management sector. The same goes for trading and corporate debt issuance. There has also been very strong progress in some parts of the post-trading area, which has developed into a European or even a global market.

1.2. Challenges faced by the CMU initiative

A first challenge put forward relates to the scope and ambition of the CMU initiative.

An industry representative stated that the ambition of the CMU is probably too high and the initiative attempts to embrace too much. Another industry speaker believed that a difficulty with the current action plan is that no single measure is likely to have a major impact on the development of EU capital markets. They all have marginal contributions, so it is difficult to identify key priorities. Some issues are difficult to tackle also because they touch on core areas of member state law. A policymaker noted

that what has been discovered in implementing the CMU plan is that the components of the capital markets are all interlinked. For example, fostering IPOs for SMEs also requires developing the secondary market, which in turn touches on a number of other aspects. Although there may be an issue of insufficient focus in the CMU, the challenge is that everything is connected.

The insufficient level of political commitment to the CMU initiative and to the development of capital markets is a second issue.

A regulator stated that the numerous Council meetings on CMU have demonstrated that although there is generally support for the objective of developing capital markets in Europe, there is no appetite at the political level for a rapid union of all national capital markets. So achieving a fully-fledged CMU seems a very challenging objective at this stage, but progress is still possible. An official believed that while much progress has been made over the last 10 years in the regulation of markets at the European level, many member states have failed to develop their capital markets and to change longstanding funding patterns on their national level. Germany for example was talking about increasing equity culture long before CMU but progress has been limited. Further harmonizing approaches at the European level is challenging but the real difficulty is to create domestic capital markets in the first place, which requires more than legislation. A culture change is needed, and action is needed both at the European and member state level on this. A regulator agreed that developing capital market activity at the member state level is necessary and cannot be achieved only with the implementation of a harmonized framework.

2. Opportunities and obstacles regarding the development of EU capital markets

2.1. Opportunities

An industry representative noted that there is a high level of savings in Europe but a great deal goes into bank deposits - over 30% of the total asset base – which have no yield and are even loss-making when taking inflation into account. Societies across Europe are ageing, which means there is a pensions gap that is widening; these savings are not producing any interest and it will take longer for savers to get to the same outcome. On average, participation in financial markets remains very low across Europe, which is both a challenge and an opportunity. For instance, the largest economy, Germany, has a 13% participation rate. Nominal wages have been growing at below historic pace in the last 10 years since the financial crisis, at less than 1.5%. A growth of wealth is needed in this context and the best way to do that is by investing in equities and bonds. These are volatile investments, however, in 2019, equity indices in Europe were up by +15% and broad bond indices by +9%.

Another industry representative highlighted some positive developments in different parts of the EU market that may be built upon. A first example is what has been achieved in the Nordic market, where capital markets work very effectively for small businesses. In the perspective of Brexit, some major financial institutions headquartered within and outside Europe have also been restructuring their activities and investing a great deal of resources in the EU.

2.2. Obstacles

Monetary policy: An industry representative believed that the 'elephant in the room' concerning CMU is monetary policy, which will have a major impact on the way capital markets work. If interests go up this may create solvency and liquidity problems and if they remain very low investors might favour risk-free savings that offer a return that is only slightly lower (so long as retail rates are not negative) and there is also the risk that some insurance companies or investment managers might default, potentially impacting pensioners. In addition negative rates and possible interest rate increases are something new for most market participants who have not been trained to react to such a situation. A regulator however believed that the very low or negative interest rate environment may favour a certain development of equity markets that represent the only option for increasing savings for e.g. retirement.

EU competition policy: An industry speaker moreover suggested that EU competition policy is another major obstacle to the CMU. If it remains the same, operators and financial institutions in Europe will not get stronger and the progress made in the development and integration of EU capital markets may profit mainly larger foreign financial institutions, resulting in the CMU 'garden' being 'gardened by others' in the end. On the other hand there is no reason why Europe should be a financing taker rather than a financing maker, so this issue needs to be addressed. A regulator agreed that the Commission also needs to encourage the building up of large and competitive European financial institutions in investment banking, asset management and post-trading; for instance there are currently 32 CSDs in Europe. In addition, European institutions currently do not sufficiently consider the EU as a domestic market; this needs to be encouraged.

Insufficient literacy and experience of capital markets: The insufficient engagement of retail investors and SME issuers in capital markets was stressed by several panellists. A regulator explained that many European households still tend to save through deposits despite the low yields offered. It is important for households to increase their participation in capital markets, because people need to make a reasonable return on their savings in order to be able to finance the higher costs of education, pensions and housing. The inefficiency of the current distribution system of financial products across the EU is another important factor, the regulator believed, because about one-third of gross returns are lost in distribution costs.

Bank-based financing system: A regulator explained that the current bank-based structure of funding in the EU is an obstacle because it is automatically more focused on debt and less on risk-bearing capacity. Another regulator observed that there is also a diminishing willingness of companies to go public, resulting in a low level of IPOs, which is nevertheless not only a European issue.

Impacts of existing financial regulations: Several speakers considered that some existing EU financial regulations may hold back the further growth of capital markets.

Building capital market ecosystems is a very difficult task and inevitably involves favouring a degree of risk taking, an industry speaker explained, which goes against most of the efforts made over the last few years to put in place regulations aiming to decrease risk.

Another industry representative noted several areas where the EU regulation has been structured in a 'counterproductive' way. The PEPP (Pan-European personal pension product) is a first example. This is a positive initiative that has adequate components like a default fund investment option, but when it is examined in detail, several issues appear. For example, there is a 1% fee cap, which might make sense from a consumer protection perspective, but it also risks limiting the number of providers interested in these products and

stifling competition. In addition, there are calls for a capital guarantee, but it is known that having a complete guarantee on the capital invested is the most expensive way to invest and is not needed in a long-term perspective. There are many smarter ways of providing savers with an appropriate level of protection, such as the target-date concept initiated in the US, whereby a fund changes its asset allocation over time in order to reach a very low-risk profile by the time of retirement. The Packaged Retail and Insurance-based Investment Products (PRIIPs) regulation is another matter for concern, the speaker felt. Although efforts to improve product information are commendable, the PRIIPs disclosure methodologies around expected performance and transaction costs in particular are unhelpful for investors and represent an additional burden for asset managers. Individual investors end up with too much information and no advice.

A third industry representative emphasized the possible negative consequences of Solvency II for the CMU. Solvency II might avoid the default of some smaller insurance companies or pension funds by beefing up their reserves but also prevents most of them from investing in equities, which may have more serious repercussions on the economy and savers than a possible default, particularly in an environment of negative interest rates. An objective evaluation of the impacts of MiFID II on EU capital markets is also needed, the speaker believed. The ambition of MiFID II was right, but several rules have adverse consequences. For example, the intention was to promote SME financing, but the price unbunding rules have in effect led to a suppression of research for most SMEs and to an elimination of SME brokers. In order to reactivate the CMU, the first priority is therefore to review EU legislations such as MiFID II, PRIIPs and Solvency II and identify the rules that may discourage investors and particularly retail ones from investing in equity.

A regulator agreed that parts of MiFID II and PRIIPs have not been helpful and have hindered access to certain financial products, notably bonds, thus requiring a review.

3. Way forward for the CMU

3.1. Building political momentum with a renewed objective and narrative

A regulator suggested that increasing the political momentum around the CMU is essential for relaunching the initiative. While the Banking Union could be mostly achieved through European legislation, this is not the case for the CMU because changes are also needed at member state level in terms of regulation and market structure. In order to increase political backing for the CMU, it is important to link its objectives to areas that voters care about such as the creation of jobs and the financing of the economy. The sustainable finance agenda is another element likely to help build more political momentum, because the low-carbon transition cannot be wholly financed through public means. In addition, this is an area where the EU has the opportunity to build a European approach from scratch. This is also true to a certain extent for digitalisation and new technologies, however in this latter case, existing regulations need to be reviewed in order to identify potential obstacles, the regulator stated; under current regulations security tokens cannot be developed for example. An industry speaker added that sustainable investment is an area where Europe has gained considerable expertise and leadership and where it can develop a differentiating approach to investment. Another industry representative agreed with the importance of increasing the political commitment in favour of the CMU but felt this would not be sufficient because many member states have lost confidence in high level European projects such as the CMU. Such projects need to be made more understandable, accessible and something that people can relate to.

An official emphasized that an analytical assessment at the European level is necessary to identify the measures and priorities that are likely to have the strongest impact on the development of the capital market ecosystem. Germany, France and the Netherlands have asked a group of experts to provide their input on this by the end of September. These recommendations should be a basis on which an appropriate narrative can be developed and further political commitment obtained.

An industry representative added that the CMU means different things to different people, therefore a rephrasing of the CMU objective is needed. Capital markets do not happen overnight and a hard deadline for delivering the CMU cannot be fixed. There needs to be a discussion about how to build efficient markets to deliver capital to those who need it across Europe and how to further integrate them, which are the main objectives of CMU. CMU should not be a fortress-Europe market either, because it also needs to give investors and savers in Europe opportunities outside Europe, and vice-versa.

A change of name was also suggested by some speakers. A regulator noted that the term CMU has become quite unpopular. One of the problems with the term is that it establishes a comparison with the Banking Union when the two projects are fundamentally different. The Banking Union is about implementing a consistent supervision of the largest banking institutions in the Eurozone, whereas the key objective of CMU is to increase the role of capital markets in the European financial system. Supervision can support that process, but that in itself will not drive the development of capital markets.

3.2. Increasing the focus on retail and SME markets

For a regulator, the key element to address is increasing the participation of households in capital markets so that they can get better returns on their savings. Pensions could be an appropriate vehicle to foster more retail investment, particularly in countries where there is resistance by households to participate directly in the capital markets.

An industry representative believed that Europe needs to get SME issuers and retail investors more involved in the capital markets. This is true both in quite developed EU capital markets and in the underdeveloped ones. Much needs to be done in terms of financial education and research to achieve this, but that should be feasible.

Another industry representative stated that the single biggest objective to achieve in Europe with capital markets is putting the individual saver and investor at the centre of efforts; this is a huge need at the European level. The limited level of retail investment has much to do with financial education and there is a huge opportunity around a public-private partnership to educate the broader public on the importance of investing in the capital markets. The opportunities offered by sustainable investing, on which Europe is at the forefront with considerable experience could also be used from an educational perspective to foster more retail investment, the speaker believed.

3.3. Improving insolvency rules and withholding tax procedures at the EU level

Several panellists believed that reviewing insolvency regimes should be a major priority of the CMU going forward.

An industry representative felt that the insolvency regime and investors' confidence in it, both retail and

institutional has been a critical factor for the positive evolution of the US and UK capital markets. Making some progress on this is very likely to help attract new pools of capital into Europe. Another industry representative considered that the further harmonisation of insolvency rules at an EU level should be reflected upon, even if this is almost as ambitious as implementing a single currency. If Europe can harmonise basic rules for debtors and creditors this could unlock many issues and in particular have a significant impact on fixed income markets and clearing activities. Moving forward on this topic may be possible with the new Commission that is intending to favour more collegial work, however progress will be difficult without senior political leadership. A third industry speaker also cautioned that bankruptcy laws have many different aspects to them with many different entities involved. Converging towards pan-European standards may be too ambitious.

An official noted that although clear insolvency laws exist in Europe, a court settlement still takes up to five years in some member states. Financial laws are not sufficient to achieve appropriate results, so insolvency regimes need to be examined. Thought is also needed about tax elements. That does not necessarily mean harmonising all tax regimes, but streamlining cross-border withholding tax regimes and procedures in particular. An industry representative considered that tax and notably procedures regarding withholding taxes will be a major issue to tackle with a focus on long-term investment and cross-border investment. This is necessary to achieve a sufficient degree of harmonisation and interoperability for the capital markets infrastructure, which is a precondition for the CMU.

3.4. Reviewing existing capital market regulations and improving supervisory convergence

A regulator thought that many improvements could be made to existing financial regulations. The upcoming reviews of many key regulations, such as MiFID II, PRIIPs, and the Alternative Investment Fund Managers Directive (AIFMD) will be an opportunity to do this. Another regulator mentioned that a recent report published by AFME shows that Member states that have the biggest household participation in capital markets are those that have the strongest regulation and supervision around transparency and inducements. It is therefore important that the re-examination of these pieces of regulation is not seen as a way to reduce the current level of regulation or supervision.

A regulator stressed that following the work initiated during the previous legislature, supervisory convergence also needs to be improved in order to achieve a single supervisory approach at the EU level. This is an on-going work conducted by the European supervisory authorities (ESAs) around which there is a real momentum. Another regulator advocated new powers for ESMA. For example the supervision of CCPs could be more effectively conducted at the EU level than the present situation where there are more supervisors than CCPs in the EU27, which does not make sense.

4. Conclusion

During the discussion it appeared that there is a significant gap between the rhetoric around CMU and the action on the ground. It may be partly that politicians respond to what their voters want, and their voters do not know what is being done there and do not see what is relevant for them. The analytical focus referred to should allow the identification of priorities, the development of an appropriate narrative and the enforcement of that narrative. There are two elements of this narrative; the first is that it is good for the economy, good for growth and good for welfare, so people should want it. The second is a narrower euro-area narrative. There is much talk about the sustainability of the euro area; risk sharing is needed to make the euro area and EMU sustainable. There is a treaty prohibition on public sector risk sharing, therefore if it is to be sustainable private risk sharing is needed. Ministers must understand that they cannot simultaneously worry about the sustainability of the monetary union and not be ambitious in developing private risk-sharing channels, both through the banking union and CMU. This narrative has to be built on a proper analytical basis.

Work is needed on supervisory convergence, sustainable finance and digitalisation and also on the review of regulations to eliminate unintended effects. The regulations concerned include insolvency regimes, securitisation, tax elements including withholding tax, possible antitrust rules, SME retail access and financial education. The Commission also has to decide which priorities are the most important among these. Regarding the name and the objective of the CMU, it could be easier to stay with the idea of creating a single market for capital in the EU, which is what CMU always was and still is.

Developing equity financing for SMEs

1. Opportunities and challenges associated with the development of SME equity markets

Several speakers stressed the importance of developing equity markets in Europe, and SME markets in particular, for ensuring economic growth with a diversification of the funding of these businesses, providing more attractive saving opportunities for citizens and enhancing financial stability. Equity markets may also favour a better alignment of interests between companies and savers.

The possible challenges facing EU SME equity markets were also described. **On the investor side, MiFID II and the risks associated with SME equity were the two main obstacles mentioned.**

An industry representative stressed that the MiFID II requirements mandating the unbundling of research and trading costs have led to a reduction across Europe in both the quality and quantity of SME research, undermining investment in SMEs and the liquidity of SME stocks, as many small and medium brokers are closing their doors. Figures in Spain show that there has been a 30% reduction of the amount of research on SMEs and 25% of the number of analysts specialized in this segment, with similar trends throughout the EU. There is a growing number of 'orphan stocks', which are companies that lack any research. Ultimately, these MiFID II requirements go against the objectives of the Capital Markets Union (CMU), particularly concerning SMEs, the speaker felt. An investor representative explained that retail investors hear about companies through word-of-mouth or read about them in newspapers so there is often an emotional connection

at the start. Research helps them to decide more rationally which companies to invest in and for how long.

Risk averseness of retail investors and the actual level of risk of SME stocks are a second barrier to the development of retail investment in SMEs. An industry representative noted that in most parts of the EU, a large part of savings is currently invested into bank deposits with limited or no remuneration. There is a demand for alternative investments with a guarantee in capital but these products, especially in the current interest rate situation, are not efficient. This is both an opportunity and also a barrier to investment in more risky instruments. An investor representative emphasized the importance of considering the risk aspects associated with SMEs for retail investors who only invest a limited number of times in stocks. On average only a small proportion of SMEs succeed, maybe one in four or five. While professional investors may tolerate a probable chance of losing their money on a failed SME, it is difficult to ask households to do the same. This risk can be reduced with diversified portfolios or by investing in SMEs that have listed debt before equity, for example, but it cannot be overlooked.

Several barriers to SME equity issuance were also mentioned.

The current low interest rate policy is a first obstacle to the development of public SME markets. An industry representative explained that low interest rates have increased the liquidity available for private equity funds which are buying a great deal of successful SMEs. As a result, the balance between takeovers and initial public offerings (IPOs) is tilted towards takeovers such that there are fewer companies going public and less investable money in the public equity markets. Another industry representative added that in many cases the external funding of SMEs is ensured through bank loans, which are widely available and cheap at present with the liquidity available in the banking system. Companies are therefore less likely to go public. However this could lead to a funding 'squeeze' in the future if conditions change.

Transparency requirements for going public are a second obstacle. An industry representative stated that many SME owners are reluctant to publish the financial information that is required of them when entering the public markets and they are more inclined to share this more privately with banks.

The limited financial literacy of many SME owners is a third issue. An industry representative called for more education on the importance of diversification in funding with both debt and equity, in order for companies to better withstand any issues that may arise, such as those that occurred during the financial crisis.

Finally, the unintended consequences of certain capital market regulations were also emphasized. A regulator criticised the Commission for extending the market abuse directive to not only address insider trading and market manipulation but also price sensitive information, reporting obligations and managing transaction registers. This extension was made for all issuers on MTFs, the result being that similar obligations apply to SMEs and to large caps. There is some proportionality such as simplified registers for market abuse but it does not work. Effective proportionality should be introduced on the occasion of the review of the regulation. The new prospectus regulation is also problematic, the regulator considered. It may not work on a cross-border basis for equities because of the inefficiencies created by the need for an additional approval of the prospectus by the national host regulator, when an issuer wants to list in another EU country. Putting in place a centralised approval system in the EU was proposed during the review process but was not adopted. An alternative could be to test a 27th or 28th regime for prospectuses.

Brexit is a further issue, an official stressed, that is impacting the European capital markets with potential liquidity loss and fragmentation, but opportunities may also arise in the longer term with the possibility for the EU27 to grow its capital markets.

2. Ongoing policy actions for developing SME markets

2.1. On-going CMU action plan

A policymaker stressed that developing SME capital markets is part of the objectives of the Capital Markets Union (CMU) but that there is a need to prioritise the development of these markets at the national level over the cross-border one. This is a long-term objective because many issues relating to culture, market structure and investor attitude need to be addressed. The Commission has put forward a number of legislative initiatives designed to help SMEs in the initial 'pre-IPO phase' during which they are more risky; after the IPO stage, enterprises usually move towards making more profits. Considering the diminishing number of IPOs over the last few years, the policymaker believed that a market failure may exist that should somehow be addressed through government action.

In addition, there is no scarcity of initiatives within the CMU action plan concerning SMEs markets, with measures to develop SME growth markets, the review of the European venture capital directive (EuVECA) and the European Long-Term Investment Fund (ELTIF) regulation and also proposals made to develop crowdfunding due to be completed by October. There has also been an assessment of the drivers of equity investment for insurance companies and pension funds and of the impact of the MiFID II research unbundling rules. However, beyond this, the development of SME equity markets is hampered by a lack of investor demand, which is hindering price discovery, together with some difficulties on the supply side. These are the main reasons leading to the stalemate that can currently be observed on the market.

2.2. Possible additional CMU actions

There is also a question as to whether additional actions would be needed in the CMU, the policymaker stressed. Most legislative proposals of the initial CMU action plan have now been implemented, but there is a realisation that further actions may be needed in certain areas. Several proposals are on the table[1], some concern SMEs, and priorities will need to be determined by the incoming Commission.

An official believed that the CMU has been successful in that a great deal of legislation has been brought forward. There is also significant political impetus in favour of SME financing but there is still a need for specific initiatives for improving the appetite of investors and addressing possible market failures in this area.

An official felt that the pan-European personal pension product (PEPP) and similar products can help provide better yields for pensioners and should be further considered as a way to develop investment in SME equity. In addition, the market needs to be opened beyond the EU so that SMEs can access investors outside the EU and external investors can access EU companies. An industry representative agreed that developing the access of institutional investors and pension funds to alternative SME markets would help retail investors to invest in these companies that tend to be too complicated or risky for

retail investors to directly invest in. Tax incentives would also be necessary in this context.

An official moreover noted that the shift to IPOs and listed markets can be quite sharp for SMEs and instruments like private equity and crowdfunding are necessary to provide a form of 'funding escalator' to bridge the gap.

2.3. Improving MiFID II research unbundling rules and investor categorisation

A policymaker stated that the Commission has heard the criticisms levelled against the MiFID research unbundling rules and will act upon evidence ascertaining whether the rules have given rise to significant unintended effects.

A regulator supported the Commission's evidence-based approach but stressed that the evidence should be appropriately identified and assessed. The IMF, for example, has reported an overall increase in SME research but failed to distinguish unsubstantial research produced in an automated fashion with machine learning tools, which has increased, from true SME research, which has decreased in coverage. Quality research is only produced if there are economic incentives, but these no longer exist because of unbundling. There have been attempts in the US also to move towards independent research but these have not worked either. The speaker suggested that stock exchanges could play a role in providing research on this segment of the market.

An industry representative noted that there is a project at the Spanish stock exchange to produce research for orphan stocks. Another industry speaker felt that digital solutions based on artificial intelligence or big data solutions can help support useful research without putting an additional burden on entrepreneurs.

Some speakers emphasized that research and analysis is also needed from the buy-side perspective. MiFID addressed this issue mainly from a sell-side angle but a buy-side analysis of the factors relevant for investment is also essential, an investor representative emphasized. An official agreed that more information and greater transparency are required for retail investors but noted that this should not lead to an excess of information and the implications for those providing the information should also be considered.

A regulator suggested that the SME market also needs a group of investors willing to bear risk and ready to be recognized as such. Changes could be made to introduce in MiFID a new category of experienced retail investors in between retail and institutional ones, as proposed in a recent paper on the CMU[2], that could be an appropriate target for SME stocks. Crowdfunding is another positive development in this regard, as it involves having a category of semi-professional investors for whom requirements are adjusted, as is the case in the US. Another idea is for the authorities to have a list of qualified investors; this approach was tested by some domestic authorities when the prospectus regulation was reviewed, but it was abandoned.

3. Possible additional solutions for developing SME markets

3.1. Public - private support mechanisms

A policymaker stated that the private-public fund specialising in SME IPOs called for by Ms von der Leyen in her political guidelines for the new Commission could help to solve the apparent market failure in the pre-IPO phase. This fund would be set up with an initial investment from the EU that could be matched by private investors. The 'funding escalator' referred to earlier currently stops short of being a full escalator and a private-public fund can help address this.

An investor representative approved the suggestion to put in place this public-private fund. If the fund is kickstarted with public money up to 50%, it could be listed so that other investors can take the remaining 50% over the long-term if the fund is performing well. In addition to providing a number of SMEs coming to the market with a first investment, the fund could take care of the initial risk assessment on the investor side and would also allow SMEs to gain a first experience of the listing process before doing it by themselves. This fund should help to start up again the SME equity market and then market forces should gradually take over. This process should be incremental because the market needs time to develop. In this perspective developing local ecosystems that can support over the long-term SMEs initially financed by this fund will be essential.

An official noted that a number of mechanisms already exist in the local markets, for example government supporting agencies of industrial authorities that support taking equity in companies. There are also mechanisms at the regional level. However a great deal of SMEs have been 'burnt' previously when taking on debt and, as a result, they are reluctant to go back to the market and prefer to leverage internal resources. To increase demand on the issuer side, there is a need for clear and transparent information and for a balance in the rules between the needs of the investor and the interests of issuers. Rules also need to be standardised across the EU. Supervisory convergence, which should be strengthened following the recent European supervisory authorities (ESAs) review, should help to achieve this.

3.2. Issuer and investor education

A official suggested that long-term efforts are needed to deal with issues such as issuer and investor education, and improving financial literacy. Some quick wins could be identified after a stock taking exercise but this will mostly be a long-term effort for which pragmatism is needed. An industry representative noted that programmes have been put in place by stock exchanges in particular to educate companies that wish to go public. Topics covered include governance practices, which many companies find complicated to put in place when they go public because they lack the necessary infrastructure.

A regulator also highlighted the importance of education programmes for small SMEs. These can teach them the 'basics' of financing and can also allow the identification of the companies that really intend to put in place the actions needed for diversifying their funding sources, and are able to do so, and also support them in this process.

3.3. Developing SME bond markets

A regulator suggested that bonds, which should be seen as an instrument half-way between bank loans and equity, are appropriate for small firms that are not ready to open up to equity participation, but which are keen to make an entrance on the public market. These characteristics may also be attractive for retail investors. Evidence, notably from ECB research, shows that, when the market is tapped even with small bonds, there are benefits for the issuers on the bank funding side also with more loans granted at a lower rate and also for the valuation of these companies because they have begun to put in place improved procedures regarding e.g. governance and budgeting. The regulator felt however that there should be no pressure for SMEs to be listed on public markets as not every SME belongs there and this may create selection effects whereby only the worst companies go onto the market.

An industry player agreed that financing should be both in equity and debt and explained that an alternative

fixed income market has been created in Spain to facilitate market access to debt instruments such as bonds and commercial papers. The level of growth of this market is very satisfactory and part of the companies present are not listed on the equity market.

4. The need for innovative solutions

A number of speakers considered that the issue of SME market financing is currently being tackled in a way that is too conservative, via traditional equity markets, stock exchanges and IPOs. More creative solutions are needed to ensure that offer meets demand in the SME equity market. An industry representative suggested that the cooperation that is developing between banks and fintechs could be a way of providing more innovative solutions. Perspectives from outside the industry are also needed to find new ways of investing that address the risk posed by SMEs, while answering customer needs. Using the analogy of a percentage of daily coffee spending invested in SME equity, the speaker suggested that innovative models supported by technology and big data allowing a large number of individuals to invest regularly small sums of money in SMEs at a regional level could help investment in SME equity to develop in a significant way, providing investors with diversification and risk mitigation. Regulation needs to facilitate the development of such mechanisms.

Picking up on this scenario other speakers suggested that some consumers could be interested e.g. in spending more on each coffee in return for a potential share of the profits if the shop grows. This type of mechanism seems feasible with a younger generation that is ready to combine spending and investing, supported by the increasing use of apps and the development of crowdfunding. Proper investor education that does not unnecessarily hinder investor appetite will also be important in this perspective. Another issue, an investor representative suggested, is how these new mechanisms, based on innovative fintech solutions, can develop in parallel with the existing infrastructure of exchanges and brokers that provide the transparency and price discovery that is necessary when SMEs grow. An industry representative also suggested that the design of regulations should strive to mirror the development of industry products that now uses faster development processes, based on prototyping and testing and involves clients and other stakeholders early on in the process.

[1] A recent working document of the IMF has called for action in 3 main areas: (i) transparency notably with the introduction of a standardised electronic reporting for all issuers, (ii) supervisory convergence and an improved regulation of certain areas (systemic entities, pension products); (iii) insolvency rules aiming to disseminate best practices. There are also calls for increasing capital market depth, for creating a safe asset at the Eurozone level or for more public intervention to foster long term investment.

[2] The Next CMU High-Level Group Report to Ministers and presented to the Finnish Presidency (October 2019) proposes to introduce the definition of a new category of experienced High Net Worth ("HNW") investors with tailor made investor protection rules.

Increasing retail engagement in capital markets

1. Current situation of retail capital markets in the EU

1.1. Limited level of engagement of EU households in capital markets

Increasing retail access to capital markets is a long-standing objective in the EU. Households, who are the main funders of the EU economy, should be at the heart of the Capital Markets Union (CMU), an investor representative believed, but there is some bad news. Statistics from the ECB comparing 2015 to the present show that the share of bank deposits, life insurance and pension schemes in total financial savings has slightly increased[1], whereas holdings in investment funds, listed equities and bonds have fallen despite the positive trend of markets over the last few years[2]. The audience was also reminded that 60% of households' assets are currently held in real estate or property, therefore the trends above only relate to 40% of overall assets.

A policymaker calculated that based on these figures, 12% of overall wealth is held in bank accounts in the EU. This may not seem excessive, because households are usually advised to keep around 20% of their savings in liquid or easily accessible assets, but in absolute terms this represents about 70% of EU GDP, which is quite significant and raises questions about possible lost investment opportunities. An industry representative tried to see this situation more as an opportunity than a problem. Involving retail more in capital markets is a necessity and must be the main objective of the CMU for the next five years as, ultimately, pooling retail investors' money into saving plans is fundamental, if not a prerequisite, to creating vibrant capital markets.

1.2. Obstacles to the further development of retail capital markets

Risk aversion and limited financial literacy: A policymaker saw numerous obstacles to moving savings out of bank accounts and into financial instruments. Foremost among them is risk aversion. Households prefer a little gain with certainty than the possibility of gaining a higher amount with more risk. This might however change somewhat if negative rates are generalized in bank and savings accounts. An industry representative felt that another reason why people tend to keep their money in bank deposits is insufficient financial literacy. A study by the Banque de France shows that only 40% of Europeans can answer basic questions about financial investments. An investor representative believed that one of the main reasons behind this loss of interest in capital markets is that listed shares and bonds are no longer sold directly to retail investors. Only packaged products are proposed in most cases, partly because they generate more commissions. As a result, distributors no longer know about securities. The speaker mentioned that retail savers nevertheless invest a higher proportion of their assets for the long term than institutional investors, when considering the total held in real estate, investment funds, life insurance, pensions, equities and bonds. These assets also bear some risk. The speaker also noted that it would help if the truth about how much could be lost from bank savings was disclosed to retail clients.

Complexity and lack of transparency of products: A policymaker noted that some retail products are quite discouraging, charging very high entrance fees for example that may take more than 10 years to recover. An industry representative believed that part of the problem is that complex and costly strategies have been added within the UCITS framework. UCITS is a success in many markets, but this complexity has reduced their appeal for retail investors. There is an interest of retail investors in finding appropriate investment solutions, when considering the pool of retail money invested in alternative investment funds (AIFs) for example. The question is how to deliver the appropriate products corresponding to retail investor needs.

Macroeconomic context: The investor representative referred to the current very low or negative interest-rate environment, which could be an incentive for moving money from bank deposits into more capital-market oriented products. An issue however, an industry speaker felt, is that the political and macroeconomic environment e.g. with Brexit, trade wars and other geopolitical events is quite frightening and might deter investors from taking more risks. In this context, households often prefer to limit losses before seeking gains.

2. Initiatives underway: progress made, unintended consequences and shortcomings

2.1. Capital Markets Union (CMU) and the PEPP

It could be said that the CMU has not worked for retail given the statistics mentioned previously, but in fact its actions for developing retail investment have not yet kicked in, an investor representative observed. The CMU needs to be completed on the retail side. Regarding pan European pension products (PEPPs), a 1% cap on fees was proposed. Some industry players disapprove of this. The investor representative felt that this proposal could be dropped if a ban on inducements can be obtained. An audience member was not sure that PEPPs will eventually take off despite the considerable amount of time that has been devoted to finalizing the text and it is still uncertain whether this product will foster a further integration of EU capital markets. The 1% fee cap seems appropriate but there are many other issues such as 'regretful' limitations put on EIOPA's role regarding PEPPs. An industry representative nonetheless believed that PEPPs might help to develop passports for pension funds.

A policy-maker acknowledged that in a liberal economy, fee capping should be anathema, as the market should do it itself, but this is not guaranteed on a cross-border level and excessive fees would hamper a product such as the PEPP. Relative fee capping mechanisms stating that cross-border prices should not be higher than domestic ones have successfully been used in the SEPA context for payments and for roaming mobile phone charges, which makes this an example to follow, although care is needed.

2.2. MiFID II, PRIIPs and UCITS

An industry representative warned that some features of MiFID II and PRIIPs, and also the KIID (key investor information document) and the financial transaction tax (FTT) may hinder the efforts made with the CMU and the PEPP to promote the development of retail capital markets. People need to have consistent incentives across the different EU legislations, which is not the case at present.

An investor representative agreed that several elements of MiFID II need reviewing to restart the CMU. One suggestion is to ban non-independent advice, because advice is also needed for simple products such as ETFs, listed shares and bonds. Banks are reluctant to offer what is perceived as riskier portfolios including shares and bonds and prefer directing individual savers towards funds or life insurance wrappers. Dark venues that exploded after MiFID II and now represent more than half of equity markets, are another issue and should come into the light. Systematic internalisers (SIs), described by the speaker as 'free riders creaming off the top of regulated markets' are particularly problematic.

A regulator suggested that the growth of the asset management sector that has been experienced in certain member states such as the Netherlands, following the implementation of asset management legislation, could support further retail investment in the capital markets. A policymaker however emphasized that customers need to be able to choose the products what they want to invest in, which is not always possible at present. UCITS is a completely harmonised product across Europe, but all banks and distributors do not provide access to all UCITS funds. Some banks use MiFID as an excuse for not providing certain funds, but if it is the customer who asks for a particular fund, it should be available on an execution-only basis. A second issue is that domestic supervisors have different ways of approving investment products with different interpretations of MiFID. This creates additional costs and frictions when funds are sold on a cross-border basis, which are then passed on to investors. As a result, even the larger asset management firms distribute different products across the 28 member states and these artificial extra costs hinder retail investment across the EU. An industry speaker agreed that enabling investors to choose the products they want is essential.

3. Additional solutions for developing retail investment in the EU

3.1. Developing employee share ownership

An industry representative reported that although there is an increasing take-up of employee saving and share-ownership schemes, around 65% of EU firms are still not covered by such plans. A statistic of the Commission shows that 300,000 firms could be candidates for these schemes across the EU. At present, however, there is no harmonised vehicle that ensures the portability of these schemes between member states. Around 50% of the larger European companies offer broad-based plans covering all employees, but only 10% of these are offered on a cross-border basis.

The passporting potential of employee share-ownership schemes should be leveraged, the speaker stated, because there are many potential benefits from these schemes for EU citizens. Assessments show that they favour the commitment of employees to their company, but they are also often a first step into equity markets and are a way of developing financial literacy. Creating an EU employee share-ownership vehicle to complement PEPPs and existing fund categories could be a relatively quick fix provided tax issues, which are part of this, can be addressed.

An investor representative believed that employee share ownership could be the most powerful tool for reaching the CMU objectives. This has been advocated by investor associations such as Better Finance for many years with concrete proposals and pilot projects were conducted as early as 2014. The fact that the project is now being picked up by the Commission is a positive move. If the EU had the same level of employee share ownership that is currently enjoyed in the US, it would increase its listed equity market by €2 trillion and could multiply flows into non-listed small and medium-sized enterprises (SMEs) by 200. This could also be a solution to bypass financial intermediaries who

no longer want to distribute equities and bonds; this latter issue could however change if inducements are banned. A policymaker agreed that the potential of employee share-ownership schemes should be further explored, noting that pension funds also play a significant role in the US retail capital market.

3.2. Improving product disclosures

Transparency and simplicity are key, in an industry speaker's view, when it comes to encouraging retail customers to invest into capital markets. There are opportunities in particular to simplify product disclosure, which is the first element the retail investor is in contact with and make it more consistent. Clients are increasingly seeking for solutions aiming to e.g. preserve capital, grow capital or generate revenues, rather than single products or a particular type of wrap. This is also related to the fact that the European investment market is very much bank intermediated. Investor protection rules will need to be adapted to these changes to move away from the current silo approach. A quick win could be to create a new rule that protects retail investors whatever the product they invest in and that may fit inside the broad framework that existing directives provide.

An investor representative agreed that more transparency and simplicity are needed because MiFID and PRIIPs, notably with the KIID, have not been successful in this regard. The most important action of the CMU in the retail area is to enhance transparency of performance and fees in order to increase trust in these products, which is very low at present. This is because it is not only impossible to know what will be the future performance, which seems normal, but it is also not possible to know precisely the past performance i.e. how much money was made, if the asset manager has met the objectives of the fund or how the product compares with other ones. First reports have been published on this by the ESAs with data notably on UCITS funds and to a lesser extent on AIFs, but further work is needed, as well as a review of PRIIPs.

A policymaker agreed that transparency of performance and fees is probably the biggest obstacle to date to retail investment.

3.3. Enhancing guidelines for product fees

Another issue is the level of fees applied to retail investors.

An industry representative stressed the importance of defining clear guidelines on entry fees and also on management and performance fees. ESMA is currently working on these issues. Some suggest that in today's very low or negative interest rate environment, perhaps fees should be limited to cases where there are positive absolute-returns. However IOSCO has produced some clear guidelines that do not prohibit performance fees when there are no positive absolute-returns. It should indeed be possible for asset managers to have an incentive to provide better returns than the market, even if interest rates are negative. In addition if fees are limited to positive absolute-return situations there would no longer be a common interest with the investor to promote products that are giving very low returns.

A policy-maker disagreed, suggesting that positive-return fees make sense if there is full transparency and the investors understand all the implications. In that case the investor needs to know that the savings will be losing a certain percentage every year for the duration of the investment. An investor representative also endorsed the idea of imposing fees on positive returns only, as a percentage of the return, suggesting that it should be included in ESMA's consultation on performance fees. This mechanism is already used by some robo-advisers.

Another industry representative believed that attempting to control the level of fees is difficult in a market where participants are for-profit. Great capabilities are also needed to manage assets and manage the risks that need to be remunerated. In addition regulation means compliance which has a cost. Fee levels will ultimately be defined by the market, by demand and competition and may also lead to an evolution of the products offered, hence the development of passive vs active products. Also the level of fees can be misleading. For example, many people believed that ETFs at zero management fee and zero total expense were free, but this is not the case, because there are costs that need to be covered. Instead, there is a need to work on fee clarity, transparency and communication and also on the way fees are structured, in order to ensure that they relate to results achieved and that this can be presented in a simple way.

Following a question from an audience member about the relative importance of costs at the product and distribution levels, an industry representative stressed the importance of understanding who does what in the value chain and the related costs in order for end-clients to have an appropriate perception of the fees. This is challenging in the case of wrappers for example, which is why transparent disclosure is essential, as previously mentioned. The experience in the UK is interesting to consider in this regard. In the past asset managers used to take all the fees and return a rebate but the RDR (retail distribution review legislation) has put an end to this and now each element of the value chain is priced individually. Prices are still pretty high but the objective of the RDR was not to force a reduction of fees but rather to clarify them, which should help to reduce them over time. This is a journey but it is moving in the right direction, the industry speaker felt.

A regulator concluded that transparency is key, but is not just about more information; it is about the comparability and simplicity of that information, making sure that the distribution and production chains that lead to the product also create the right incentives and that the retail investor regains trust in, and understanding of, what they are getting.

3.4. Strengthening EU supervision

Supervisory convergence: A regulator raised the issue that European directives may get implemented in national legislation with different interpretations, potentially hindering cross-border markets. The Commission has said that it may move to a systematic use of regulations, which do not have to be implemented in national legislation, but interpretation issues could still arise, as has been evidenced in the case of MiFIR, MAR or PRIIPs. In this regulator's view, this justifies reconsidering the role that the European supervisory authorities (ESAs) may play, their activities and responsibilities and whether direct supervision that is used for credit rating agencies and trade repositories could be extended to other activities. An industry representative agreed that there are issues with national barriers and gold-plating by some member states that need to be addressed.

Reconsidering the licence application rules of the EU passporting regime: The regulator moreover suggested that the rules of the European passporting regime regarding the location of licence applications should be reconsidered and limited to the countries where the company is performing its activities. Indeed the present rules do not prevent applications for licences from being made in the country with the lowest regulatory regime in the EU, even if the company applying has no real activity in this country. This means that in such a case home-country control and supervision are limited, and

the host country has to rely on the supervision of the home-country. Such a system needs to be reconsidered.

Pan-European collective redress scheme: Also on the EU authorities' table is a pan-European collective redress scheme for retail investors, including direct investors, an investor representative mentioned. The proposal is to model the scheme after the excellent Dutch collective redress system so that, unlike the US system, the money goes to the abused investors and not to the class action lawyers.

[1] Bank deposits represented 34.4% of total financial savings at the end of 2015, and 35.3% today, so are up. Life insurance and pension schemes were 31.6% at the end of 2015 and 33% today, again up.

[2] Investment funds represented 9.1% of total financial savings at the end of 2015 and are slightly lower now. Listed equities were 4.5% four years ago and are 4.2% now. Listed bonds is the biggest drop, from 3.7% down to 2.4% today.

MiFID II state of play and remaining challenges

1. Transparency and market structure improvements and pending issues

1.1. Equity markets

A regulator noted that transparency is a means to improve investor protection and financial stability. The crisis demonstrated that without transparency there will be higher risk premiums, higher volatility, and eventually capital markets that do not function so well. However achieving a level of maximum transparency is not needed in all markets. What is needed is a level of transparency adapted to the market concerned. Looking at the equity market, there has been a change in the market structure with MiFID II with fewer dark pools and less OTC trading but there has not been an increase in the truly lit market, due to the increase of systematic internalisers (SIs) and auctions. All in all, equity markets are not in a substantially better position.

Another regulator stated that significant improvement has been seen on transparency since MiFID II came into place, particularly on the equity side. Transparency has improved, as well as the ability of national competent authorities (NCAs) to monitor some of the markets. Improvements have also been observed in the exchange-traded fund (ETF) space. In addition, efforts have been made in specific areas such as pre-trade transparency waivers. Around 1,000 different waivers have been looked at to ensure a fair and level playing field between trading venues. A first report will be published on this by ESMA in October. However, there is still much work remaining to be done on transparency.

An industry representative observed that there are 660-plus trading venues registered across the EU. Some may call this 'competitive', but it could also be called 'fragmented'. On the equities front, the evidence shows transfers between the OTC and the systematic internaliser (SI) segments with an explosion of SIs - around 212 SIs are registered now - but the share of regulated markets in the lit venues has slightly decreased after the MiFID II introduction. 10 years after the G20 Pittsburgh commitments, the EU is not coming out that well on transparency, despite progress in risk management and reporting. Some safeguards, such as the double-volume cap do not seem to function. The proxies such as the number of IPOs and market capitalisation do not show significant progress either. It is therefore questionable whether the current market structure is in line with the political objectives set for MiFID. More work is needed to avoid further erosion of the equity ecosystem. Another factor is that the intra-EU competition introduced with MiFID has significantly reduced the transaction fees of exchanges, but the total execution costs for end-investors have not actually decreased, which remains to be tackled.

A regulator noted that improving transparency in the market is challenging because 'lighting up' some parts of the market leads certain trades to move to other parts. This raises questions regarding the appropriate market structure to favour. Transparency may not have improved significantly as a result of the transfers from OTC towards SIs and auctions.

Another industry representative thought that MiFID II has had many positive outcomes. Post-trade transparency has improved, the algo control framework is a step forward and best execution has progressed, although there is still room for improvement. There are, however, other areas which are less positive and where implementation has not been satisfactory. MiFID I allowed a dramatic reduction of explicit costs to the benefit of investors through a decrease in commission rates. Implicit costs also went down over time, in terms of spreads narrowing and more liquidity coming into the marketplace, which also benefits end-investors. Competition and choice deliver best execution to end investors and, in the speaker's view, the legislator's focus should be on investor outcomes. The concern with MiFID II is that some of the objectives have been interpreted in such a way that increases costs for investors, e.g. with a strong focus on shifting liquidity to lit markets such as domestic exchanges, which is not the right metric to consider. The correct metric are investor outcomes, especially given the objectives of the CMU. The marketplace needs to support many different types of investors with different objectives and different order sizes. The ability to do this is what needs to be looked at and different modalities of trading are key. The clients of the speaker's firm are generally institutional, such as pension funds, but they usually invest on behalf of thousands of individual retail investors. These orders are very large and these clients do not want to go to the lit markets, because as soon as they do so, the information on their transaction will be public, and they may get a worse outcome, to the detriment of the individual investors on behalf of whom they are acting. The preferred route with MiFID II should be to analyse the outcome for end-investors as opposed to simply looking at lit market liquidity, the speaker suggested. Innovations in the market such as periodic auctions are worth considering in this perspective for instance, because they have been designed in such a way that protects the best execution for clients. Such methods of trading should be allowed to continue.

A regulator agreed with the previous speaker that there has not been that much progress in the equity markets, because it is being looked at the wrong way. Many costly measures have been put in place, such as the double

volume cap operating now on hundreds of shares, but this is not delivering better outcomes for investors. Going forward, there should be more focus on investor outcomes rather than just on transparency criteria.

Another industry representative was concerned that the way regulated markets currently operate might put off some retail investors. Their organisation has seen a decrease of 13% of the orders executed through the stock exchange compared to last year. Part of the explanation is that orders are increasingly executed at closing time. On the Euronext market for example, 49% of the daily turnover is processed at the closing. This means that price discovery is less efficient and transparency benefits are becoming questionable. The reason for this is that an increasing number of large players on the market are seeking cost efficient ways to transact and the volume-driven policies of the exchange lead them to concentrate orders at certain times of the day. As a result, retail clients may progressively abandon this type of market, making it even less efficient. If the trend is to go back to a kind of order fixing for blue chips, this will clearly not be a positive outcome for investors.

1.2. Non-equity markets (bonds, derivatives, commodities)

A regulator considered that the bond and derivatives area is still problematic. Bond market transparency has not yet been achieved. However, it was also predicted that the transparency measures of MiFID II would have negative effects on the EU bond markets, which has not materialised and is a positive outcome.

Another regulator, taking the example of the Swedish corporate bond market noted that, on the non-equity side, there has been some progress but transparency is still very patchy, with many deferrals and waivers. There is post-trade information on various Swedish bonds, ranging from liquid government bonds to illiquid corporate bonds, that is provided two days to four weeks after the trade, in eight or nine different venues. There have been some improvements in the corporate bond market, which has moved from being a completely OTC dark market to more electronic trading on SIs and multilateral trading facilities (MTFs), which is very positive for efficiency and price formation. However, the transparency in the post-trade of government bonds has actually worsened. Some initiatives to harmonise could have been taken at the national level. However, there was enormous pressure from the marketplace to stay aligned with neighbouring countries in order to avoid bond trade flows moving to these countries.

Having MiFID II is positive however and should support progress over time with some improvements of the legislation. There is a need to regulate transparency in bond markets, the regulator stated, because if it is only done in equity markets, market-makers and other centrally placed intermediaries will definitely drive bond markets into darkness. There is now much more data, and data quality is improving, which will increase the possibility to follow the market, identify patterns, and improve the way the market works. The right balance of transparency is needed however, as full transparency is not always effective. That will, in the end, depend on the market structure and the markets. An industry representative agreed that maximum transparency is not always optimal for the market. The right level needs to be found.

Another regulator was very supportive of the increase in transparency that has happened thanks to MiFID II in the bond and in the commodities markets, which were very opaque markets previously. The problem however is that there is a great number of different products in the market and it is difficult to apply the same liquidity and transparency rules to all of them. Fine-tuning the framework starting with the most liquid and electronic markets would have been preferable, before expanding it to other products. Transparency rules seem insufficient in part because they do not target the right areas. As for derivatives, the G20 agreement on derivatives trading was implemented smoothly and went well, including tricky issues around equivalence.

On bond markets, a regulator stated that the implementation discussions around MiFID II helped to clarify that the objective was not maximum transparency. Instead, it was agreed that there should be a phasing-in process depending on the actual liquidity of instruments and other factors. In the end, this has led to very minimal bond market transparency in many aspects and much work remains to be done, which also requires focusing on the right market segments.

2. Data provision and reporting improvements and pending issues

2.1. Usefulness of MiFID II data

A regulator noted that at present 30 million transactions are processed per day, which is a significant increase compared to MiFID I. The data collected allows them to spot problems and deal with anomalies, which has helped a great deal the improvement of market cleanliness. This reporting also helps to obtain a better view of what is happening across markets. Problems such as simultaneous trading on multiple markets are much easier to detect now. The data sharing that has happened among European regulators post-MiFID II has been another improvement and greatly supports the achievement of clean markets in Europe. Another regulator stressed that all the data provided is used by supervisors and agreed that the sharing of it is an extremely useful outcome of MiFID II. A third regulator noted that much work has been done by ESMA in cooperation with the NCAs on trying to improve data completeness and quality, but it is a difficult task for which more time will be needed, because of the magnitude of the change that the method has brought.

An industry representative mentioned issues regarding the disclosure of costs and charges in relation to execution services for wholesale investors due to different interpretations of their definition. The feedback received from clients shows that this type of disclosure is not that helpful and having an obligation around this does not seem necessary. The speaker suggested that the process could be simplified by allowing investors to opt out from receiving this information, if they wish to. The speaker also underlined the duplication of reporting obligations that exists between MiFID II and the European Market Infrastructure Regulation (EMIR). Addressing this issue would be a quick fix, as would the new quality of execution reporting (RTS 27). Over 1,000 data points are produced, and clients do not consider it to be very helpful and therefore do not want to receive it.

2.2. Cost and availability of market data

A regulator explained that ESMA has started looking at some of the impacts of MiFID II rules. A consultation was conducted on the cost and consolidation of data, which are quite controversial topics, but for which greater convergence and commonality are needed across European markets. According to the input received, there is clearly an issue about the cost of market data, however there is no consensus about the causes of this and therefore how to solve it. While certain concepts can be clarified or further guidance can be provided by ESMA about how data should

be provided e.g. in terms of timing or costs, there are limits to how far these improvements can go. What is key is to properly implement the requirements in a consistent way throughout the EU, particularly those around data completeness and data quality in the OTC derivatives and bond spaces, which requires convergence in supervision and enforcement.

An industry representative stressed that data providers are increasing their fees by a huge percentage. There is a real issue of profitability, and it should not be forgotten that this is data coming from investors' trades. Therefore investors are being asked to pay a great deal for data that they themselves helped to create. In addition, without brokers, there would be no data. The speaker also noted that data firms are not regulated, and the reason for this is unclear.

Another industry representative agreed that data costs are a problem. The cost of market data has been going up significantly, and it is not a new issue. The recognition of the problem and ESMA's assessments in this area are a step forward however. The industry has proposed moving towards what is called the 'transparency plus' model, where data providers would have to disclose the costs of producing the data.

A third industry representative noted that the Federation of European Stock Exchanges has published statistics on the revenues from data. Exchanges across the EU are making a total of about €245 million revenues from market data, which is a fairly small amount compared to the revenues generated e.g. by crypto-assets which have not attracted so much regulatory interest. The prices of level 1 and level 2 data have increased over the recent years by 1.5%. Moreover, exchanges only represent 15% of the total costs of market data, which means that regulators should be looking at the whole value chain if savings are to be made for end-investors.

3. Issues to be considered in the further stages of MiFID II

Macro-economic context: An industry representative described the challenging economic backdrop against which MiFID II needs to be considered. There is an urgent need for the EU to progress on many fronts, notably on capital markets, for which MiFID II is instrumental. The speaker noted that the overall growth of the world economy is cooling down, but Europe is lagging behind the other regions with a growth at +0.9%, compared to +6.4% for Asia and +2.4% for the US. Resilience in the EU is also lower than in other leading jurisdictions. On monetary policy the US Fed has significantly more leeway compared to the European Central Bank (ECB). EU banks are healthy, but only 2 of the top 30 banks globally are on the continent. Europe is also lagging behind on many key market indicators such as the number of listed companies, IPOs, market capitalisation and retail participation levels. Finally further integration is needed on the Economic and Monetary Union (EMU) front, as well as a finalisation of the banking union and CMU.

Brexit implications: A regulator noted that the UK leaving the EU would impact MiFID II significantly. There is a great deal of activity covered by MiFID II happening in the UK today, and this will continue post-Brexit. The UK has onshored an identical version of MiFID II, which will come into effect if there is a hard Brexit. There will be perfectly mirroring rules, which provide consistency and certainty for firms and minimise work for the UK-based industry. The speaker identified three areas where there may be potential duplications post-Brexit between EU and UK requirements and that need to be addressed. Another regulator noted that the UK is far more than 50% of the capital markets in Europe. The idea of the Brexiteers is not to have exactly the same legislation, so the UK might change its version of MiFID II later, which also needs taking into account.

The first area where post-Brexit overlaps may happen is the share trading obligation (STO) and derivative trading obligation (DTO). The regulator noted that overlapping STOs and DTOs between the EU and UK are just not going to work and this is not good for the EU and UK markets. This issue needs to be rethought. The focus should be on best execution for the investor rather than STO, the speaker believed, and now that there is much more data available on best execution, a framework should be developed around that. On the STO, the FCA has not set out its approach yet, as it was not necessary to do so until it was clear that the UK was leaving on a particular date. This will be kept under review, and the FCA is listening to market participants. Work has been done by ESMA and the NCAs to limit the scope of potential overlap by removing UK shares from the trading obligation, for example. There are some remaining issues with e.g. sterling versions of EU shares that are mainly traded in the UK. In addition the way that the new approach has been designed to focus on International Securities Identification Numbers (ISINs) would also catch any new listings, absent any further guidance. Another regulator emphasised that from an EU27 perspective the aim is to avoid overlapping and conflicting requirements in a Brexit context. The EU is now waiting to see how this issue is going to be addressed by the UK. The second area is transparency calculations. A regulator noted that MiFID II has a relatively mechanistic way of determining whether something is transparent or not, and at what level. There cannot be two systems in the UK and the EU that deliver different transparency thresholds post-Brexit, otherwise there is a risk of regulatory arbitrage in the decisions that will be made about where to trade. The third area is trade reporting. A regulator noted that in a hard Brexit, firms will need to report both to the FCA and to their home regulators and that data will not be able to be shared. This will lead to extra-costs, which may undermine the ability to oversee markets if no common solution is found.

4. Proposed way forward for improving MiFID II

4.1. Overall objectives and approach for improving MiFID II

A regulator suggested that legislative solutions for tackling the problems raised by MiFID II should not be jumped to until the legislation is fully implemented and enforced and a detailed review has been conducted.

An industry representative cautioned against setting too big an ambition for the review of MiFID II, which should not take 10 years to deliver like the initial implementation. MiFID has been extremely costly to implement, and still continues to be so for financial firms and also for their clients, because it impacts a broad range of activities (brokerage, securities trading, asset management...). Progress can be achieved with adjustments to calibrations and the implementation of quick fixes through Level 2 measures, without having to review the whole legislation. In parallel, or in sequence, there should be a broader review taking into account the implications of Brexit and its expected impacts on the European market structure.

A short-term action plan should be prepared, the industry speaker proposed, for tackling some issues with MiFID II on which there is a wide consensus, particularly with Brexit looming. This includes having a single deferral regime for large bond and derivative trades. This may not be considered as a major improvement but for investors

such as pension funds performing large trades it would be a major improvement. A second issue to put on that list would be the STO and the tension with best execution. There are some cases where, if the requirement of the STO is met, the trading does not happen where there is most liquidity. Clarifying that the best execution obligation should take precedence over the STO could be a way of dealing with that tension, if there is a desire not to review the STO.

A regulator felt that a step-by-step approach, taking the low-hanging fruit first, should be adopted for tackling the issues previously mentioned, while preserving the positive outcomes of the legislation. But first the precise goals of MiFID II need to be more clearly defined. Is MiFID II mainly aiming to develop capital markets or increase transparency? Is growth the priority or financial stability? This needs to be clarified first, as it will increase the credibility of MiFID II.

Another regulator emphasized that the review of MiFID II should be performed on an evidence-base, which is possible 18 months after implementation. Many of the changes suggested are a 'refit' of MiFID and should not require going through a whole new legislative process. Adjusting calibrations or implementation measures should be possible, however in some cases it would require ESMA being equipped with stronger powers or tools than what has been adopted in the ESAs review.

An industry representative felt that the starting point should be a revisiting of the political objective of MiFID II in terms of transparency, based on an observation of the outcome so far. There is a collective responsibility in ensuring that capital markets in Europe have a regulatory framework that allows them to contribute to economic growth and to achieving the CMU, while ensuring sufficient financial stability.

Another industry representative believed that the main focus of MiFID II should be on removing barriers to competition wherever possible, and providing better outcomes to clients. Whenever there is a monopoly or lack of choice, there may be a deterioration in investor outcomes. It is seen in market data or with closing auction fees, for example, which are generally more expensive than continuous trading. The most important short-term goal in that perspective is to figure out the STO, due to a serious impact on best execution for clients. Using currency in combination with ISIN could also reduce the overlap issues between the EU and UK with STOs. Another priority is to progress the agenda on the consolidated tape, as it will give better outcomes to clients.

4.2. Proposals for improving market structure and transparency

An industry representative felt that what needs to be achieved is a true regulatory level playing field between execution venues and trading platforms. MiFID has been important in reducing transaction fees on exchanges, but the key question is why these savings are not coming out for the end investor and where they are lost in the intermediary chain.

A regulator noted that there is no right level of transparency for markets, except that 0 or 100% are wrong. More of a philosophy also needs to be developed around what it is that makes markets work well, alongside transparency and to consider that when calibrating the regime. This would also help to develop a more venue agnostic approach, focused on market or investor outcomes rather than on the type of venue through which orders should be executed. If this can be achieved, it would help to solve the current problems with the STO and transparency.

An industry representative noted that market structure discussion is essential because it relates to the price formation process. A recent study shows that wherever the primary market remains closed, the alternative execution venues that use reference data provided by the primary market do not even open. Since these different venues trade the same instruments, they should be subject to similar requirements, or varying requirements in light of the savings that can be achieved for end investors. The issue is that with MiFID I and II, only about 40 to 50% of overall trading volumes in Europe are price-forming, whilst there are 65% in the US and well beyond 80% in Japan.

The industry speaker mentioned other areas of transparency requirements that would need adjusting particularly for commodities. The pre-trade transparency regime needs to be reworked; there is not a single exchange across the EU so far, after 18 months, that is compliant. On the permission limits regime, the EU needs a much more differentiated approach going forward in light of, for example, other important initiatives on the radar in relation to the international role of the euro, because for a market maker, it is impossible to build up a euro denominated liquidity pool in the present set up. Again, the double volume cap had a clear intention behind it, which was a very good one, but it should be made sure that it works in this way.

4.3. Benefits and challenges of implementing a consolidated tape

An industry representative felt that a consolidated tape would help to improve transparency, which is necessary for attracting more retail investors. This requires an understanding of what is going on in the market and who is doing what, which does not exist at present. Regarding SMEs more specifically, research is also essential.

A regulator noted that there is a great deal of support for the idea of a consolidated tape, but there is no consensus on what it should contain (pre-trade, post-trade information), how it should work in practice (real-time or a record of trades at the end of the day) or how it should be put together and implemented. There are also a number of preconditions for putting it in place, such as data and time standardisation and making sure that all the trades can be captured. These are difficult questions that still need to be answered.

An industry representative noted that so far no viable commercial solution has emerged for the consolidated tape after 18 months of implementation of MiFID II. The key problem is around the data quality in the OTC and SI sphere, where the clean-up of the data disaggregation and so forth is so expensive that no viable solution is possible. Improving transparency in that area is the priority, because a quasi-consolidated tape for exchange data already exists.

Another industry representative noted that a consolidated tape would allow having visibility of the market with the different trading modalities offered, which should get people more comfortable with the idea of innovation and competition. Bringing it together and showing what the market looks like would be beneficial.

Upcoming priorities for EU securities post-trading

1. Progress made in the EU securities post-trading area

An industry representative considered that significant improvements have been made over the last few years in the post-trading environment thanks to the Central Securities Depositories (CSDR) and the European Market Infrastructure (EMIR) regulations. Considerable progress has also been made on TARGET2 Securities (T2S), which is expected to have significant efficiency and risk mitigation impacts. T2S should help to optimize the use of resources and should also be a continued catalyst for harmonisation, with further developments expected in the future. The industry has also shown a strong commitment to enhancing harmonisation in several post-trading areas, such as corporate actions. Continuing these efforts is essential, although they require tackling many details that are not visible to the wider public.

A Central Bank official noted that T+2 settlement could not have been achieved in Europe without T2S, for example. The industry could nevertheless make even more efficient use of the opportunities presented by T2S, the official felt, and should continue to collaborate with the public authorities on developing it further.

2. Main challenges and issues ahead in the EU post-trading area

2.1. Further harmonisation steps and needs

A Central Bank official stated that the upcoming introduction of the Eurosystem Collateral Management System (ECMS) would bring further harmonisation. ECMS is a joint approach supported by all national eurozone central banks that will foster harmonisation in the collateral management area[1]. Moreover, settlement discipline, which is part of CSDR, will also provide additional harmonisation incentives. If missing a delivery is expensive, institutions will seek to improve their processes and on the cross-border level, there will be a request to further harmonise procedures and practices.

An industry representative emphasized the need for more efficiency in risk, capital and liquidity management and also in collateral management, an issue which is being addressed by the Collateral Management Harmonisation Task Force (CMH TF)[2]. With the introduction of ECMS, collateral will only be accepted on T2S accounts, which is another way of driving further harmonisation. Delivering more operational efficiencies and progressing towards a European capital market however requires the lifting of the so-called Giovannini barriers, which have been updated by the European Post Trade Forum (EPTF). The speaker was hopeful that significant changes could be made in this regard in the coming 5 years. In the area of collateral management for example, it is necessary to be able to manage the possible default of a counterparty on a cross-border basis, which requires adequate securities and insolvency laws to be able to get access to the securities posted as collateral and liquidate them. National laws are unhelpful here, because there are significant differences between them. As harmonising them is too difficult, the solution could be to implement a new European securities law (as an additional 28th or 29th regime). Markets like choice, so it is likely that they will convert to this new option. Finally, withholding tax rules are also a significant hurdle to efficient collateral management. There are operational solutions for managing this with triparty agents not using the collateral when the process moves into corporate action dates, but this is a drain on liquidity for banks, which requires a solution to be found at the legislative level.

A regulator believed that some of these obstacles on the public side could be overcome. For example, the issue around withholding tax has become a budgetary tax issue for certain tax fraud cases, which could make this a priority. However, the issues related to insolvency and securities law will take much more time to tackle, probably more than 5 years.

2.2. Possible outcome of the European Distribution of Debt Instruments (EDDI) initiative

The prospects of the Eurosystem EDDI initiative, which is currently in consultation, were also discussed. EDDI aims to support integration in the current issuance and initial distribution ecosystem of debt instruments in the EU by providing new choice of location of issuance.

An industry representative stressed the importance of offering choice and maintaining the efficiencies that have been obtained through T2S. It would be helpful to be able to access EDDI through a T2S connection rather than via several local CSDs.

A Central Bank official was still uncertain about what the Eurosystem will make of this project and mentioned that the responses to the EDDI consultation indicate at this stage that the market does not believe there is a need for EDDI. A regulator agreed that the goal of EDDI is still unclear.

Another industry representative felt that EDDI could be a route to further harmonisation in a similar way to T2S. As with many European projects, there are diverging views and controversy to begin with. EDDI might not be a top priority for Europe, but it might prove to be more interesting than expected in the context of further harmonisation and with the common currency. The speaker was moreover confident that the industry could help to drive these changes if progress is made on the public side notably in terms of legal harmonisation.

3. Possible evolutions needed in the post trading area to support the CMU

3.1. Higher post-trading efficiency in the whole of the EU

An industry representative stated that the CMU needs an efficient and safe post-trading. The implementation of CSDR and T2S have delivered a considerable degree of safety that often goes beyond the CPMI-IOSCO principles. These initiatives have also fostered progress in terms of efficiency that is however limited by insufficient legal harmonisation notably regarding the securities law.

A regulator stressed that a third aspect in the perspective of the CMU is the ability of the EU post-trading system to support the distribution of products and services in all EU markets, including in some areas which are not part of the Eurozone and have high growth potential. The goal of the CMU is to bring the benefits of the capital markets to investors throughout the EU and to ensure that all Europeans benefits from growth. Improvements in the post-trading sector should therefore not be limited to the Eurozone because growth in the future is more likely to come from periphery countries. Similarly, if efficiency gains are limited to the larger financial institutions where there is already scale, it will be impossible to build scale in the smaller jurisdictions and thus to leverage the growth opportunities offered by developing non-Eurozone markets.

3.2. The prospects of further CSD consolidation in the EU

An industry representative emphasised the issue of fragmentation in the European post trading market. There is a multiplicity of CSDs, around 42 of them. Additionally, there is a lack of interoperability among these CSDs and insufficient competition between them. This creates issues for pan European service providers and for issuers and investors, who want to access a functioning pan-European capital market.

Another industry representative felt that the insufficient level of consolidation of CSDs is the main issue. The efforts made to date to lift barriers to cross-border post-trading processes in the EU with the EPTF and T2S, have focused on making cross-border settlement more efficient. The consolidation of CSDs, which is about creating economies of scale would be a step further. However, to make consolidation work and create synergies, it must be possible to build common processing platforms. This is hindered by differences in securities laws and also in the characteristics of domestic ecosystem, notably with variable levels of intermediation between issuers and investors. To integrate different EU markets, there must be a deeper level of harmonisation, and the industry has not yet reached this point. In addition, it is not always possible to legally consolidate CSDs, because many national authorities prefer to have a national CSD to service their domestic market. This can be seen in the framing of the CSDR, which some national authorities have taken advantage of to make CSDs even more local and undo some efforts made to develop efficiencies at cross-border level. The review of the CSDR, which should be launched in 2020, should be an opportunity to further assess the situation and determine a possible way forward.

A regulator explained that national supervisors prefer institutions to exist on a local level because they seek to keep control over local markets. If there is a greater level of consolidation or interoperability between infrastructures, supervisors will need to develop cooperation further. Progress towards more pan-European solutions seems inevitable though, in order to increase economies of scale and the competitiveness of the EU post-trading industry. However it is first necessary to realize all the benefits or T2S, which has not yet been achieved. The current level of cost for local CSDs is higher than it was before T2S. This is because the benefits of the cross-border elements have not yet been realised, as shown by the very low level of cross-border settlement currently observed under T2S. The reasons for this need to be understood. The regulator felt it would be very interesting to read the reports of settlement internalisers in the coming months to identify the share of cross-border volumes that is settled on the books of custodians vs what goes through the CSD, which may help to better evaluate where T2S stands in terms of bringing post-trade across national barriers.

Answering a question about the relative importance of competition vs consolidation for CSDs, the regulator suggested that this is not a binary choice. There can be a common post-trading infrastructure that connects with the trading venues and intermediaries that exist in the local markets, until there is more legal harmonisation. The regulator also highlighted the additional need to understand the competitive dynamics around infrastructure providers. In general, competition in financial services allows to increase choice and reduce costs but it is different for market infrastructures for which creating synergies seems preferable to having an excess of competition between CSDs. Eventually there will be more consolidation as we move forward, the regulator felt.

3.3. Improving the provision of supervisory data

A regulator stated that in the context of further interoperability among market infrastructures, the regulators of CSDs, trading venues and CCPs need to cooperate. This is extremely time-consuming, and can be difficult due to a lack of adequate data. An industry representative agreed that sharing data between the industry and the public authorities is very important, but was surprised that the regulator was seeking more data, given the amount that regulators are already provided with. The regulator emphasised that they are not requesting more data from the industry. The challenge for them is to optimise the way that data is handled, moving away from a static assessment of data, which requires resource-intensive reporting systems, towards a set up that would allow regulators to have direct access to the books of financial firms. The US is discussing at present the idea of 'regulatory nodes' which would enable regulators to do this. Implementing this type of system however requires a different kind of expertise, and it will be a challenge for regulators to put this in place over the coming years.

4. Potential impact of new technologies in the post-trading area

4.1. Potential changes that can be expected from new technologies

A Central Bank official felt there is a significant potential for technology to change post trading, noting however that the industry is not yet ready to reap all these benefits. In Germany for example, the Deutsche Bundesbank and Deutsche Börse created two prototypes for the delivery versus payment (DVP) settlement of securities using two different types of blockchain technology. This trial suggests that blockchain is suitable for the purpose but not superior to existing systems. However, DLT is still in its infancy. The business case for blockchain looks promising if securities can be created and redeemed on the blockchain, including all other corporate events, rather than in the traditional book entry way. The further step would be to bring cash to the ledger in order to enable DVP on the blockchain; there have been some private and public sector initiatives to move in this direction. Ultimately it should be possible for post-trading infrastructures and T2S to use DLT.

An industry representative suggested that DLT is an area where it will be possible to raise synergies and that should play a major role in providing liquidity to the market. Implementing DLT in the collateral industry requires collateral tokenisation and delivery against delivery rather than delivery versus payment. DLT will also allow the post-trade industry to reengineer its operational processes and reduce its costs by removing duplications and low-value processes such as reconciliations. Another industry representative agreed that technology could have a significant benefit in post trade, although the implementation of new systems is often challenging. While blockchain is now operational, the industry is still establishing practical business cases for uses that may go beyond what is possible with current systems. In addition, it is necessary to ensure that risks can be appropriately controlled on blockchain-based platforms, which might require a review of regulation. The industry is also in the process of realising the benefits of robotic process automation (RPA) and better communication through application programming interfaces (APIs). Using RPA

can substantially mitigate operational risk for example. APIs and social network-type infrastructures are also used to facilitate the communication between operators and customers and also among institutional investors, providing customers with direct access to their own data and the possibility to organise their own reporting.

4.2. Regulatory and supervisory implications of the use of technology in post-trading

A Central Bank official noted that the use of DLT and digital technology in general pose new regulatory challenges that need to be addressed in securities regulation. Europe has not been very successful so far in its attempts to regulate platforms. Regulations for participants or instruments are well established, but the platforms themselves 'escape' regulation. If the industry seeks to move DVP settlement to DLT platforms, there must be a specific approach to platform regulation. The way stock exchanges are regulated could be a source of inspiration. The participants, instruments and the listing are regulated, but so is the exchange, including access of the trading parties and the permissible trades.

An industry representative felt that supervisors remain hesitant about DLT, which is understandable because they want to see it work in practice. In the US, there is already a parallel real-time system for treasury settlement based on DLT and which is currently used for reconciliation. This DLT platform is being used in combination with cloud, big data and machine learning. These technologies, as well as artificial intelligence, are also being used by the industry to improve the efficiency and resilience of existing processes. For example, a settlement fail-prediction service developed by the speaker's company provides early warning indicators to its clients, making it is possible to identify in real time when parties behave in unexpected ways. Supervisors should encourage experimentation with new technologies and the parallel use of different technologies. While this is happening in some jurisdictions that are developing new legislation around technologies such as blockchain, others are attempting to squeeze new technologies into existing frameworks, which will not help. The industry representative added that bigtech or large fintech firms will increasingly play a 'quasi infrastructure' function in the market that may need to be regulated as such.

Another industry representative stressed that any changes in law touching post trade (e.g. possible changes regarding the securities law) should also address digital transformation that will develop in the post-trading area. Evolutions due to digitalisation also needs to be addressed in a consistent way in the EU. For example, it will be important to have a harmonised European law on crypto-assets, instead of many national ones.

A third industry representative suggested that some regulatory changes could be needed in relation with fintech. For example rights, obligations and reliefs may need to be adapted to new technologies. In addition, trusted third parties used in the context of digitalised processes, should not be allowed to escape regulation. Cyber-risk is also an important issue that should be tackled at the international level.

A regulator emphasized the intensity of the monitoring that the authorities are performing at the domestic, EU and international levels and which is essential for being able to react to the incredibly fast evolution of technologies. The issue around how to regulate DLT and fintech companies in particular is now high on the agendas of IOSCO and ESMA. ESMA published in February 2017 a report on the potential benefits and risks of DLT that is still valid. The FSB is also tracking developments in fintech and market structure. Ultimately, users of DLT will still need to comply with existing regulatory frameworks such as MiFID, EMIR and CSDR. At this stage, given that technologies are still evolving, ESMA considers it premature to make a specific regulatory response to the changes the technology could potentially lead to.

4.3. Technology neutrality

An industry representative noted that the traditional approach to regulation is technology-neutral, based on the principle that the same risk or activity should be subject to the same regulation. This activity-based approach to regulation is however not easy to apply in all cases. Taking the example of CSDs, it is clear that if a firm undertakes core CSD activities, it needs a CSDR licence. But CSDs also perform many other ancillary services, including collateral management. This is operated under the CSDR licence, but collateral management is not intrinsically a regulated activity, which shows that some gaps may need closing.

A regulator felt that technology often changes how activities are performed rather than changing what is actually done, which is why regulation needs to be technology neutral and should not change for a given activity. However it is also important to consider disruptive shifts in technology which may fundamentally change certain processes. Regulators consider post-trade as a series of steps, which are then regulated, but technology may change the path of these steps or condense some of them into a single point. This is why regulation cannot be completely technology-agnostic. Even if it is claimed that MiFID and CSDR are technology neutral this will not always be true.

4.4. Possible regulatory approach to fintechs and crypto-assets

A regulator considered that regulatory matters should not only be discussed with incumbent companies but also with fintechs. The challenge however is that fintech entrepreneurs often ignore issues around financial regulation and in some cases eventually discover that their project is not in line with regulatory requirements. Regulators also need to adapt their approach to this change in mindset. This is why EU jurisdictions need sandboxes or 'financial innovation hubs' in order to better understand how to tackle these new developments.

A Central Bank official believed that when fintechs seek to scale, which is often the case, they need to address regulatory issues. Moreover, they realise that they need a licence of their own rather than continuing relying on a licensed partner.. Another regulator agreed that sandboxes and hubs are necessary, but felt that they are not always the right answer. Such environments cannot be used for infrastructures for example that process very large volumes; they are more adapted for financial service providers or certain infrastructure processes, rather than the whole system. The regulator further suggested that the current approach to regulation in Europe may need adapting. Currently it is segregated by type of service provider, but technology may lead to changes in the post-trade value chains. It would be better to pause and reconsider this approach now, given the ongoing developments in the market, rather than having to do so further down the line when changes might be much more costly to make.

The first regulator also suggested focusing on the subject of crypto-assets. Tougher regulation would encourage participation in safer crypto-asset markets. At the request of the European Commission, ESMA issued in January 2019 a first advice about crypto-assets. Among other things, that advice clarified the existing EU rules applicable to crypto-assets that qualify as financial instruments

(transferable securities or other types of MiFID financial instruments). This implied looking at how to qualify crypto-assets, i.e. analyzing when they should be considered as transferable securities. The advice also assessed whether there is a need for a bespoke regime for those crypto-assets that do not qualify as a MiFID financial instrument. Going forward, there will probably be a need for a bespoke regime for aspects relating to anti money laundering (AML) in particular and for appropriate disclosure requirements.

[1] The objective of this project is to merge the national central banks' existing 19 different national collateral management systems (CMS) into a single collateral management system covering the entire Eurosystem.

[2] The Collateral Management Harmonisation Task Force (CMH-TF) formulates and monitors the implementation of a single rulebook for collateral management, custody/corporate actions and other asset servicing processes. The work done by the CMH-TF includes the development of harmonisation standards for triparty and bilateral collateral management, corporate actions (on stock), billing processes and other collateral management processes. Thus the CMH-TF supports the work of the AMI-SeCo (Advisory Group on Market Infrastructures for Securities and Collateral), the aim of which is to facilitate an active dialogue with market participants on issues related to the clearing and settlement of securities and to collateral management, as part of the governance framework of the T2S initiative. The CMH-TF is composed of representatives from market infrastructures, custodians, market participants and Eurosystem national Central Banks.

AIFMD review

The Chair noted that the review of the Alternative Investment Fund Managers Directive (AIFMD) has been initiated[1]. KPMG was asked for a report on whether the objectives of the AIFMD have been achieved and what changes might be needed. The conclusion of this report is that the basic objectives of the Directive have been met: the AIFMD has played a significant role in helping to create an internal market for AIFs and a harmonized and stringent regulatory environment for AIFMs. The report however identified several areas of potential weakness related notably to a different interpretation of rules across EU Member States (e.g. regarding depositary and marketing rules), overlaps or inconsistencies with other EU requirements (e.g. in the areas of reporting and leverage) and overly burdensome rules (for investments in non-listed companies).

1. Progress made with the AIFMD in creating an internal market for AIFs

1.1. Further integration of the EU AIF market

The AIFMD's first objective is the creation of an internal market for alternative investment funds (AIFs), the Chair noted. However the small percentage - less than 3% - of AIFs distributed in more than three countries, shows that this is not yet a pan-European market. The risk is for the EU AIF industry to lag behind other regions.

A Central Bank official stated that KPMG's conclusion that significant progress has been made in developing an EU single market for AIFs is consistent with ESMA data showing an AIF sector of € 5 trillion assets under management, representing a third of the EU fund industry and still growing. All objectives have not yet been achieved in this regard, but the directive has had positive impact. A single rulebook was established with a strong set of common rules. Following the ESAs review, progress should be made in terms of supervisory convergence. This should help to ensure a more consistent implementation of the AIFMD rules, provided that supervisors coordinate and use the tools at their disposal to deal with common issues consistently, together with ESMA. Any further changes required with regard to AIFMD should be made through enhanced supervisory coordination rather than Level 1 changes, the official suggested.

An industry representative emphasized that the initial objective of AIFMD was to tackle the risks posed by hedge funds and other alternative funds, but it was complemented later on by the objective to create a single market for AIFs limited to professional investors, due to the risks involved. Bearing this in mind, the speaker felt that the single market for AIFs works relatively well in practice. The industry representative moreover noted that the regulation adopted earlier in 2019 and due to be implemented by August 2021 to favour the cross-border distribution and marketing of UCITS and AIF funds should foster the integration of the EU AIF market. This legislation is positive but will mean adapting the passporting of AIFs and UCITS, the way legal documentation is drafted and the management of IT processes and systems in order to facilitate cross-border marketing. This must be done step by step, not in parallel with changes to AIFMD. The cross-border marketing legislation should be implemented first and assessments should be conducted to verify whether passporting has improved as a result, before making significant changes to AIFMD.

A regulator agreed that the cross-border fund distribution regulation could help to enhance the percentage of AIFs distributed cross-border, which is low at present. The impact of this regulation may however be different for AIFs and UCITS, because UCITS benefit from a larger distribution.

1.2. Depositary location requirements

An industry representative stressed that depositary rules are also important in building confidence, safety and soundness in the AIF sector and therefore need to be considered in the context of the AIFMD review. Differences in the local implementation of these rules have not been material enough to cause problems, however there is still potential to reduce cross-border frictions in this area and to contribute to deepening the EU AIF market. In particular, the rules relating to depositary location should be reconsidered in the context of the AIFMD review, the speaker believed. The current system requires that depositaries to EU AIFs must be established in the home member state of the AIF. Although the intent is understandable, it has led to a fragmented system where depositary quality and the level of competition vary by location across the EU. Changing this could improve options for managers without undermining the rest of the AIFMD rule set. Much time was also spent during the drafting of the AIFMD legislation on defining depositary liability, but the current set up remains untested and may not be optimal, the speaker felt.

A regulator recognised the interest of large financial institutions in centralising their activities in order to reduce costs. Regulators however need to ensure that outcomes are also positive for investors,

which might increase some costs for the industry. In addition there is already a great deal of competition on fund depositary services in Europe. The depositary bank function is crucial when constructing an investment fund, as it provides assurance to investors. Decoupling a fund's domicile from that of the depositary bank creates issues with the legal framework, although this may be overcome. The main problem is that national safekeeping laws are different across jurisdictions, raising the question of which regulation applies if a fund appoints a depositary in another jurisdiction. A regulator will insist that the fund's home law applies, since that is the one under which investors have invested and this provides them with the protection to which they are entitled. In addition, an important activity for a depositary bank in Europe is controlling the fund's flows of money and to which counterparty they are going. This refers to the national prerogative of anti-money laundering (AML) legislation in particular. It would be difficult to have a product domiciled in one country where another party would be subject to different AML legislation in Europe, let alone in a third country. Moreover there are systemic risks associated with fund activities. Concentrating the depositary activity in a few jurisdictions and in a very limited number of firms will create additional risks.

The industry representative acknowledged that these different issues need to be further assessed and that discussion on them during the AIFMD review would be welcomed. Depositary banks are EU domiciled and regulated banks and a certain level of equivalence across borders is needed for markets to work effectively on a pan-European basis, including in this area. A possibility could be to allow for central operation out of a core custody bank and to address local concerns such as AML through a lighter registration regime or through data sharing. This would be beneficial for smaller member states and for managers who would like to work across borders through a relationship with a single depositary.

A Central Bank official agreed that depositary location is an issue to be further assessed. Achieving a more coordinated and consolidated approach in this area is a trajectory that is worth considering after the initial progress made with the implementation of AIFMD rules.

1.3. Additional issues suggested for the AIFMD review

A Central Bank official suggested that loan origination funds are an area that also needs reviewing. EU jurisdictions have domestic regimes for these funds that show some similarities and ESMA has laid down common principles. A more consistent approach across Europe in this area would be beneficial, because this is a key aspect of the evolving post-crisis landscape.

An industry representative observed that the limited use of administrative measures and sanctions by regulators is identified as a weakness in the KPMG report. Similar assessments conducted by ESMA[2] regarding UCITS showed that in 2016 and 2017, less than 50% of national competent authorities (NCAs) within the European Economic Area (EEA) issued an administrative measure or a sanction regarding these funds, which normally involve a higher level of investor protection due to their retail orientation. It is essential that a similar report should be prepared by ESMA for AIFs before possible revisions to the existing rules are considered, in order to have a sufficiently evidence-based approach. The speaker also reminded the audience that there is a Level 4 in the Lamfalussy process, whereby the Commission should monitor the actual enforcement of already adopted EU laws. However, until now, the Commission's compliance with this requirement has been poor, including for AIFMD.

2. Progress made in terms of risk mitigation

2.1. Achievements of AIFMD in terms of risk mitigation

The Chair stated that the need for a specific regulation for managing the risks posed by AIFs had appeared after the financial crisis. As the focus was initially on hedge funds and private equity funds, it was a surprise when the Commission decided to address all AIFs, which are a heterogenous group, including for example real estate funds and the so-called 'special' funds[3]. Such a diverse group of funds could not be regulated at the product level, so the compromise was to regulate fund management companies via the AIFMD.

An industry representative considered that the systemic risk management objectives of AIFMD have been largely achieved. AIF managers have experienced various market events since the implementation of AIFMD, including the Brexit referendum and the end of the Euro crisis, with no particular problem.

A Central Bank official did not believe that all the objectives on the risk side have been achieved. Much remains to be done on liquidity and leverage risks in particular, which may create systemic risks. The crisis showed that what can work at the individual fund level may not give the desired systemic outcome at sector level. There is ongoing work on AIFMD notably on the implementation of Article 25 relating to leverage limits set by AIFs and the ability of the competent authorities to intervene on leverage levels. The European Systemic Risk Board (ESRB) recommendations on mitigating liquidity and leverage risks in investment funds also need considering in this perspective. In doing so it is important to understand the dynamics of the non-bank financial sector and define what the public interest should be in order to determine the type of macroprudential tools and requirements that are needed for possible intervention on an ex-ante and ex-post basis. This involves examining a range of questions and the AIFMD review must not prejudge the answers.

A regulator acknowledged the existence of several areas for improvement. Both the microprudential and macroeconomic views are key to risk management. AIFMD is principle-based and takes a holistic approach to liquidity, leverage, operational risk and other issues, drawing on the experience of UCITS. Areas for improvement include a stronger harmonisation of leverage definitions and reporting rules, given that asset managers have multiple licences and manage multiple products and are seeking to streamline processes as much as possible across funds. A second issue is the segregation between risk and portfolio management. It is quite strict in the case of UCITS and the KPMG review asks if there is a similar issue for AIFs. Depending on the type of alternative fund managed, risk and portfolio management are quite close. The implementation of the proportionality principle must also be reviewed again. Finally, the macroprudential focus is on leverage, although other risk categories must be considered. The methodology must be fine-tuned to adapt risk management to different asset classes, as this cannot be a one-size-fits-all.

2.2. Liquidity risks posed by AIFs

A Central Bank official noted that liquidity risks need to be addressed both from a systemic risk and investor protection point of view, as shown by the recent examples of Woodford, H2O AM and GAM funds.

Progress has been made through the work of IOSCO and ESMA on stress-testing guidelines, but it is important to assess if this provides the necessary investor protection.

An industry representative noted that the Woodford funds incriminated were not structured as AIFs but as UCITS and so this issue would fit better in a debate about the liquidity risks of UCITS. The design of UCITS funds is different from AIFs and there is a higher investor protection objective, given their stronger retail nature. For AIFs, the debate is mainly about ensuring that the existing liquidity rules are enforced.

A Central Bank official agreed with this distinction but considered that while the functioning of these funds may be different, the questions on investor protection are the same. It may be that there is a different answer for AIFs, but this issue still needs reviewing to check whether sufficient progress has been made, taking into account the dynamics in the financial system as a whole.

A market expert advised that cases such as the Woodford or Third Avenue funds must be reviewed in a broader historical context, taking all the different implications into account. Third Avenue is only the fourth regulated fund in the US industry's history that has had to suspend redemptions. This had no systemic effect and yet, following this event, the US SEC created a vast framework of liquidity risk management, despite indications that the industry was managing those risks well, considering the wider effects on the system or fund sector.

The same is true of Woodford, the market expert stated. The fact that the fall of the fund had no knock-on effects across the UK or EU market suggests that it was not a systemic event and does not require new regulatory interventions. It also demonstrates that the fund market is robust. The aim is indeed to build robust systems rather than stable ones, because stable systems are essentially moribund with nothing happening to them, even after a shock. A robust system is built in a more dynamic perspective. It allows people to take risks and is able to endure shocks and continue to work, once issues have been tackled. An efficient financial system should be a robust system, not a stable one, because people should be able to take risks and put invested money to work. In some instances, money will be lost but a balance must be maintained between serving the economy and maintaining investor trust and confidence with a sufficient level of protection.

If there is an idiosyncratic event, regulators must question what the appropriate response is, having weighed all the costs and benefits in that context. The SEC got it wrong on that occasion, the speaker felt. The required liquidity risk bucketing is proving to be extraordinarily expensive, especially for small funds and the industry is now in the hands of service providers and consultants, who charge vast amounts for bucketing. In addition prescribing a unique set of liquidity management rules across such a diverse industry in terms of asset classes, sizes of funds and levels of risk is very difficult.

A Central Bank official agreed that Woodford was not a financial stability event. However when such an event happens it is important to understand its potential systemic and investor protection consequences, because the possibility of a shock or the potential 'crystallisation' effects on the market need to be anticipated. This does not necessarily mean introducing new rules, but understanding how problems appear if there is a shock in the fund sector. A stable system is good to have, it is a static one that should be avoided.

The expert agreed that assessing the potential risks is important, provided that any risks are not seen as a harbinger of negative circumstances yet to come. Reviewing every major US market event since 1940 shows that predictions about flight, panic or run risk generally never come to pass.

3. Brexit implications and third-country issues

3.1. Brexit implications for AIFs

The Chair advised that the UK leaving the EU and therefore becoming a third-country at some stage, raises again the question of how to treat non-EU AIFMs and AIFs, and whether the current approach to third-countries in the AIFMD requires any change.

A market expert responded that the internal AIF market will look much smaller after Brexit since much of the AIF management is in the UK. The main challenge may not be the rules to apply to non-EU players, but rather how to nurture the industry within the EU post-Brexit. A special form of portfolio expertise is required for hedge funds, private equity or venture capital. The financial characteristics and infrastructure required are also different from other regulated funds. The EU's challenge will be to encourage the AIF sector to develop in the future and encourage investors to embrace it.

An industry representative stated that the EU industry has been preparing for a hard Brexit since the result of the 2016 referendum, given the uncertainty that was created. The asset manager represented by the industry speaker is particularly well placed, having fully-fledged legal entities in the UK and in several EU27 countries now, with asset management capabilities and an internal broker with a MiFID licence. Moves have been made to secure access to derivatives also.

A regulator noted that UK regulators have decided to onboard EU rules. There should therefore be equivalence in the short term at least, since the laws will not change, which is positive. Moreover, the question of equivalence with the UK needs to be considered in a context where portfolio management activities have been delegated outside Europe to the US, Hong Kong and others for many years.

A Central Bank official believed that defining what to do on the third country aspects of AIFMD and how to apply equivalence in this area is challenging and Brexit makes it even more so. The national private placement approach works reasonably well. Difficult discussions have taken place over the past year in the context of Brexit around third-country delegation and applying a third-country regime to CCPs and investment firms. This has allowed the identification of the main questions to focus on from a regulatory perspective i.e. whether there is a financial stability concern that arises from having two jurisdictions where there was previously one and how to ensure that supervision is effective and that the relevant norms and standards apply in each jurisdiction. The debates have become more depoliticised over time, the official believed, which is positive, but we need to stick to the relevant questions.

3.2. Third-country AIFs

A market expert stated that the issue of third-country AIFs had been raised again when ESMA was asked to provide the Commission with advice on the possibility of extending the AIFMD passport to non-EU AIFMs and AIFs from different third-country jurisdictions including the US. They did not find any investor protection or systemic risk issues with respect to US funds. There was however a misunderstanding of the way the US fund system works, because it was assumed in the comparison that the rules

for regulated US funds apply to European private funds that are offered in the US market, which is not the case. The predicate for deciding that the AIFMD passport would not be eligible for US funds is therefore wrong. This signals a broader inclination to exclude third-party funds from the EU market, the speaker felt.

An industry representative observed that bringing US fund products into the EU under current EU rules including AIFMD, PRIIPs and UCITS is challenging at present. This means that some of the most liquid exchange-traded funds (ETF) in the world for example are not available in Europe, which raises questions that go beyond the AIFMD regulatory discussions. Reviewing third-country access rules is necessary in the context of a European-based market that is potentially due to shrink post-Brexit, the speaker felt.

4. Reporting requirements

A regulator stated that the issue of reporting has been raised in the context of the AIFMD review. There are often complaints from the market that data is filed, and then no feedback is received. As for regulators, they point out data quality issues, particularly regarding investment strategies and the 'other- other category' which is considered to be too vague. These areas should be reviewed to make the reporting more meaningful going forward.

An industry representative believed that the current reporting provided is sufficient for monitoring purposes and that there is no need to change it or extend it. Two different sets of reporting are already required by AIFMD and UCITS and central banks e.g. in Luxembourg and France also ask for inventories of each of the funds domiciled in their respective countries. If supervisors want more detailed reporting than what is provided via AIFMD requirements they should obtain them from the central banks, rather than imposing additional reporting requirements on the industry. More generally, further coordination among securities regulators through ESMA or between banking supervisors and/or central banks and local securities regulators would facilitate the sharing of the data and help to improve the data at the disposal of the authorities. The regulator clarified that they are looking for a better outcome in terms of data quality, especially for the category of 'other-other' funds and not for additional input of data from the industry.

The Chair noted that the KPMG report also highlighted consistency of reporting as a weak point and asked if NCAs interpret and implement the existing reporting rules differently. An industry representative agreed that these comparability issues between reporting requirements across EU jurisdictions should be further assessed.

[1] The Alternative Investment Fund Managers Directive (AIFMD) requires a review of the Directive (review of the application of the AIFMD; its impact on investors, AIFs and AIFMs within the EU and in third countries; and the degree to which the objectives of the Directive have been met). The first stage of the review has been completed with the publication on 10 January 2019 by the Commission of a report commissioned from KPMG intended to provide and assess evidence for the Commission's review. The Commission has indicated that it will continue its work on the AIFMD review, taking into consideration the information and conclusions contained in this report, alongside other sources of data and further analysis. The intention is for the Commission to issue its own report on the functioning of the AIFMD to the EU Parliament and Council in 2020.

[2] ESMA released a report on the enforcement of administrative measures and sanctions for UCITS on 4 April 2019.

[3] Spezialfunds are predominantly German funds limited to institutional investors such as insurance companies or pension funds, allowing for a more lenient regulatory framework compared to retail funds. These funds are often based on one investor.

PEPP: what needs fixing?

1. Introduction

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 challenged 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 have relocated investment risks from the institutional investor to the individual saver.

A regulator introduced the key topics for discussion which focused on the opportunities and remaining challenges in the implementation of the Pan-European Personal Pension Product (PEPP). The aim of the PEPP is to create simpler, more transparent and more cost effective personal pensions in Europe, which will contribute to pension sustainability and long term investment in Europe, and better returns for citizens.

2. The key expected benefits of the PEPP

2.1. The PEPP will give more freedom, choice and flexibility fir EU citizens saving for their retirement

An official described how a large number of multinational organisations are based in Ireland, which means a large number of EU citizens will work in Ireland for two or three years before leaving. Ireland sees the PEPP positively, because it allows the mobility of different workforces across the Union by providing choice. It is important to have consistency across EU member states in order to avoid people having multiple pension pots. The PEPP is important, but it will not solve everything immediately. The PEPP also links into Europe's pension shortfall. One aim of the Capital Markets Union (CMU) project is to build Europe's capital markets, but Europe has a yearly pension shortfall of around € 2 trillion. The PEPP has a secondary effect of boosting Europe's capital markets by increasing the pool of investable money. The use of digitalisation in the provision of information to users of PEPPs may also have positive effects for savers on the take up of the product. The PEPP can give savers greater clarity and understanding. Ultimately, the PEPP project is about trying to overcome the inertia for people regarding their saving for their retirement.

A regulator agreed on the need to discuss pensions and retirement planning. The information aspect is very important. Croatia has a completely different situation for Ireland, however. Croatia's population uses the benefits of higher wages and better working opportunities in other member states by working abroad. A product like the PEPP would be interesting for many Croatians who work abroad. While global asset managers are powerful and marketing is important, there is a strong home bias in the financial industry. Many Croatians who move abroad save in domestic banks. The PEPP is an opportunity for the domestic financial industry to offer such products. Another regulator agreed that the PEPP could be highly relevant for any member state's diaspora.

2.2. The PEPP is an opportunity to educate savers about the opportunities and risks potentially open to them as long term investors and will create a single market for personal pensions

An industry representative stressed that the industry is acutely aware of the real need for workers to save in order to make up for Europe's pension shortfall. Some aspects of the PEPP will fulfil this need. The PEPP is a great opportunity for asset managers of all kinds to propose innovative investment solutions to savers across Europe. The first benefit here is on the marketing level. The existence of a European pension plan, with the same name across Europe, will help a bigger percentage of the population to start saving. The second benefit concerns economy of scale. Whether the providers are insurance companies, asset managers or another type of company, they will be able to provide a single solution, which is scalable across member states. Additionally, the co legislators did not decide, for example whether the benefit would be a lump sum or an annuity. This flexibility helps providers and asset managers develop life cycle investment solutions appropriate for both the accumulation and decumulation phases. Another industry representative agreed, suggesting that the PEPP is a true opportunity. While Europe is assessing its progress on the journey to a financial single market and the CMU, it is important to make progress by raising public awareness, especially amongst young people, of Europe's ability to develop concrete solutions for the pension gap.

2.3. The PEPP could increase the mobility of workers in the EU and be a pioneer project

An official noted that one of the highest priorities of the new Commission is to ensure that Europe has an economy that works for people. At a time when Europe faces a significant challenge from negative demographic developments, the PEPP can provide benefits for individuals and society as a whole. The PEPP also has a very positive externality, because it supports mobility within the EU. Secondly, the PEPP can pioneer. The field of pension products is an aspect of social security and social affairs, which is the domain of member states. From this perspective, the PEPP is a pioneering project. Finally, it is important to consider how the PEPP interacts with the CMU. The PEPP can increase the robustness of the EU financial sector by increasing cross border shareholdings, which is one aim of the CMU.

A regulator agreed, noting the indispensable cross border dimension of the PEPP. This cross border aspect is the only way to achieve economies of scale. It will help reduce the concentration of home bias in investment. One of the main problems with pension mechanisms in some European countries is the concentration of investments in certain asset classes. It will be very important to bring pensions to the European level to create mass and to diversify these holdings.

2.4. The PEPP could also contribute to the ESG agenda

An industry representative stated that the PEPP should be green, noting that the project itself mentions the possibility of an environmental, social and governance (ESG) dimension. Europe could finance the CMU and the growth of European economies while ensuring sustainable growth. The EU can 'kill two birds with one stone' by taking into account ESG factors and the new EU taxonomy. Providers, asset managers and insurance companies should contribute to these definitions. A regular stated that default, standardised features bring economies of scale and efficiency gains to the PEPP providers, expected to result in cost-efficient products and importantly sustainable investments over a considerably long time horizon. It is possible to use this also as a way to target younger generations, because they are rightly very serious about environmental issues.

3. Key issues still to be addressed for implementing the PEPP

There are teething problems that will need to be addressed if the PEPP is to be a success. Indeed, there is a long list of key issues here, including the simplicity of the basic PEPP, the content and presentation of KIDs, the fee cap, the cost of capital protection, the definition of risk mitigation techniques, portability, disparity on national tax incentives, and the need for national authorisation. The success of the PEPP depends on ensuring there is an appropriate regulatory framework, particularly in an environment of low interest rates

3.1. The PEPP must be simple and transparent

3.1.1. Developing a simple product

An investor representative suggested that the principal benefit of the PEPP is to have a safe, simple and cross border personal pension. However, the regulation of last July is no longer very simple and no longer very safe, especially the default or 'basic PEPP'[1]. With EIOPA's delegated acts, there is still a chance to make the PEPP less complicated and much safer. EIOPA's advice to the Commission initially was to have a default option for the PEPP, which was simple and safe enough to be sold without advice. At present, the PEPP is neither simple enough nor safe enough. The investor representative appealed to member states to play fairly not only on tax but on all the other rules. For example, on 7 August, the French authorities issued their risk mitigation techniques for the basic PEPP, which is not overly complex.

An industry representative stated that the road to hell is paved with good intentions. The Key Information Document (KID) related to Packaged Retail and Insurance-based Investment Products (PRIIPs) was extremely simple, but it was very bad. However, people will only buy these products if they understand them. Major European financial groups will find it easy to offer these products because they already cover the entire Union. It will be more challenging for smaller institutions to offer this product without adding complexity or cost. However, the PEPP is an interesting opportunity to provide products for more European countries. It could foster greater cooperation in the insurance industry, for instance. Ultimately, the PEPP must be simple for people and simple for institutions.

3.1.2. Making the PEPP a mass-market product remains challenging

Noting EIOPA's good work on the PEPP, an industry representative suggested that all regulatory texts are imperfect, but there is added value in the implementation of a regulatory text. Therefore, EIOPA's role will be very important. The PEPP will succeed if it both appeals to young educated Europeans, who currently have no adequate pension solution, and also becomes a mass market product. Otherwise, it will not solve either the pension gap or the need for more savings to finance the European economy.

The industry representative explained how it is increasingly difficult to give clients the three advantages that industry wants to give: guaranteed capital, liquidity and an acceptable return. This issue must be discussed with savers and member states, and all parties must decide what to privilege. While institutions privilege the long term perspective, people will not buy the PEPP if they are not convinced of its benefits. The industry representative

is convinced that tax is very important to make PEPP a mass market product. If the industry wants people to buy a new product, people have to be sure of its benefits. One good way to do this is through tax incentives.

3.1.3. Transparency and clarity: the KID must be simple and intelligible for pension savers

An investor representative stressed that Europe should not copy paste the PRIIPs KID. The KID is supposed to be the document that consumers and savers understand. The KID must be intelligible, comparable and not misleading. 'Intelligible' means clear and short. 'Comparable' means that the industry must use actual past performance and cost as a percentage of savings to benchmark fund performance. 'Not misleading' means regaining or acquiring people's trust. There must be transparency on the capital guarantee and prominent warnings about the reliability of forecasts. The investor representative concluded by quoting Stanford Professor of Finance Ezra Solomon, who said, 'The only function of economic forecasting is to make astrology respectable.' If the experts do not agree, consumers should not be held responsible.

A regulator emphasised the importance of transparency between different products. PEPP will not live in its own ecosystem. This is very important for the structure of KIDs. An industry representative stated that the basic PEPP is very important, but the industry must be very clear on liquidity and return. Risk mitigation techniques should be defined extremely clearly and there must be transparency on other options. There is no reason why consumers should not be allowed to make direct investments in certain classes of assets.

3.2. The fee cap in the basic PEPP is appealing, but consumers must understand the consequences

The basic PEPP will have costs and fees capped at 1% of the accumulated capital per annum. This cap is a key feature of the basic PEPP and EIOPA has to develop Regulatory Technical Standards (RTS) to specify the types of fees and costs to be accounted for in that cost cap. Securing long-term stable income and adequate future retirement income is the key objective of PEPP. Therewith, risk-mitigation techniques to be applied in the asset/liability and investment management is an integral part of the PEPP framework. It is important for the PEPP to offer clients life cycle investment strategies.

3.2.1. The PEPP's fee cap should have a standardised definition, including its components

An investor representative stressed that the fee cap is only for the default option. This cap is necessary because of the importance of making the PEPP a success and the present interest rate environment. However, it is worrying that the French authorities should have lifted the 15 year ban on inducements for personal pension products. By itself, this will increase fees by 0.75 1%. With negative interest rates, this is not a solution for consumers. The components of the fee cap should also have standardised definitions. An official agreed that the industry's concerns about cost are valid in a zero interest rate environment. Direct investment in ETFs and other asset classes should be considered, but people must know what they are doing. If the PEPP is successful, there will be an entirely new cohort of customers.

3.2.2. Capping the cost could affect the quality of the service that the provider can afford to offer

An industry representative described how providers have two levers able to deliver sustainable returns in the current economic environment. The first lever is how the provider defines the guarantee or profiling of the investment. The industry representative's firm is very much in favour of life cycle products: in other words, a diversified multi strategy investment that de risks over time. This is more powerful than a guarantee, which costs 'an absolute fortune' in capital. The second lever is liquidity. The PEPP is a scheme for long term saving. There must be a way for the PEPP to be invested partially in illiquid products, which make higher returns than UCITS or daily liquidity products. Acknowledging the existence of the fee cap, the industry representative considers it important to discuss its composition. For example, advising and distributing should not be part of the fee cap. In the UK, many individual savers do not receive advice because it has become too expensive. It will be silly if the less well off part of the population is prevented from investing in the PEPP because they will not receive proper advice. A regulator agrees that this should be balanced against the standardisation of the product, which could help reduce the fees.

Another industry representative agreed, suggesting that their institution also does not support the fee cap. Their institution would obey the law after informing all parties of the risks. The cap will not be excessively dangerous if there is clarity on its composition. The general range of management costs is around 1%. However, firms will have to disclose what is in these funds. Risk mitigation is not true mitigation; there is no zero risk investment. A guarantee has a huge cost in capital, and firms must be transparent. A regulator stated that the cost of the guarantee needs to be very transparent. The industry representative reiterated the importance of not including the cost of the guarantee in the cap, as this would be unmanageable.

3.3. The definition of risk mitigation techniques will be essential for the success of PEPP

The definition of risk mitigation techniques – i.e. the criteria to be met for non guaranteed investment options – is another issue to be addressed by EIOPA. An investor representative felt that the PEPP is not simple. Complexity has been a significant impediment in personal pension products in the past. Secondly, in relation to adapting the risk scale to the time horizon of the pension product, a diversified portfolio of equity is much less risky over 20 30 years than money market funds or short term bonds. It is also crucial for investors to be able to invest directly in investment funds, low cost ETFs, listed equities and bonds.

3.4. The PEPP must be manageable for providers

An industry representative stressed that the success of the PEPP depends on ensuring that the regulatory framework enables providers to fulfil their role. As it stands, Solvency II does not correctly measure long term risks; as a result, it is overly conservative. The cost of capital under Solvency II and persistently low interest rates mean that the most expeditious way of restoring an institution's solvency rating is to sell equities. This problem will impact the performance and diversity of PEPPs. Improving Solvency II requirements for long term liabilities will help insurers provide long term savings products, including the PEPP.

Noting that the PEPP is interesting because it is completely optional, an audience participant queried whether there could be regulatory spill overs from the PEPP into compulsory regulation in other sectors. An industry representative considered it possible for some spill over on the industry's capacity to invest in certain asset classes, especially in the present economic circumstances. There might need to be a multi sector

consensus to adapt the rules if Europe should seek to foster further development of the PEPP. Another industry representative did not foresee any obvious areas for spill over, adding that there is a need to ensure that national competent authorities (NCAs) and regulators should make the PEPP simple for market participants and their clients.

3.5. Appropriately determining the mechanics of portability is a key challenge

An industry representative stated it was essential to determine appropriately the mechanics of portability. If the details are not considered thoroughly, Europe will encounter 'roadblocks or even worse'. An official agreed and described how, in their experience, the biggest proponents of the CMU, the Banking Union and the financial union are the same member states currently challenging ring fencing within the Banking Union. Europe must take a broader packaged approach here. Portability is essential. The PEPP cannot lead to a situation where pensions are concentrated in only some member states.

3.6. Member states should give the PEPP an appropriate tax treatment to ensure its success

The decision to provide incentives to participate in the PEPP via the tax code still rests with member states. An official described how Ireland currently offers preferential tax treatment to pillar 2s and pillar 3s. While a final decision has yet to be made, it would make sense to treat the PEPP in the same way as other pillar 3 products. There has been this focus on tax, but it is important to look across the Union and consider the structures of member states' pillar 1s. A regulator agreed that tax is part of the solution, but it is not the only solution. The official noted that tax is a national issue, which can be problematic. The official considered the real issue to be the fact that discussions about pensions have focused on pillar 1, but pillars 2 and 3 also contribute to the sustainability of public finances. If Europe focuses on pillar 1 and ignores pillars 2 and 3, there will be substantial problems with the system. If there was a generous and affordable pillar 1, there could be different policies for pillars 2 and 3. An official warned that, if pillar 1 was linked to the CMU, there would not be a pool of money to invest.

Another official highlighted the potential reboot of the CMU; taxation treatment could form part of this discussion. If the Commission develops a proposal, member states will discuss it. However, it is essential to have a more packaged approach when discussing financial union. There should be no 'cherry picking' in relation to the different topics. A regulator noted that the Commission has been clear that the minimum acceptable tax treatment would be the treatment already available to other personal pension mechanisms. In respect of taxation, an audience participant wondered why the Commission has not offered to match the benefits given by a country to the second pillar. Even a small sum would provide an incentive for member states to act. A regulator confirmed that this was a good idea.

3.7. More consistent supervision is required in the context of a cross border PEPP

PEPP providers will be supervised by their NCAs, while EIOPA encourages the process of convergence. A regulator highlighted the need to leverage the EU's internal market and make the PEPP cross border. An official expressed his personal view that there is a role for EIOPA in the supervision of the PEPP, but it is essential to take account of the principles of proportionality and subsidiarity. The official praised what has been established in the Banking Union, i.e. a system with the SSM at the centre that fully includes national supervisors in its daily work. Over the long term there could be something like that in this area. Another official emphasised the need for consistency in supervision. One big issue with the PEPP is that Europe has a huge number of entities operating under different frameworks. The European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and EIOPA will be involved at level two, so it is important to secure a consistent approach. The official noted the work done in the recent review process of the European Supervisory Authorities (ESAs). EIOPA and the other ESAs have the tools to establish coordination groups, coordinate collaboration platforms, and a strengthened peer review process that will contribute to achieve the objective of supervisory convergence. Location does not matter to investors. If there is a consistent approach, investors will have confidence in it. The new tools available from the review of the ESAs will be important to achieve this objective.

A regulator considered the European label of the PEPP to be extremely powerful. If something goes wrong in one country, it could destroy the brand of PEPP throughout Europe. Europe must consider the supervision side very closely. An industry representative felt that NCAs must ensure that both product and distribution rules in their countries are compatible with the PEPP product. A regulator suggested that this is the challenge of cross border business. There are multiple approaches to consumer protection throughout Europe, and Europe must simplify this. Another industry representative highlighted the existence of a multi regulatory problem. Different requirements on capital and solvency will create additional complexity. Another regulator opined that Europe is at the beginning of this process. Convergence is important, but Europe must launch the product, see how it functions and then work on the PEPP as it evolves.

4. Conclusion

A regulator felt there could be some effects on other products in terms of transparency and cost effectiveness, if the PEPP is a success and if European consumers trust it. Europe must make the product a success. The regulator noted that EIOPA would return to some of the issues raised in the panel in its forthcoming advice to the Commission. Finally, the regulator stressed that the PEPP is an opportunity for all market participants – consumers, the public sector and the private sector – to deliver something that European citizens will see as acting for them. To put it in the motto of the new Commission, it can be an economy that works for people.

[1] For basic PEPPs with a capital guarantee, the speaker's organisation sought to guarantee pension savers' contributions in real terms before the deduction of fees or, at the very least, prominently warn pension savers that fees and inflation will severely reduce the value of this guarantee over time. However, the regulation ultimately resulted in a 'capital guarantee scam', where accumulated lifetime savings are protected only after deducting accumulated fees and ignoring the negative effect of inflation.


The Eurofi Financial Forum
HELSINKI | 11, 12 & 13 SEPTE
PROGRAMME

Helsinki 2019

SPEECHES

Full transcript

Mika Lintilä

Minister of Finance, Finland

Welcome address

It sounds like I have been in politics too long. Dear colleagues and dear friends, firstly I would like to warmly welcome you to sunny Finland. Why are you laughing? Maybe someday you will be able to see it. You can still laugh. In the modern world interdependence is high. This is especially true for a small, open economy like Finland. When the global economy sneezes, we often get the flu.

For sustainable growth, economists need a positive feedback loop between a stable operating environment, trust in a better outlook, productive investment, new jobs, etc. Now that positive feedback loop seems to be broken. Financial markets play a crucial role in all of this. They are connecting those with ideas but no money with those with money but no ideas. Financial markets are also used to dealing with risk and uncertainty. However, the road ahead is especially foggy.

One quote actually says that only uncertainty is certain. The list of investors' concerns is long. Everybody knows about the trade war, Brexit, possible bubbles in asset prices, climate change, and political polarisation. These are all mentioned and are fuelling uncertainty. All of these topics have been discussed during this Eurofi meeting in these past two days.

Our job as policymakers is to try to address these concerns with the tools that we have. Central banks have monetary policy tools and supervise this, and we as governments are responsible for legislation and fiscal policy. Tomorrow and Saturday I will host an informal ECOFIN meeting here in sunny Helsinki. We will obviously not be able to deal with everything but we shall have very interesting discussions on rebooting the Capital Markets Union (CMU), the role of the financial sector in countering hybrid threats, the role of finance ministers in tackling climate change, including energy taxation, and the review of the EU fiscal rules. For Eurofi members, the two financial market topics are especially timely. On the CMU, the Finnish Presidency wants to shift the focus to retail clients that are the main drivers of the European economy.

Regulatory and other barriers still prevent smooth movement of investments and financial services across borders in Europe and we need to take a critical look at such barriers. The resilience of the finance sector infrastructure against hybrid threats is another timely issue. The financial system is critical for the function of our societies and we should step up our efforts to protect it. Cyber security is a topic that maybe could be discussed more here at Eurofi too.

However, dear friends, it is time to let you enjoy. I hope that you will enjoy your your stay here in Helsinki, in Finland, and most of all I hope that you will spend a lot of euros here in Finland because, actually, we need our GDP to increase. A warm welcome to you. ■

Olli Rehn

Governor, Bank of Finland

Which economic and financial priorities for fostering growth and innovation in the EU?

Ladies and Gentlemen, Dear Colleagues and Friends,

It is my great pleasure to welcome you to Helsinki and to the Eurofi Financial Forum 2019. Helsinki is a major Nordic financial centre and Finland is an active founding member of the EMU and the Banking Union.

Moreover, central banking has a long history in Finland. Compared to the "youngsters", like the Fed and the ECB, the Bank of Finland is a "veteran", having been founded in 1811, which makes us the 4th oldest cental bank in the world. That means, if you don't count Finland being an organic part of Sweden, which has the oldest central bank in the world, Sveriges Riksbank, founded in 1668.

The Eurofi on its part has been providing a valuable platform for the exchange of ideas and information between the public authorities and the financial industry for two decades. I am confident that over the next few days the Eurofi Helsinki Forum will give us plenty of food for thought on topical issues in European economic and financial policy.

The theme of the morning sessions – the economic and financial priorities for fostering growth and innovation in the EU – could not be more pertinent. Apart from managing immigration better and reinforcing external and internal security, our key policy challenge in the coming years will be no less than boosting an economic and industrial revival of Europe.

Let me share some thoughts with you on the priorities to this effect.

First, on macroeconomic policies. As we are on the ECB's silent period, I will not comment on – or even touch – monetary policy. I just note that the euro area economy has been on a path of recovery and growth since 2013. But prolonged pervasive uncertainty stemming from the escalating trade war and related to vulnerabilities in the emerging market economies, as well as ongoing geopolitical tensions, have left their mark on the economic sentiment.

Europe's labour markets have been resilient, so far, and that is supporting domestic demand. However, the falling external demand is taking its toll, and having its effect also on the labour market.

The Bank of Finland and other central banks in the Eurosystem are ready to do what is needed to reach our price stability target and support sustained growth and job creation. But monetary policy cannot be the only active player in the field. Other policy areas should contribute more decisively to raising the long-term growth potential and reducing vulnerabilities.

Tommaso Padoa-Schioppa warned monetary policy makers not to confuse the independence of the central bank with isolation. As he put it, "strong currency requires a strong economy and a strong polity, not only a strong and credible central bank" [1].There is much room for enhancing coordination, each policy maker working within the perimeter of its mandate. With limited policy spaces this is ever more important.

Sound fiscal and economic policies at the national level are the first line of defence to deal with economic shocks. Implementation of structural reforms needs to be substantially stepped up to increase resilience, boost productivity, and reduce unemployment in a lasting way. Automatic stabilisers should play their full role. All countries can reinforce their efforts to achieve a more growth-friendly composition of public finances.

Why is that important? Because productivity growth is critical to rising living standards. Sustainable growth requires more investment, research and innovation. To accomplish this, sufficient public sector contribution is necessary. We need to be able to secure investment in public infrastructure, including digital infrastructure, not least in countries that are lagging behind in 5G, or even more regrettably, sometimes even in 4G.

A large and integrated single market is the cornerstone of the EU, but the member states also benefit from open global markets. At the same time, the transformation brought about by globalisation and the digital revolution has resulted in winners and losers. This, in turn, has helped to promote populist policies promising easy answers to difficult questions.

Protectionism, however, is not an answer. Isolation is not possible without great losses in citizens' living standards. We should continue to work for a Europe that pursues growth also from beyond its own borders through free-trade agreements; for a Europe that combines a strong entrepreneurial drive and a stability culture; and for a Europe that guarantees civil rights and social justice in the digital age.

These are concrete goals for sustainable growth and job creation – and fundamentally for human development – that really matter to the citizens in Europe, which should always be our key yardstick.

Next, let me turn to key policy priorities in the financial sector.

A well-functioning financial system is fundamental for growth. It is a well-known and regrettable fact that we are still missing a genuine pan-European financial market. It is a fact that the post- crisis trend of financial reintegration has been weak, which is partly explained by the initially slow recovery of Europe after the crisis.

Yet, the key underlying factor is that there are still too many shortcomings in the EMU financial architecture. While we have made good progress in reinforcing economic governance and strengthening the regulatory framework, there still remain too many obstacles for further integration.

That's why the completion of the Banking Union and enhanced efforts towards the Capital Markets Union are critical building blocks of both the integrated single market and a more resilient monetary union.

With regard to the Banking Union, we need to implement the remaining measures to ensure an effective and credible resolution framework, set up the common deposit guarantee scheme, and address remaining regulatory obstacles that unnecessarily penalise cross-border integration. To accomplish this, we need to ensure that greater risk-reduction will go hand in hand with greater risk-sharing.

The Capital Markets Union aims to break down barriers that block cross-border investments. Although we have had successful EU initiatives to boost investment – with the Juncker Plan having triggered some EUR 400 billion of investments – we need significantly more private financial risk sharing to support innovation and efficient allocation of capital.

There has been good progress in taking CMU-related EU legislation forward, but major further steps are still needed to create a well-functioning CMU. Many initiatives will be discussed during the Forum, including a more harmonised insolvency framework and enhanced transparency of company financial data that is critical for investment decisions.

I would like to highlight one particular issue – the need for a European safe asset. We have frequently underlined this need within the Eurosystem. I am not taking any stand on any specific, concrete proposal to this effect. But if well-designed, a European safe asset would contribute to both financial integration and financial stability. Namely, the CMU would genuinely benefit from a common safe asset against which newly issued securities can be priced, including in the green bond markets. It would also offer financial stability benefits by lowering risks on banks' balance sheets.

The non-existence of a European safe asset also contributes to an excessively unipolar global financial system and the vulnerabilities it creates. It would not be about challenging the dollar – it would be about building a more stable global financial system. It would also be about providing an additional channel for foreign investors to invest in Europe, including into sustainable finance and the green bond markets.

There are major challenges involved in taking the CMU forward. For that, we need a clear vision and persistence. We need to revitalise the action plan. With this in mind, in my view it would be useful to reassess the narrative attached to the CMU. A new concept – "Growth and Investment Union" for example – might put a more positive drive on the project.

Dear colleagues,

The current global headwinds underline the importance of boosting the economic revival of Europe through structural reforms, public and private investment in research and innovation, and a revitalisation of the Single Market. We need to complete the EMU financial architecture to enhance capital allocation and improve private risk sharing. Only in this way can we reap full benefits of the Single Market.

And, crucially, 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. In this challenging task, the financial system will need to play an important role in managing risks and mobilising capital for green investments.

Let me wish you most productive discussions and enjoyable days in Helsinki! – Many thanks for your attention. ■

Augustin Guillermo Carstens

General Manager,
Bank for International Settlements

The quest for financial integration in Europe and globally

1. Introduction

Let me first thank Eurofi for inviting me to participate in this prestigious forum. Although the BIS is a global institution, we follow developments in the European Union very closely. This is not only because of the geographical location of our headquarters in Basel - just a few kilometres from the two largest European countries - but also because Europe and the European construction project are so important in the world economy and the global financial system

As you all very well know, over the last 10 years the international community has developed a comprehensive set of reforms that profoundly affect the regulation of financial institutions and financial market activity. The reforms aim to improve crisis prevention and crisis resolution mechanisms in order to make episodes of major financial instability less frequent and less costly.

Now that the bulk of the reforms have been completed, the priority is to ensure that they are adequately implemented. It is also time to evaluate whether they have been able to meet their objectives and to analyse how regulatory changes have affected the functioning of international capital markets. In particular, it will be necessary to analyse whether the financial system has become not only safer but also more able to support the orderly development of both domestic and international financial intermediation. In that context, the G20 has established as one of its policy priorities the analysis of possible signs of fragmentation that could jeopardise global financial market integration and the consideration of the appropriate tools to address it.

Integrated financial markets bring a number of social benefits. They help enlarge the opportunity sets of lenders and borrowers, increasing competition in the provision of financial services and offering possibilities to diversify idiosyncratic risks away from the national economies, thereby contributing to financial stability.

This last benefit is particularly relevant within a currency union like the euro area. A well functioning monetary union requires effective risk-sharing mechanisms that could help weaken the link between economic developments, the availability of finance and financial stability in each member country.

Yet, in addition to its benefits, international financial market integration also involves some costs. Integrated markets can transmit shocks and volatility. Sudden stops have macroeconomic costs. And internationally active financial institutions also need to be supervised and regulated comprehensively. In particular, the availability of adequate loss-absorbing resources is critical. Therefore, policymakers need to balance delicate trade-offs to reap the full benefits of financial integration while minimising potential costs.

In the rest of this presentation, I will first review possible ways to address market fragmentation at the global level. I will then focus on market integration within the euro area.

2. The global case

Although there is no commonly agreed definition of market integration, I consider it the ability of providers and users of financial services to operate on competitive terms in jurisdictions other than the one in which they are headquartered or located. Frequently used indicators of the degree of market integration are the size of international financial flows, the penetration of foreign players in local markets and price gaps for similar services or products in different jurisdictions.

In the analysis of financial integration, regulatory divergences are often mentioned as a major source of fragmentation. Indeed, diverse national rules may inhibit foreign participation in domestic markets. Those divergences may be produced by a number policy characteristics [1]:

- First, the incomplete or inaccurate implementation of internationally agreed regulatory standards that typically target internationally active firms.
- Second, domestic rules complementing international standards, such as structural measures on the banking side (such as separation of retail and investment banking activities in different legal entities) or ring-fencing measures for local subsidiaries of international firms.
- Third, the introduction of rules for financial activities performed by domestic firms in foreign jurisdictions (extraterritoriality), such as clearing location requirements for transactions denominated in the domestic currency but conducted anywhere.

Naturally, national choices may respond to domestic singularities or policy priorities in a context in which the structure of national economies and their financial systems diverge markedly. In other words, regulatory divergences can often be the consequence rather than the cause of the structural heterogeneity of the world economy. In fact, adapting financial regulation to national specificities may well help strengthen domestic financial systems and in that way enhance global financial stability.

A case in point is the ring-fencing measures of internationally active firms. For instance, the TLAC standard aims to appropriately distribute loss-absorbing and recapitalisation capacity within a group and provide for pre-positioning in material subsidiaries or subgroups [2].Furthermore, a number of host jurisdictions have established rules that require foreign banks to create intermediate holding companies grouping all interests in that jurisdiction and ask them to hold sufficient liquidity, capital and bail-in-able debt to cover their estimated local needs on both a going-concern and a gone-concern basis. Requiring the pre-positioning of the estimated loss absorption needs in the local company ensures that the normal operation and resolution of the local subsidiaries would not depend on the availability of funds provided by the foreign parent entity. That certainly protects, in principle, financial stability in the host jurisdictions. It may also help to limit the propagation of financial stability shocks across borders.

Yet ring-fencing also imposes costs on international banks, as they face constraints in seeking to efficiently manage the group resources. It could even be argued that those constraints may also affect the stability of the group as a whole, as the pre-positioning of a large part of the group resources in different legal entities could leave little room for the group to provide additional support to subsidiaries if the pre-positioned resources were to prove insufficient.

It has recently been proposed that consideration be given to replacing pre-positioning requirements with cross-border guarantees under which parent companies commit to support subsidiaries in case of need, both in normal times and in resolution[3].That would, of course, weaken the rationale for ring-fencing and allow international groups to centrally manage a larger amount of resources, thereby supporting their efficiency and promoting market integration. Yet work remains to be done to determine whether and how those guarantees could offer sufficient comfort to host authorities and, more broadly, to financial markets. This work is particularly relevant in situations where the parent company - the guarantor - might also be in trouble; where the legal enforceability of those cross-border contractual arrangements is in question; or where the regulatory and accounting treatment of the guarantees for both the parent and the subsidiaries is unclear. And guarantees have often proved to be less adequate than tangible equity in times of crisis.

Moreover, enhanced information exchange among authorities and better functioning of supervisory colleges and crisis management groups could reduce the need for extraterritorial and other unilateral actions to ensure financial stability and market integrity in all jurisdictions. Recent reports on market fragmentation by the Financial Stability Board[4] and the International Organization of Securities Commissions have spelled out those ideas, together with a concrete action plan [5].

Even in the sensitive area of ring-fencing, international cooperation may facilitate a better outcome. Stringent local loss absorption requirements are partly the consequence of a non-cooperative framework that resembles a prisoner's dilemma type of situation. No matter what foreign authorities do, domestic authorities prefer to require the pre-positioning of sufficiently large volumes of resources at the subsidiary level. But if all host authorities do the same, they risk creating rigidities in the allocation of resources that could ultimately affect the stability of the group as a whole.

A fully cooperative solution that would remove any need for ring-fencing is not achievable. But progress could undoubtedly be made within crisis management groups towards deciding on an allocation of resources within international groups that would strike a good balance between the need to protect stability in each of the host jurisdictions and the need to preserve sufficient flexibility for the management of the group as a whole.

3. The European case

The case for financial integration within currency unions is particularly strong. Arguably, the bar for an adequate level of financial integration is higher within a monetary area than across countries issuing their own currency. In particular, within a well-functioning monetary union there should be no strong links between economic developments in a particular jurisdiction and the value of banks' deposits in that jurisdiction. Otherwise, as we have seen during the recent euro area crisis, adverse shocks to specific economies may trigger outflows of deposits to other jurisdictions, causing extreme financial instability and creating politically challenging tensions within the monetary union.

Achieving that goal requires common risk monitoring, risk prevention and mutualisation arrangements like those foreseen in the banking union project. These include common supervisory and resolution mechanisms supported by a single resolution fund and, eventually, a common deposit guarantee scheme.

Yet a crucial complement of those public arrangements would be a truly integrated banking industry in which pan-European banks would be able to spread country-specific risks over the currency union as a whole, thereby helping to break the link between national developments and domestic financial stability.

Looking at the potential obstacles to global financial integration that I mentioned before, it is a fact that the European Union has been able to remove a number of them within its perimeter. In particular, while still incomplete, a single rule book has been developed, embedding not only a homogeneous implementation of the international standards but also a suite of common complementary rules, affecting most relevant aspects of the regulated financial market activities. Moreover, within the banking union, the existence of single supervisory and resolution authorities provides for consistent policy approaches for both crisis prevention and crisis management.

Yet it seems that regulatory harmonisation and the creation of the banking union have not yet delivered substantive results in terms of banking integration. In particular, the volume of cross-border loans or deposits within the euro area, the penetration of foreign banks in domestic jurisdictions and the number of cross-border merger and acquisition operations in the banking industry have not increased much since the creation of the banking union[6].

One explanation which has often been put forward is that there are not sufficient incentives for banking integration. In particular, authorities within the euro area can still impose specific capital, loss absorption and liquidity requirements on subsidiaries of pan-European firms beyond the obligations imposed at the group consolidated level. In other words, even after the recent review of relevant European Directives and Regulations,[7] the legislation still permits the ring-fencing of local subsidiaries of European banks even within the banking union.

Ring-fencing of local subsidiaries could be seen as fundamentally inconsistent with a fully functioning banking union[8].At the same time, it could also be a natural consequence of the still limited degree of financial integration within the euro area and the insufficiency of the existing risk-sharing mechanisms.

Logically, progress in deepening the economic and monetary union and completing the banking union would strengthen the case for a full transfer of financial stability responsibilities to EU authorities. More specifically, the availability of a common (fully mutualised) deposit guarantee scheme - in addition to the existing Single Resolution Fund - would provide arguments for reducing the current ring-fencing possibilities for the local subsidiaries of pan-European groups.

In the European Banking Union, achieving such integration and removing ring-fencing is even more relevant than at the global level, and it also looks more feasible. For instance, together with local authorities, both the ECB and the Single Resolution Board are already involved - though in different ways - in defining the requirements for banks' liquidity, capital and loss-absorbing capacity at both the consolidated and the subsidiary level. Moreover, the enforceability of intragroup guarantees aimed at ensuring the transfer of resources from the parent company to subsidiaries in case of need looks somewhat less uncertain for legal entities operating under EU law than among firms incorporated in completely different jurisdictions. That could reduce the need to pre-position large amounts of resources with the subsidiaries and help to achieve a balanced allocation of resources within pan-European groups that would mitigate the potential impact of ring-fencing practices on the integration of the European banking industry.

4. Concluding remarks

I am fully aware that this is much easier said than done. Moreover, regulation is never the only cause, and often not the most relevant cause, of market fragmentation.

As is the case in other parts of the world, the banking sector in Europe faces challenges that can constitute structural obstacles for additional integration. For example, the persistently low level of profitability - most likely associated with the industry's excess capacity - does not favour the cross-border expansion of European banks but, more naturally, additional within-border consolidations seeking economies of scale.

In addition, the disruption posed by technological developments is generating uncertainty as to the industry's prospects and the sustainability of some traditional business models. That uncertainty - to a significant extent already reflected in banks' equity prices - does not help commercial banks' development of expansionary corporate strategies through regular mergers with, or acquisitions of, other traditional financial institutions located in foreign jurisdictions.

However, it is likely that over time technology will further increase the availability of all types of financial services on a remote basis, which could foster greater integration of the financial industry at both the global and the European level without requiring the physical presence of foreign players in the different domestic markets. That would in no way eliminate the need for deep regulatory reflection, but, arguably, it would have a completely different tone. In my remarks, I have discussed cross-country cooperation as a desirable development to enable regulation to achieve a better social return by promoting more financial integration. In the future, what now looks desirable may become essential. In a context of de facto integration linked to blurring borders in the provision of financial services, close international cooperation will become an essential element of any regulatory framework aiming to protect the integrity and stability of the financial system.

Thank you. ■

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[1] See Financial Stability Board, FSB report on market fragmentation, June 2019.

[2] See Financial Stability Board, Guiding principles on the internal total loss-absorbing capacity of G-SIBs ('internal TLAC'), July 2017.

[3] See eg. W. Ervin, «Ring-fencing: escape from the prisoner's dilemma», Banking Perspectives, third quarter 2018; and F. Villeroy de Galhau, «How to develop a financial Eurosystem post-Brexit», speech at the Eurofi High Level Seminar in Bucharest, April 2019.

[4] Financial Stability Board, FSB report on market fragmentation, June 2019.

[5] International Organization of Securities Commissions, Market fragmentation and cross-border regulation, June 2019.

[6] See F. Restoy, «The European banking union: achievements and challenges», EURO Yearbook 2018 - completing monetary union to forge a different world, IE Business School, February 2019, pp 215-33.

[7] See European Commission, Adoption of the banking package: revised rules on capital requirements (CRR II/CRD V) and resolution (BRRD/SRM), April 2019.

[8] See M. Draghi, «The benefits of European supervision», speech at the ACPR Conference on Financial Supervision, Paris, 18 September 2018.

Bruno Le Maire

Minister of Economy and Finance, France

The future of the Capital Markets Union – Towards an Investment and Savings Union

Ladies and gentlemen, Dear friends,

I am glad to be with you this morning, to discuss the future of the Capital Markets Union – a topic which has been one of my main concerns for the past two years, as Finance and Economy minister.

It has been one of my main concerns for very simple reasons. Because we need European capital markets that allow us to allocate resources where they are most needed. Because European capital markets are essential to give Europe the financial depth that befits its economic size and political ambition. Because a European capital market will benefit our citizens and our businesses.

Building a true Capital Markets Union has been on the European agenda since 2015. We are going in the right direction, but we are going too slowly

Why? Partly because the CMU was initiated at a time when we were struggling with the aftermath of the financial crisis.

Because we overlooked the risk of market fragmentation, which was increased by the financial crisis, but also by non-cooperative national strategies. The protection of local interest hindered the integration of our capital markets. The differences in capital taxation increased tax competition among Member States. And so, opportunities have been missed.

We didn't do all we could to help our companies grow.

Why is there no European Google or Apple? It's not a matter of creativity or talent, it is a matter of access to finance. And today we're lagging behind our main technological rivals.

Let me remind you some interesting figures on venture capital financing in the world in 2018: 100 billion dollars raised in the United-States, 80 billion in China, 20 billion in Europe. That's a shame. We need to invest more to stay in the innovation race – on artificial intelligence, on space, on energy storage.

We didn't do enough to offer our citizens profitable, high-quality savings products.

European households are large savers. The household saving rate reached 10% of EU GDP in 2018 and even 12% in the Eurozone. But European savings are mainly allocated in short-term, fixed- income assets rather than equity or infrastructure. According to the OECD, financial assets held in safe, low-return currency or deposits account for 40 % of households' portfolios in the EU 27. It's four times higher than in the United States.

It is the consequence of a lack of knowledge about financial concepts and instruments. But it also comes from a lack of simple and easy-to-use savings products, which fit the needs of our fellow citizens: long-term savings products to prepare for retirement; sustainable savings products to encourage the energy transition and green investments.

We need to build these instruments and propose these instruments to our citizens right now.

And finally we didn't do everything necessary to ensure Europe's financial independence.

The current fragmentation of our capital markets means that key technological companies cannot find tickets in Europe. They often end up being financed by third country actors. We may end up losing control of future technological champions, we finance our startups but then they are bought by third countries. In France, we spend money on our startups that are then bought by American companies, that is unacceptable. The CMU should help us preserve our economic and financial sovereignty.

We talked a lot about the CMU in the past few years. Now it is time to get things done

So, what should be our top priorities for the new five year mandate? I am confident that our discussions and exchanges with the Eurogroup ministers, the new Commission and my friend Valdis Dombrovskis will help us deliver on this agenda.

First – making sure companies of all sizes can better finance themselves.

EU companies need more equity to grow and innovate. Yet in the current interest rate environment, they are less willing to go listed than before. Capital markets should also provide funding channels for SMEs that are too large to be covered by Venture Capital funds, and too small to go public on a stock exchange.

We should therefore drastically simplify securities and market regulations to help SMEs get access to equity markets. We need a fitness check on our EU regulatory framework which is now too complex and which impedes the development of regulated stockmarkets. I'm asking for a full simplification of EU rules.

We should also encourage insurers and institutional investors to invest more in equity than it

is the case today. It is a major challenge of the Solvency 2 review next year. The reform has to guarantee the investment in equity.

Second – we need better savings products answering the needs of EU citizens.

A genuine EU capital market should improve returns on long-term savings for EU citizens through a wider range of investment products. Those products should also better respond to the needs of work mobility.

In France, through the PACTE law, we encouraged the development of Employee Savings Plans and employee shareholdings. Because it helps giving purchasing power back to employees and better aligning their interest with the company's interest. Because it provides our economy with long- term financing sources which can help our companies grow.

Today, it is difficult to retain the same savings plan when moving from one EU company to another. Any Slovenian, Italian, Polish or French employee should be able to carry its savings plan and benefit from similar financial guarantees.

→ ***My first proposal: we could therefore imagine a European employee savings scheme which any worker could carry with him throughout his professional life, no matter the country or the company where he works.***

Third – the CMU must contribute to our environmental targets.

The CMU should help us tackle the very concrete challenges we all face in terms of climate change and environmental protection. The development of a high quality sustainable finance, a green finance, is a growing concern of EU citizens. It is time to act. Green finance must be located within the EU.

The EU has already taken significant steps through the project of taxonomy of green assets or the disclosure framework on sustainability for financial entities.

→ ***My second proposal is to go further and enhance non-financial reporting through a genuine European reporting standard on social and environmental performance for corporates. A substantial improvement in the quality and the comparability of non-financial data will make it easier for investors to build sustainable, green portfolios.***

France will make very concrete proposals in the coming weeks to enhance EU non-financial disclosure requirements, based on the best international practices.

We could also strive to build genuine green savings product. In France, we created three main labels for retail savings products: on ESG investment, on green investment and on socially inclusive investment. These labels allow any citizen to invest in dedicated responsible saving products. It is key to enhance the involvement of the general public and to push companies to be more committed.

→ ***We could therefore aim at an EU label for green retail savings product, based on the new EU taxonomy. We need to have our own European taxonomy, based on our own vales. That is my third proposal***.

Four – we must build an ambitious innovation framework.

Data science and information technology are disrupting financial services. Europe should be at the forefront of innovation in customer services, payment systems, market infrastructure and collateral management models.

Two technologies are gaining traction: blockchain and the emergence of virtual assets; the advent of artificial intelligence and machine learning. These innovations will soon irrigate the entire field of financial services. An SME raising funds in 2030 will use crowdfunding or token emission rather than traditional initial public offering.

France was one of the first countries to adopt an ambitious regulation on blockchain and digital assets.

At a time when global crypto currencies are developing at a fast pace, it is necessary to develop a similar framework at the European level.

→ ***My fourth proposal would be to aim at a comprehensive EU action plan on cryptocurrencies. It is time to act and know what we want for cryptocurrencies.***

Because cryptocurrencies raise many challenges: financial security and investor protection; transparency to prevent money laundering and terrorism financing; data and privacy protection; and financial sovereignty.

I expressed my concerns about the Libra project, because nothing demonstrates in Facebooks' blueprint that those risks will be properly managed. Along with the other members of the G7, France made it clear that no private entity can claim any monetary power, which is inherent to the sovereignty of Nations. Under these conditions, we should refuse the development of Libra in Europe.

→ ***Under these conditions, we should refuse the development of Libra in Europe. We should work on a clear and common EU position on Libra and in parallel work on improving the efficiency of our common payment systems. That's a fifth proposal.***

I see two avenues to make progress on this topic.

On the private side, European banks could work together to reduce transaction costs and delays in Europe.

On the public side, we could work on a public digital currency issued by central banks. I already talked to Mario Draghi and Christine Lagarde to explain this proposal. And I will propose at the IMF and World Bank annual meetings in October to start thinking about creating such a public digital currency. That's the right way to address this issue, the wrong way is Libra.

Finally – we should strengthen European financial independence

Europe should of course be an open market, where international investors seek opportunities and develop their businesses. But it should also be able to exert its autonomy of decision, especially in times of crises and turmoil. We therefore need large financial groups that are able to compete internationally and weather future macro-economic turmoil.

That's why we need to be careful, when transposing the latest Basel 3 package, not to weaken our banking sectors in comparison with non EU players. We need to assess the effects of Basel 3 on their businesses and on the good financing of the EU economy. I don't want Basel 3 to weaken our banks to the single profit of American banks. It's not a matter of technicality, it's a matter of politics.

Second, we need appropriate mechanisms to deal with non EU financial players. Recent political developments have demonstrated that relationship with third countries is becoming a crucial topic in that respect.

→ ***Third-country equivalence regimes are effective tools. But we should review them to make sure that all existing equivalence regimes provide for the same level of investor and consumer protection. This would be proposal number 6.***

When designing these regimes, we need to strike the right balance between open markets and the protection of our legal sovereignty. We have been too swift in opening our markets and too shy in protecting our legal sovereignty. This is true for finance, this is true for many other European issues.

Identifying our priorities for the years to come is of paramount importance. And France is determined to take an active part in this collective work.

That is why, together with my Dutch and German colleagues, we took the initiative to kickstart an expert group on financial services – in charge of putting forward very concrete implementation measures. I thank Fabrice Demarigny for all the work already done.

We urgently need to make the Capital Markets Union a reality for EU citizens and companies.

→ ***My last proposal would be to change its name: nobody in the EU understands what Capital Markets Union means. We should explain to citizens that the Capital Markets Union is not only in the interest of private companies, but also in their interest, for their savings. We should make it a much more concrete, tangible political object. That is why I propose to rename the Capital Market Union to a "Savings and Investment Union".***

I'm looking forward to work in the coming weeks and months with the new EU Commission, Finnish Presidency and all stakeholders to bring to life this new Savings and Investment Union to the benefit of our citizens, our businesses and our sovereignty.

Thank you. ■

Dietrich Domanski

Secretary General,
Financial Stability Board

Three priorities for international regulatory and supervisory cooperation

Ladies and Gentlemen,

Looking back over the past decade, the G20 reforms coordinated by the FSB have made the core of the financial system safer and simpler. Global systemically important banks now hold €1.2 trillion more capital than in 2011[1]. OTC derivatives markets are more transparent and better collateralised. Almost three quarters of USD and EUR interest rate contracts are now being cleared via central counterparties[2]. Importantly, greater resilience has been achieved without negatively impacting the overall supply of credit to the real economy, defying concerns raised when the reforms were announced.

The FSB is pivoting from post-crisis policy design to reinforcing the resilience of the global financial system. This pivot reflects evolving priorities for international regulatory and supervisory cooperation. Today, I would like to discuss three such priorities that could be summarised as the three "I-s": implementation, integration and innovation.

Implementation

The full, timely and consistent implementation of the agreed reforms is a precondition for achieving the intended levels of financial resilience. It is too early to declare the job done. The FSB's annual report[3] to G20 Leaders shows that implementation progress remains uneven, both across reform areas and across jurisdictions. Remaining work includes: implementing the final Basel III reforms; operationalising resolution plans for cross-border banks and building effective resolution regimes for insurers and central counterparties; making OTC derivatives trade reporting more effective; and further strengthening the oversight and regulation of non- bank financial intermediation.

Ensuring resilience in all these areas is important as vulnerabilities persist and in some cases have increased further. Elevated asset values, high private and public debt, and deteriorating credit quality all pose risks. Since 2010, the share of corporate issuers with the lowest investment grade rating has risen from around 14% to 45% in Europe and from 29% to 36% in the United States[4]. There are questions about the extent of financial institutions' exposures to riskier credits, including leveraged loans, but also through collateralised loan obligations (CLOs). While CLO structures appear more robust now than pre-crisis, leveraged loan credit quality has deteriorated over the past few years and it remains unclear whether CLO prices are aligned with risk.

Limited fiscal and monetary policy space increases the risk that authorities have fewer tools that 10 years ago to deal with shocks to the financial system. And an end to the period of very low interest rates and search for yield seems out of sight. This heightens the importance of effective supervision that includes a macroprudential perspective. Given this backdrop, it is important that quick, analytically robust, assessments of risks can be shared by authorities and where necessary acted on. The FSB is currently reviewing its surveillance framework to ensure that it can provide such assessments.

Integration

A second priority is to preserve the benefits of integrated financial markets, including in terms of financial stability. G20 Leaders recognised the economic benefits of an open, integrated financial system early on, and the post-crisis reforms were designed to foster integration. Promoting integration is an ongoing task as markets evolve and regulatory reform is moving on to implementation and evaluation. It is against this backdrop that the FSB embarked on work on market fragmentation, and published a report on the topic in June[5].

The relationship between market fragmentation and financial regulation is complex. Some types of market fragmentation can be seen as a by-product of measures to improve domestic resilience. In places, such fragmentation can have a positive effect on financial stability, for instance by reducing the transmission of economic shocks between jurisdictions. But there may be instances of 'unintended' fragmentation, potentially with adverse consequences for financial stability, through limiting opportunities for cross-border diversification and risk management, impairing market liquidity or preventing capital and liquidity from being channelled to where it is needed in periods of stress.

The challenge is to identify and address harmful fragmentation. Recognising this challenge, the FSB report lays out approaches and mechanisms that may enhance the effectiveness and efficiency of international cooperation, and help to mitigate any negative effects of market fragmentation on financial stability. This includes steps to consider issues around market fragmentation at different stages: as policies are developed; as they are implemented; and when they are being evaluated.

That the G20 Leaders welcomed the FSB's work on market fragmentation and committed to address unintended, negative effects is a strong signal about the importance of preserving integrated markets, and the important role that international cooperation plays in this

regard. Indeed, work is being taken forward on deference processes in derivatives markets; pre- positioning of capital and liquidity by international banks; and as part of the FSB's evaluation of too-big-to-fail reforms.

Innovation

The third priority concerns financial innovation. Technological innovation holds great promise for the provision of financial services, with the potential to increase market access and the range of product offerings, and lower costs to clients. Authorities need to find ways to harness the benefits of digital innovation while containing risks. This is obviously a challenge that regulation always faces. But digital innovation is special because of its pervasiveness, and potential disruptiveness. The impact of digitalisation ranges from the plumbing of regulation and supervision – regtech and suptech are the buzzwords here – to broad strategic questions concerning the approach of regulation. Let me highlight two examples.

New technologies such as distributed ledger technology could lead to a more decentralised financial system – by eliminating, or reducing the role, of intermediaries that have traditionally been involved in the provision of financial services. Decentralisation may pose challenges for financial regulatory and supervisory frameworks focused on centralised financial institutions, including question around the location of financial assets or records. More fundamentally, a more decentralised financial system may reinforce the importance of an activity-based approach to regulation, particularly where it delivers financial services that are difficult to link to specific entities and/or jurisdictions[6].

New entrants into the financial services space, including FinTech firms and large, established technology companies ('BigTech'), could materially alter the universe of financial services providers. This could in turn affect the degree of concentration and contestability in financial services, with both potential benefits and risks for financial stability. A recent example are proposals to use new types of crypto-assets for retail payment purposes on a broad, potentially global scale. In the Osaka Summit Declaration[7],G20 Leaders have called on the FSB to assess the implications of such new developments and advise on multilateral response as appropriate.

International cooperation

Let me conclude with a fourth I – international cooperation. The priorities I have discussed reinforce the case for international cooperation – because of the intrinsically global nature of key financial markets and technological innovation, and because of the potential global impact of financial instability.

For the FSB, this means completing the pivot in our work priorities that I mentioned at the beginning. It also means working with all stakeholders to understand the challenges that lie ahead, and find solutions that support sustained economic growth and financial stability.

Thank you for your attention. ■

The views expressed in this speech are those of the speaker and do not necessarily reflect those of the FSB or its members.

[1] Basel Committee on Banking Supervision, Basel III Monitoring Report, March 2019.

[2] Bank for International Settlements, OTC derivatives statistics at end-December 2018, May 2019.

[3] Financial Stability Board, Progress in implementation of G20 financial regulatory reforms, June 2019.

[4] Bank for International Settlements, Quarterly Review, March 2019.

[5] FSB, FSB Report on Market Fragmentation, June 2019.

[6] Financial Stability Board, Decentralised financial technologies: Report on financial stability, regulatory and governance implications, June 2019.

[7] G20, G20 Osaka Leaders' Declaration, June 2019.

Hester M. Peirce

Commissioner, U.S. Securities and Exchange Commission

Braided bread and boiled beer

Thank you for the opportunity to address you today. It is a particular pleasure for me to be here in Helsinki as I have Finnish ancestry. My grandmother's parents made their way from Finland to the United States and eventually settled in Fitchburg, Massachusetts, a community that was home to many other Finns who also had made the journey. My father has a lot of wonderful stories from this part of the family, and I still regularly make braided Finnish coffee bread from a family recipe. That bread features cardamom seed, something I am able to buy in my local Indian grocery store. It must have been harder to come by that southern Indian spice at the time that my ancestors were baking here in Finland.

Thus, as I braid the Finnish bread, I can revel in the richness brought to our lives by the amazing way our markets are similarly braided together across national borders. The value of this interconnection is an important lesson for us to bear in mind as we talk about financial markets and how to regulate them. Financial markets, including derivatives markets, play a central role in uniting the global marketplace. Before I go any further, I must give my standard disclaimer: the views I express are my own and do not necessarily reflect the views of the U.S. Securities and Exchange Commission or my fellow Commissioners.

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 financial marketplace.

There are a number of things regulatory caretakers of the global derivatives markets can do. First, we should recognize appropriate jurisdictional limitations. We all make choices about how to protect investors and other market participants in transactions that occur within our 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 within its limited jurisdiction, the consequences will be less severe than they would have been if a single regulatory approach governed everyone everywhere.

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[1]". In other instances, fragmentation is a result of seemingly small regulatory differences that seem not to have any obvious justification. For example, in a recent white paper, ISDA pointed to different data and reporting requirements as a source of fragmentatioon[2].

In some cases, regulators have built unnecessary barriers to their own markets by dismissing the approaches taken by their fellow regulators as inadequate. The preference for one's own approach and suspicion of the approaches taken by others is not unique to our area of financial regulation. I am reminded again of my Finnish family. My father remembers the smell of beer as it simmered on the stove in his grandparents' house; his great aunt preferred her beer warm, perhaps a habit carried over from Finland. I am not a beer drinker, but a frequent response when I tell others of my great great aunt's preference for warm beer is "That's just wrong!" Maybe it is wrong for some people, but it seemed to work for her. We should be wary of our own tendency to condemn other regulators' approaches as "just wrong" simply because they do not suit our own preferences. As long as nobody is forcing you to drink warm beer, you should not worry about the fact that someone else is not drinking her beer at your preferred temperature.

I understand that Mr. Himino of the JFSA touched on these themes in his panel remarks on Wednesday[3], and I wholeheartedly endorse his insistence that we confront and address unintended negative consequences of difference in our regulations. Avoiding fragmentation both domestically and abroad is one theme that is guiding our efforts at the SEC as we finalize the framework for security-based swaps. In the United States, regulatory authority over the derivatives markets resides at multiple regulators, including the SEC, Commodity Futures Trading Commission, and the banking regulators. The SEC—with the benefit of the insights of the CFTC, including Commissioner Brian Quintenz from whom you heard earlier this week—recently finalized our rules on capital, margin, and segregation for security-based swap dealers[4]. I expect that we will soon release final rules on security-based swap dealer recordkeeping

and reporting. We also are working on finalizing some changes to and guidance for our cross-border rules with the help of comments we received on a proposal that came out earlier this year[5].These changes are designed to allow firms to serve clients effectively across borders without compromising investor and market protection. At the same time, we are trying to be more sensitive to the potential distortions that can arise when we impose requirements on transactions that technically occur within our borders but involve two counterparties outside those borders.

In all of these rulemakings, we have worked closely with the CFTC to harmonize our rules, and where harmonization is not possible, to reduce the differences. We are now entering another stage in our implementation process, a stage where it is important for us to work, and to work efficiently and diligently, with our international regulatory counterparts. Once the two remaining pieces of our rulebook that I just described are finalized, the clock for registration will begin running. Depending on when we complete these rules, security-based swap dealers may be required to register with us as early as the second half of 2021. To help firms make decisions about registration and about how to structure their businesses, it is critical that we provide clarity to firms as soon as possible whether substituted compliance will be available and, if so, for what requirements. Accordingly, when the Commission proposed its cross-border amendments in May of this year, we announced that we were inviting our counterparts to talk with us as soon as possible about substituted compliance for one or more of our rules[6].

We are eager to hear about what kind of relief firms will need. As we begin this process, I want to assure other regulators that I will be advocating for an approach to substituted compliance that respects both our different approaches and our shared objectives. 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 our regulatory counterparts can strengthen our respective regulatory frameworks and our markets, as it not only lowers burdens for the firms we regulate but also allows each of us to focus our limited supervision, examination, and enforcement resources on the firms that are most active in our markets. I hope that the SEC can play an important role in proving that a technical, outcomes-based, non-political approach to these determinations can work in these markets.

I am not saying that the work will be easy, which is why we have already begun and must work diligently. We may receive requests from several jurisdictions, and conducting the legal analysis to make a comparability determination will take time and staff resources. Our staff will have to understand other jurisdictions' regulatory objectives, legal requirements, and approaches to examination and enforcement. Preparing these applications will take time, and it will take time for us to review them. We also will need to enter into a memorandum of understanding with each jurisdiction that receives a comparability determination. I am optimistic that the SEC staff will be able to complete this work quickly; indeed, conversations are already underway. If you have not yet reached out to us, now is the time to do so. Time is of the essence.

Shared concern for global derivatives markets serves not only to help those markets function well, but to deepen cross-border relationships. 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 facilitating, not undermining, the broader economy. I thank you for the chance to be here with you in Europe and welcome those of you who find your way to the United States to stop by for a visit. I might even serve you some braided Finnish bread, but, rest assured, I will not be serving boiled beer. ■

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[1] Int'l Org. Of Securities Comm'ns, Market Fragmentation & Cross-border Regulation app. A (Case Study 1: OTC Derivatives Trading (Prepared by the U.S. CFTC)) (2019) available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD629.pdf.

[2] See Int'l Swaps and Derivatives Ass'n: Regulatory Driven Market Fragmentation (Jan. 30, 2019), available at https://www.sec.gov/info/accountants/ocafaqaudind080607.htm.

[3] Ryozo Himino, Vice Minister for Int'l Affairs, Fin. Serv. Agency of Japan, Exchange of Views: Can Global Cooperation on Financial Services be Deepened in the Foreseeable Future?, Eurofi Financial Forum 2019 (Sep. 11, 2019).

[4] See Capital, Margin, and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital and Segregation Requirements for Broker-Dealers, 84 Fed. Reg. 43872 (Aug. 22, 2019), https://www.sec.gov/rules/final/2019/34-86175.pdf.

[5] See Proposed Rule Amendments and Guidance Addressing Cross-Border Application of Certain Security-Based Swap Requirements, SEC Release No. 34-85823 (May 10, 2019), https://www.sec.gov/rules/proposed/2019/34-85823.pdf.

[6] See generally Press Release, U.S. Securities and Exchange Comm'n, SEC Proposes Actions to Improve Cross-Border Application of Security-Based Swap Requirements (May 10, 2019), available at https://www.sec.gov/news/press-release/2019-69.

Liange Liu

Chairman, Bank of China

Views from an Asian bank on the role of the financial sector in fostering innovation and economic growth

Thank you very much, Secretary General. Thank you for your invitation and giving me this opportunity to address this distinguished audience.

Distinguished guests, ladies and gentlemen, dear friends, I am very pleased to come to the land of a thousand lakes. It is a great honour for me to address the very distinguished guests at this forum. Since China adopted reform and opening policies more than 40 years ago, China's annual real gross domestic product (GDP) growth rate has been 9.5% on average. More noticeably, however, despite the fact that the world is struggling with the legacy of the financial crisis, a weak recovery, unilateralism and protectionism after 2008, China has maintained medium and high growth.

Sustainable development has taken place in China. Such development is underscored by the transformation from quantity to quality. China has proposed new development concepts featuring innovation, coordination, green development, openness and sharing. This is China's solution to addressing our immediate challenges, to provide new development momentum and to strengthen the foundation for future growth. As the mainstay of the country's financial industry, the Chinese banking community has been fulfilling China's new concepts and has played an active role in fostering innovation and sustainable development.

Taking this opportunity, I would like to share some of my views on how banks in China are fulfilling their roles. First, Chinese banks are committed supporters of innovation and new industries. With an increasingly ageing population and a drop in saving ratios, the Chinese economy can no longer rely on the supply of labour and capital so much as it did in previous decades. Innovation is becoming the number one driving force. Chinese banks have responded well to these new circumstances by steering in more resources to new, innovation-intensive sectors such as high-end manufacturing, renewable energy and internet-based technologies.

In the first half of this year, loans given to the technology and information industry by Chinese banks grew by more than 15% in total over the same period last year. For banks to be a true facilitator to technology companies, especially start-up companies, it is not just about granting loans. At Bank of China, we recognise that start-up technology companies have different financial needs during different stages of their lifecycle. We have combined loans with more sophisticated tools, such as equities and bonds. This new service approach has covered more than 4,700 technology companies and generated a loan book worth more than 56 billion Chinese yuan.

At Bank of China we are preparing ourselves for a digitalised future. In such a future, people will travel more frequently across country borders, officials will need to govern a more complex public system, the older generation will want to enjoy their post-retirement life better, and our transportation system will carry people around more quickly and comfortably. These are all strong scenarios and we, as bankers in China, need to design a fully-fledged financial ecosystem for each of them, promoting the digitalisation of relevant sectors.

Second, Chinese banks are committed explorers into a green economy. Green development has become a global consensus. The 2015 Paris Agreement marked a new chapter in pursuing a low carbon future. Chinese lawmakers rooted the building of an ecological civilisation into the constitution in 2018. The fight against environmental pollution is high on the government agenda. Chinese banks are playing their part. In 2018, nine Chinese banks joined a total of 27 institutions globally in endorsing China's green investment principles of Belt and Road. As of the end of 2018, green loans granted by the Chinese banking sector reached more than 10 trillion Chinese yuan in total. The total balance of green bonds issued was over 660 billion Chinese yuan.

To promote a green economy, Bank of China has developed its own green finance development plan. We have said we will step up our support to industries related to clean energy, environmentally friendly transportation and pollution containment. We have issued five tranches of bonds and sustainable development bonds amounting to US$6.4 billion in total. We have also engaged our European partners in our shared green agenda. Last June, in our capacity as the Chinese chair of the China-France Business Council, we hosted major enterprises from the two countries for a roundtable discussion focusing on how to enhance the Chinese partnership and green development with French and European business communities.

Third, Chinese banks are committed sponsors of inclusive finance. While the Chinese economy is getting bigger, its benefits are not distributed fairly, and the income gap remains a major challenge. Chinese banks have, in recent years, devoted significant resources to the promotion of inclusive finance. All the major banks have each set up a dedicated department for enhancing the coverage and depth of their inclusive financial services. As of the end of June this year, the Chinese banking network covers over 96% of rural towns and villages in China. Loans provided for small and micro businesses reached

35.6 trillion Chinese yuan in total, and the amount continues to grow rapidly.

Taking Bank of China as an example, we own the largest rural banking group in China, with a focus on supporting small and micro business at the country level, and making financial services available to rural areas, agriculture and farmers. In the first half of this year, Bank of China inclusive financing grew at the rate of 27%. Meanwhile, Bank of China is the first in China to have introduced small and medium-sized enterprise (SME) matchmaking services. We have hosted 55 crossborder matchmaking events over the past five years, covering 30,000 companies from nearly 90 counties. We helped those SMEs not only to find their business partners but also to find their place in the global industrial value and capital chain.

Fourth, Chinese banks are committed advocates of a further opening up of countries. The opening up of the Chinese financial industry sets the benchmark for how far China can go in opening up other key industries. Significant progress has been made over recent years with the introduction of several Stock Connect programmes, such as the one that links Shanghai and London as well as Shanghai and Hong Kong, with Chinese A shares being included in major indices such as the FTSE Russell Global Equity Index.

As market access restrictions are lifted or relaxed, an increasingly large number of foreign banks, security forums and insurance companies are accelerating their pace in China. As of April of this year, there were 982 foreign-owned banking institutions operating in China with combined assets of 3.5 trillion Chinese yuan – a size 10 times bigger than that in 2001 when China gained accession to the World Trade Organization (WTO).

Among the Chinese banking community, Bank of China is the bank that goes furthest in connecting China with the rest of the world. Our overseas network now covers 57 countries and regions. We have been appointed as the renminbi (RMB) clearing bank in 12 markets out of a total 26 mandates granted by the Chinese central bank. We clear RMB payments and RMB trade transactions on a scale that is bigger than any other bank in the world.

In addition, Bank of China is the chair of the China Chamber of Commerce to the EU, and chair of both the China-France Business Council and the China-Italy Business Forum. We are also the banking partner of China International Import Expo and the world's only bank that has been appointed as the official banking partner for both the Summer and Winter Olympic Games. In all these roles, Bank of China has built itself into a strong facilitator for Chinese companies to go abroad and for overseas enterprises to come to China to make investments and conduct business.

Fifth, Chinese banks are committed facilitators to coordinating development. Over the past few years, China has taken a series of initiatives to foster greater economic coordination, such as ones that promote the prosperity of Belt and Road, the integration of the Yangtze River Delta Economic Zone and the development of the Guangdong-Hong Kong-Macau Greater Bay Area. In these gritty moves, Chinese banks are getting involved and seizing opportunities internationally. Bank of China is committed to providing financial services to countries and regions along the Belt and Road. So far we have followed more than 600 projects around the Belt and Road routes and extended credit facilities exceeding US$140 billion. Meanwhile, we are encouraging partners in interested countries to join our complementary streams to explore third-party markets.

Domestically, to support the next wave of China's development, Bank of China is currently building regional headquarters in Shanghai to put the city's status firmly as a rising international financial centre. We will let the Shanghai headquarters become a hub of some of our core business, such as RMB fixed income, currencies and commodities (FICC), financial-market infrastructure, services and RMB crossborder clearing.

Sixth, banks in China are committed guards against risks in banking. To control risk effectively is a vital factor defining a country's financial competitiveness. While pursuing the new development approach, Chinese banks are getting themselves more in line with international standards for risk management, including the implementation of rules under Basel III and reaching rapidly requirements related to capital adequacy, liquidity levels, credit risk, market risk and operational risk. To ensure the industry's long-term health development, measures have been taken to fix previous loopholes in shadow banking, corporate governance, B2B lending and wealth management products.

During the course of fostering innovation and sustainable development, the Chinese banking sector is also growing bigger and stronger. By the end of 2018, China had developed a banking system that includes over 4,500 names. Total banking assets have reached 268 trillion Chinese yuan. Four Chinese banks were recognised as global systemically important banks (GSIBs). In terms of Tier I capital, 136 Chinese banks are among the world's 1,000 largest banks. Chinese banks have become an integral part of the global banking community and are playing their part in promoting the development of the global financial industry in the future and in further implementing China's new development approach. Bank of China will continue to work together with our European peers and friends, act as a bridge to promote China-Europe economic and financial exchanges, and make our contribution to sustainable development both in China and in Europe.

Thank you for your attention. I wish the forum the utmost success. Thank you very much. ■

Pål Erik Sjåtil

Managing Partner, Europe,
McKinsey & Company

Which economic and financial priorities for fostering growth and innovation in the EU?

Distinguished guests, it is an honour to stand in front of you and talk about such an important topic: digital innovation in Europe. For the next 10 minutes I will try to share some facts to summarise where we stand and also share with you a few actions or priorities that Europe perhaps should consider. I would also say that it is fitting to do this in Helsinki, because Finland is the country that gave us the Global System for Mobile Communications (GSM), 5G and the Linux operating system. Not long ago, this city hosted what was then the fifth-largest company in the world by market cap. More importantly, the Symbian operating system had, at that time, almost 70% market share and was effectively the platform for mobile technology. We also know that, today, those platforms are with Google through Android and with Apple through iOS. Nevertheless, Helsinki has stayed an innovation hub in mobile technology and is today a leader in mobility as a service, as one example.

My background is that I serve companies – not only tech companies but also other institutions – on how they aspire to digitise, apply new technologies and so forth. Even if it is easy to be very negative – and we have already heard some remarks on how Europe is falling behind – I would also like to stress that these companies are working very hard and are all very ambitious in terms of how they try to do their things to digitise and apply these innovations. Europe has some strengths to build on.

In respect to financial markets, Europe is where digital innovations in the B2C banking system are being applied the most. The Nordics are clearly a leader in terms of a cashless society. Comparing the UK to the US, 50% of sales in banking today in the UK are digital compared to 20% in the US. The UK has launched open banking. It is still early days but other countries are copying this. In many B2B verticals, Europe is still the beacon of innovation, particularly in areas such as manufacturing. If you look at how AI is being deployed in robotics, for example, Europe is still clearly one of the leaders.

We also have talent. Europe has almost six million software developers – one million more than the US. We have many of the leading educational institutions in the world in the areas of science. Looking at the start-up scene, European start-ups are being financed much more than just a few years ago. Early-stage financing in the tech world is up almost 400% compared to just five years ago. In the AI space the number of small start-ups in Europe is relatively comparable to the US. It is easy to be negative when you have these conversations and I will share a few facts for why I also think that Europe has some catching up to do. It is important, however, that we do not forget that we still have many things to build on as we implement this catch-up.

Why then do we still risk falling behind? One thing is that, while Europe has many start-ups, in terms of the scaling of these start-ups and in terms of the larger, leading companies, the picture is, of course, very different. Europe only has 10% of unicorns while the US has more than 50%. In terms of top global AI companies, Europe only has four of the top 100 while the US has three quarters. In terms of the total venture capital (VC) funding that goes into AI, Europe attracts only 11% while the US attracts almost 40% and China 50% of total funding.

I started talking about platforms. As we all know, platforms are becoming extremely important. If we look at the key B2C platforms in tech, whether it is search, entertainment or social media, or B2B platforms such as the cloud, these platforms are no longer hosted in Europe but in the US or China through companies like Apple, Google, Alibaba and Tencent. The combined market cap of the 5 largest tech companies in the US right now is 10-times larger than the combined market cap of those in Europe.

You could then ask: why does it matter? I think it matters greatly in areas like R&D, because these companies are merciless in spending on R&D, which is hard for European companies to match. Acquisitions are another example. Google has made 300 acquisitions of start-ups – some small as well as some large – over the last five years. No European company can match that as it is now. US tech companies also pay much higher wages, quite frankly, than European ones, which means that they also attract much of the talent that we would like to drive start-ups here in Europe. Immigration is one lever. Interestingly, in the US, more than half of the privately-held unicorns were founded or co-founded by someone who was not born or raised in the US.

We have also studied digital in terms of incumbents, not just in start-ups or younger industries. We did a survey of 1,600 executives in Europe, the US and China, just to compare what they are spending on digital innovation. While I said that European companies are working hard and investing a lot, the US still invests, on average, approximately 30% more to digitise and deploy frontier technologies in their companies.

I genuinely believe that, for Europe not just to maintain but also increase its growth, we need to shift gear on digital innovation. McKinsey likes to model

things, and we have even tried to model what we believe might be the effect of AI if we were to diffuse this with success in the economy. Our estimates show that Europe could add €2.7 trillion to its gross domestic product (GDP) by 2030 if it were to successfully deploy AI through productivity improvements. This is approximately 20% additional growth to GDP, which is, quite frankly, massive.

Let me then share some actions or priorities. The first point that I will talk about is scaling. As I mentioned, we have as many start-ups, if we look at the really small ones. In terms of seed investing over the last 12 months in Europe, our number is comparable to the US. However, we have a challenge when it comes to scaling and creating future platforms. It might sound like an easy solution but I believe that allowing for more consolidation is an important lever.

Taking the banking landscape today, the top five banks in the US have a market cap that is three-times higher than the top five in Europe. Even more important is the telecom-operator landscape. Operators are very important because they are the ones that create the standards on which many of these innovations can take place. In the US, there are now, effectively, six operators, but the two largest ones hold an almost 60% market share. If you do innovation in the US, you will deal with two carriers. I might be insulting T-Mobile by saying that they have 17% market share, but you deal with three carriers: AT&T, Verizon and, to some extent, T-Mobile. In Europe, there are more than 100 operators. Even though they are not all large, and the 12 largest in Western Europe hold the same amount of market share as the top 3 in the US, it is still a much more fragmented landscape and it does not make it easier for these digital companies – either incumbents or start-ups – to scale.

The second point is late-stage VC funding or growth investing. I do not have a good explanation for this; most likely some of you know more about financial markets than I do. In terms of late-stage VC funding, however, the US attracts roughly six-times more than Europe, so there is something around how the scaling takes place, as well as the funding of that scaling, which is very different in Europe and the US.

The third point that I would like to stress is perhaps a soft thing but still very important. It is not easy to scale. We invited the CEO of Zalando to one of our meetings to talk about how they achieved this. What they argued was that the biggest hurdle to their success in terms of scaling in the way they have done across Europe was finding managers able to do it. There are very few managers in Europe who know what it takes to scale, and to scale at the pace that is often required to win in these markets. Their solution to it was to bring people back from North America. They brought managers back from the US who had done this with other institutions. It is not something that we can solve by regulation, but it is something that you should keep in mind. It is not easy to do this. It is damn hard, and it is often more convenient, quite frankly, to lower the ambition slightly and to not grow as quickly.

For Europe, we have a real chance as the B2B verticals are now going to be disrupted, as we have seen in B2C. Many of these verticals are European strongholds. These are verticals where we have the leading companies that are often global niche players that absolutely dominate. As these are now being disrupted, it is a massive opportunity for Europe. We could own and really hold some of these platforms. It is, however, also a threat. Some from the US and China are deploying new technologies into these verticals at a pace that we do not see to the same extent across these verticals in Europe.

A point that has already been addressed is continuing to accelerate the Digital Single Market, which was launched in 2015. This is a fantastic initiative that will help start-ups as well as incumbent companies as they digitise. I still think that there is a way to go. Again, when you meet executives, this is one of their asks whenever you have a discussion with them, so I encourage all of you to see what you can do for this to work more efficiently.

While I do not know how much you can solve by regulation, you can be an enabler because you can simplify the interfaces and create application programming interfaces (APIs) between these hubs. That is about making sure that we have a more integrated ecosystem in Europe between these very strong hubs. I would not advocate for having just one or two hubs in Europe. One of the strengths of Europe is that we are rather decentralised. We have already developed several very strong tech and innovation hubs, but I do not think we have a sufficiently strong ecosystem between them. This goes back again to scaling as well as making sure that talent and technology are deployed quickly enough and where it has the highest return.

There are a couple of governmental areas. One is on talent. When you ask executives about what is holding them back from deploying AI, for instance, the number one thing that they raise is capability: they just do not have enough talent. How we are going to not only repurpose our education system but also address reskilling our workers is, of course, going to be a massive point. This is a challenge not only for Europe but everywhere.

Lastly, we should not underestimate what all of this does to society. I am based in Paris, so I have experienced the Yellow Vests first-hand outside of my apartment for almost half a year. Particularly in Europe, you could argue that inequality is not as high as it is in some other parts of the world. We have a social contract and quite well-functioning welfare states. I still believe that, as we deploy all these new technologies, it is important that we address our welfare and education systems while also holding businesses responsible for making sure that we bring everybody along and that there is not too much tension in society; otherwise, it will be very hard to deliver on this innovation ambition.

Let me conclude by saying that I believe that Europe can do this. We have always proven to be early adopters of new technologies, both as consumers and as businesses. However, I do think that it will take an ambitious approach. To succeed in this, Europe will have to play offence rather than defence. We need to spend as much time talking about what our strengths are as we do this and not just about where we have gaps. It requires cross-functional cooperation. Neither businesses, governments nor regulators can do this alone. It is very important that there is a joint vision and ambition for how we are going to achieve this.
That was my last word. ■


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EXCHANGES OF VIEWS

Risk sharing in EMU

Nadia Calviño - Minister of Economy and Business, Spain - **Pierre Gramegna** - Minister of Finance, Luxembourg - **Vilius Šapoka** - Minister of Finance of the Republic of Lithuania - **Klaus Regling** - Managing Director, ESM

1. While risk sharing is essential for the resilience of a monetary union, it remains limited in the euro area

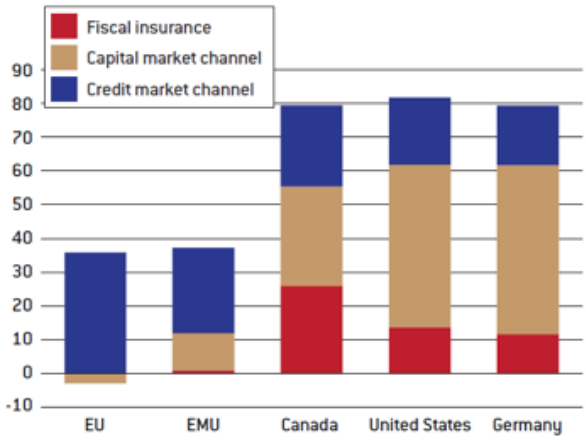
1.1. Risk sharing remains limited in the euro area

The Chair welcomed and introduced the panel and reminded them that the degree of risk sharing in the monetary union is less than half of that in the United States or within large economies like Germany or France. The reasons are clear: financial markets are fragmented in Europe along national borders, therefore there is not much private risk sharing. In Europe there is not a common tax system or a common social security system that leads automatically to fiscal risk sharing as in the US, but also within France or each Member State.

It is instructive to look at the following chart. The higher risk sharing in the United States has the result that the regions stay together. There can be different business cycles in different regions, but the common tax and social security systems help to keep it together, and there is obviously one unified capital market. The argument is not to become like the United States but to develop mechanisms that provide more risk sharing.

Today it is more difficult to deal with asymmetric shocks in the Euro area, and when business cycles in some countries in Europe deviate from cycles in other countries, markets and fiscal channels do not help much to align these cycles. Therefore, more public and private risk sharing would be useful taking into account that the more private risk-sharing is achieved via markets, the less public risk sharing is needed via fiscal channels.

Risk Sharing (% of shock smoothed by different channels)



Source: IMF (2013), Bruegel (2015)

1.2. Risk sharing is essential in a monetary union...

A minister stressed that risk sharing in a monetary union is unavoidable. The main lesson from the EU sovereign debt crisis is that everyone is in the same boat and risk is shared amongst themselves.

According to another minister, there is no doubt, in any case, that risk sharing is a very important element. It creates confidence, not only for the government and the public, but also for potential investors, and the euro area should go forward.

1.3. ...Even if comparaison n'est pas raison

A minister noted that European monetary union is compared with national countries. Obviously, comparaison n'est pas raison. More solidarity is wanted.

It can be called stabilisation or whatever people want. Luxembourg is ready for more solidarity. However, it would be difficult at any time to achieve the same kind of solidarity that you have in a country that is united and has one system, but ambition to deepen the EMU is required.

It is crucial to remember that the common currency is a true European success story and public support for the euro is at a record high. The Economic and Monetary Union (EMU) has worked extremely well over the last 10 years. The Banking Union does not exist anywhere else in the world. Their first EU meeting was in December 2013, when it was agreed to create the Banking Union. The next day the newspapers and media were not positive, in the sense that they said it would never be delivered on. It has been delivered, for the most part. It has gone further in the last couple of years. It has now been agreed to give a bigger role to the European Stability Mechanism and a common budgetary instrument for convergence and competitiveness is under discussion. Much progress has been made. But if the starting point is the maximum, saying what the United States does and what Japan does in its own country, and it is compared it to what the EU does together, that comparison is a little bit biased.

1.4. Going beyond the sterile "risk reduction – risk sharing discussion"

A minister stated that the discussions at the eurozone level should go beyond the debate on "risk reduction – risk sharing". This kind of discussion has been extremely divisive. When discussing the completion of the Banking Union or a fiscal instrument, it is risk reduction that is actually being discussed, along with stabilisation within the monetary union, and reducing the depth and the price of crisis. Addressing the fragmented financing sector or a fiscal capacity would make the monetary union more robust.

2. A macroeconomic stabilization function would make the euro area stronger

A minister noted that there are several proposals for a macroeconomic function on the table. Implementing in all parts of the EU domestic structural reforms is the right starting point to deepen the Economic and Monetary Union (EMU). A euro area budget with permanent transfers is not necessarily needed. Indeed, a reinsurance of national unemployment systems or an investment stabilisation fund are possible and adequate ways forward. An effective Banking Union which notably requires the implementation of a European deposit insurance scheme (EDIS) would also certainly be a stabilising element for monetary union and would reduce risks in the euro area.

2.1. There are several proposals on the table for a macroeconomic function

The Chair noted that there are several proposals on the table to better deal with asymmetric shocks hitting one country or synchronize national business cycles in the euro area. One is a reinsurance of national unemployment systems, which is also found in the US and which is supported by the German and Spanish finance ministers. If it is designed correctly, it will not lead to permanent transfers. There are other proposals from the Commission, like a stabilisation instrument for investment. There is also a rainy-day fund, which is something the International Monetary Fund (IMF) proposed; or shorter term European Stability Mechanism (ESM) facilities. All of these are possible without additional permanent transfers. They sound like very different schemes, but they all have the same economic objective of helping a country in monetary union that is exposed to an asymmetric shock. Furthermore, the financial sector through an effective Banking and Capital Market Union would be a stabilising element and would reduce risks in the euro area.

The EU budget is not the appropriate instrument for an effective macro- economic stabilization function

The Chair felt that the EU budget is often not given the right weight. The EU budget is important for convergence, but that does not mean macroeconomic stabilisation; that would require a new instrument, such as the instruments just mentioned. There is not an overlap there. The amount of money that is channelled through the EU budget should not be forgotten. But this is a seven-year budget plan, which already indicates it cannot react very quickly to new asymmetric shocks or deviations in the cycle.

2.2. Implementing in all parts of the EU domestic structural reforms is the right starting point

A minister explained that the elephant in the room is that it is not a problem about risk sharing. The biggest problem is that there are different levels of risk. Of course, in an economic and monetary union there is a mixture of fiscal and monetary policies. There is a homogenous monetary policy, and it requires more flexibility from national fiscal policies. This is not an easy task, because governments, presidents, and parliaments have different views on taxation and expenditure. The sustainability of public finances is crucial for the sustainability of the euro area. It is vital therefore that the Stability and Growth Pact rules should be respected.

At the end of the day, the best insurance policy is to proceed with structural reforms inside member states. These reforms cannot be done from the outside (or from Brussels). It is a question of national ownership. Therefore, politicians should also do their jobs at home, and then it is far easier to find a consensus on possible ways forward to deepen the EMU.

Another minister noted that, looking forward, it is essential to continue 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 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 ensuring 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.

The Chair noted that the panel agrees on national policies. Appropriate domestic fiscal policies and structural reforms are the basis. Having fiscal buffers at the national level is the starting point, but it is right to think about what can be added from the European dimension.

2.3. A budget with a federal tax system is not realistic and the macroeconomic stabilization function should be designed so that there are no permanent transfers

A minister noted that a federal tax system as in the US is not realistic. However, making progress on taxation will be one of the key elements of the agenda

of the next Commission, because the differences are so wide, and it inhibits free movement of capital and free movement of services. Cracks are starting to be noticed in the system with the digital giants. More of this will be seen in the coming years, but it is not exactly a monetary union issue; it is also an EU issue, but even more so for the monetary union.

Progress is needed on the fiscal stabilisation side. This is a very political issue, but the question is how it can be calculated. The system should be designed so there are no permanent transfers. Ça va de soi but that cannot really be written down, because the cycle is going to be so heterogeneous in the different countries.

2.4. Risk sharing, through a reinsurance for national unemployment systems, is one way forward

A minister stated that, in the case in Spain, what has been put forward is a reinsurance mechanism for unemployment – as exists in the US – which would be a very powerful tool at the eurozone level in order to reinforce national automatic stabilisers. This kind of fiscal system is not about risk sharing but, again, risk reduction, because if national crises or downturns can be made milder, it will make a more stable monetary union.

Another minister stressed that insurance is a great invention in the area of finance; if there are contributions to the pool of resources and something happens, disbursements will follow. Of course, it depends on the risk profile. The insurance premium depends on actions; for example, if a driver does not care about traffic lights or speed limits then it is very clear that the insurance premium will be very high, and the driver will think twice before even buying a car.

A minister noted that people understand such a reinsurance for national unemployment systems. People cannot understand the precautionary instruments of the ESM or the backstop to the Single Resolution Fund (SRF). There is no way to explain this to a normal citizen. However, when talking about deposit insurance or unemployment insurance people understand what Europe is about. Backstops need to be built for the people so that they understand what benefit they can get from being in a monetary union.

A minister stated that, on unemployment insurance, there is a new proposal that should be soon proposed by the Commission. The Commission has not yet put it on the table, and it has not been worked on, so it should be expected that in three months' time it will be delivered, but it should not be given up on

2.5. Defining an appropriate scheme to foster productive investment in Europe would also be an encouraging way forward

A minister emphasised the need to foster investment and productive investment in Europe. If a system or a mechanism can be devised, such as a budgetary instrument or a fund to do so, Luxembourg would support that 100%. Over the last couple of years investment has been less than prior to 2008. It is less than in the United States.

Looking at it from that angle, there would be more support in the economic and monetary union (EMU) – the 19 countries and eventually the 27 – than looking at it from an angle telling people of the need to share a risk and solidarity. It is better to say, 'Let us invest more altogether. Let us give ourselves means.'

Promoting and sustaining quality investment in key areas, such as education, skills, infrastructure and innovation, would support the growth potential of EU 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

On sustainable finance, Europe is ahead of the others in this area. Two out of the three issues that were at stake were solved in this Commission. The taxonomy needs to be finalised. On unemployment, in all fairness and also thinking of the public view, if we are telling our people at home that they have to have solidarity with the unemployment in another country, it is difficult. Even if it is emphasised that it is not permanent, it is on a transitional basis, and it is for economic cycles that are not the same, politically it is very difficult to explain. The investment side, though, is easier to explain.

On the ESM, it may be difficult to explain, but it is extraordinary what has been done and what is going to be done with it. It is the task of politicians and also journalists to explain what it is good for. It might be complicated, but this is a safety net built together, and to explain it in a precautionary manner is probably the wisest thing to do.

The Chair stated that the Spanish Government has been arguing for a reinsurance of national unemployment systems. Another government prefers thinking about investment stabilisation. These are different concepts, but they have the same economic goal.

Another minister noted that, regarding investment stabilisation, there is a proposal on the table. It is quite mature. There is a very wide consensus that this would make sense. Therefore, this should be worked on. It has been proposed to put together elements of the reform delivery tool and the investment stabilisation mechanism, and to start building on that basis a budgetary instrument. Again, it can be explained to citizens as an investment stabilisation fund, a system to ensure through the cycle, for a seven-year period, that investments will be protected. It is another very important cyclical dimension of fiscal policy. The first thing that a government cuts, whenever there is a crisis, is investment. There are a broad variety of options, and they are optimistic that progress can be made in the coming months. They should not fool citizens by saying they are addressing a problem when they are not.

The minister agreed on the need to be ambitious, but also realistic and pragmatic. That is the right approach, and it is the one being taken, with some red lines.

Let us recognize that the Budget Instrument for convergence and competitiveness currently discussed is not a fiscal capacity for stabilization

A minister noted that, on red lines, honesty is required. Nobody will believe it if this is called a fiscal capacity. Governments need to be true to their citizens and be honest in saying that it is a nametag. An instrument cannot be taken which says, 'Reform support programme', and be called a fiscal instrument on the pretence that nobody will notice it. A real stabilisation tool is needed; an instrument that can allow investment stabilisation. The European Commission had proposed it. In any case, the worst that can be done is to give people a false sense of safety, saying that it is solved and there is a tool, and then the tool does not work when the worst comes to the worst.

In any case, with a basic budgetary instrument this reinsurance mechanism for national unemployment systems, would be very powerful from two points of view. One would be to ensure that the most important fiscal stabiliser is reinforced and that a deep recession is not

entered because of that. That would be a very powerful tool because it has a very strong and stabilising effect.

2.6. EDIS is a necessity to improve private risk sharing

2.6.1. EDIS is a necessity

A minister stated that deposit insurance on the Banking Union side has been discussed for a long time and makes a lot of sense. Nobody is interested in having a run on a bank, and everyone sees what happens when there is panic in financial markets: everybody suffers. There is no upside to this. Everyone should be interested in a system which ensures that the whole financial system is more resilient. A number of options and alternatives have been proposed so as to have a common deposit insurance mechanism, and also to avoid permanent transfers. This would be basic common sense. Everybody agrees it should be done. Politically it is difficult, but this would be the most mature thing to do as it has been discussed for so long, and it is one of the pillars of the Banking Union. In principle, it has been already agreed at the leaders' level since 2012 but it is proving to be difficult to deliver.

Another minister agreed that talking about EDIS is a still missing element of the Banking Union that the public understands. It is easy to explain the need for it, and even if the level of risk is different in this respect, of course the solidarity aspect should be remembered. Even for those countries which have a very low level of risk, they also benefit from that, because nobody wants a panic in the society.

EDIS will be setup one day. This would be a final nail in the coffin of instability and fragmentation of the banking sector. Political difficulties in risk sharing are understood when the risks are not evenly distributed. However, a mutually agreeable balance could be found notably because 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. In the long term, every member of the EMU will benefit from stability, resilience and confidence that a fully-fledged Banking Union will bring. It is important to remember 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.

2.6.2. EDIS should be done

A minister stressed that EDIS should be done. It is the third pillar of banking union that has not been delivered yet. Last, but not least, there should be a more positive talk about whatever is done in Europe, be it in the monetary union or any of the things that Europe does. When the Juncker plan was launched four or five years ago there were two criticisms. One was that it was a drop of water. The other was that it would not work and would not be delivered. It has been delivered. Again, institutions like the European Investment Bank should be trusted, which is doing a wonderful job and will do a wonderful job also in green finance. There are already quite a few instruments, but people tend to linger on what would be the ideal that they do not have yet. The instruments that are there should be leveraged.

Another minister noted that a number of options have been proposed on deposit insurance and also on the unemployment insurance, so that the system does not lead to permanent transfers or structural transfers and allowing a clear roadmap. On EDIS, first of all there is a very wide consensus, so a way forward should be able to be found. Finally, turning to private risk sharing, another minister stressed that increasing equity investment in the financing structure is the key issue where the EU should do its job.

The Chair summarised that everyone should remember all the progress that has occurred since the previous crisis and the ESM has been created as a permanent institution. The monetary union is much better prepared for future crises today than it was 10 years ago. Also, there are other areas, such as the work of the EIB and the so-called Juncker plan. Everybody is confident that EDIS, or common deposit insurance, will be achieved one day, though maybe not as quickly as some would like. A great deal of work has been done on what is called the Budgetary Instrument for Convergence and Competitiveness (BICC), but it takes longer to make progress with stabilisation. The Chair thanked the panellists and the audience. ■

What toolbox is needed to deal with new emerging risks?

Dino Falaschetti - Director, OFR - **Sam Woods** - Deputy Governor, Bank of England - **Francesco Mazzaferro** - Head of the ESRB Secretariat, ECB

Francesco Mazzaferro

The Chair welcomed the attendees and introduced the panel. The topic concerns new emerging risks, of which there are many possibilities to choose from. One question is about how to interpret the extraordinary new situation where 30% of international yields are negative. BlackRock stated two days ago that the situation could continue for 30 years. Another market participant even takes the view that it could continue forever.

Another issue of great interest is the speech that Governor Carney gave in Jackson Hole, covering the idea of whether authorities should use digital currencies, whether there should be an international currency, the pros and cons of the use of a national currency for international markets and what the role is of private initiatives like Libra. Libra is possibly a player in international monetary policy, and what is thought about it should be understood.

A number of countries' authorities have undertaken initiatives to check whether the level of risk weights is of concern. In some countries institutions have been setting a floor to risk weights to try to ensure a minimum of resilience in the financial sector.

On the negative level of interest, two years ago the European Systemic Risk Board (ESRB) issued a report on the low-for-long and it was the first really discussing the medium-term implications of the low level of interest rates. To now speak of the low level of interest rates is embarrassing because there are in fact negative interest rates.

The Chair asked how to interpret and rationalise a situation in which there are so many negative interest rates around the world, and whether it is a curiosity of the period or a new normal. The Chair queried whether it raises concerns.

Dino Falaschetti

Dino Falaschetti stated that it certainly is concerning. In a macroeconomics class at the University of Chicago, Bob Lucas had insisted that there could never be negative interest rates, but now they are a reality. One concern is that there is not a lot of transparency in markets. They seem to be contradicting themselves in terms of the bond market and the equity market, and the Office of Financial Research (OFR) is trying to carry out research to identify what is the signal and what is the noise.

Sam Woods

Sam Woods noted that the obvious deduction is that the danger it creates for supervisors is the pressure it puts on firms to move up the risk curve. The loosening in terms and in price in the UK mortgage market are not alarming in themselves but are, in part, a reaction to that pressure. National catastrophe pricing on the insurance side in the London market has been hardening recently, but the longer-term trend is a perfect example, with more capital coming from non-traditional sources into things like catastrophe bonds, thereby driving down prices. Leveraged lending is the other part of this market to be worried about.

The most obvious part of the toolbox that regulators and central banks have been given is the cyclical buffer. The logic of that tool is plain. The question mark is around the various sets of indicators that have been created. There are numerous versions aiming to indicate what should be done with that part of the capital stack. The question is whether those indicators will provide what needs to be known fast enough, given the lagging nature of some of them and of the implementation period. That goes to the question of what the resting place of the counter-cyclical buffer should be. In many jurisdictions it is currently set at zero. There is a question as to whether it will be high enough before something hits if it stays at zero for long.

Francesco Mazzaferro

The Chair noted that one of the winners of the situation is the Republic of Austria with its 100-year bonds. Those who had been buying at the beginning of the year have been gaining 65%. This is a consequence of the fact of

a 100-year bond at negative interest rates. It is remarkable in terms of yield.

There is also the consumer protection aspect. If the interest rates will be negative and that becomes predominant, sooner or later there will be the question of whether it is possible for banks to pass the rates on to customers. Then there will be any number of implications, such as the business model or whether people will accept having a negative interest rate payment on bank accounts. There might be cases of banks offering mortgages at negative interest rates, which effectively means that you are paid by the bank to start a contractual relation in order to buy a house.

The Chair asked what the view of Libra is in London. The Bank of England seems to be an institution that has reflected extensively on it.

Sam Woods

Sam Woods replied that the EU should not be closed to new ideas and new technologies. Indeed, the thrust of the remarks from the first speaker at Eurofi that day were precisely the risks of doing so, of being left behind or possibly of things happening outside the EU's perimeter.

Libra has the potential to become a large and systemic payment system, and that should not be allowed to occur outside of the regulatory perimeter. It is very easy to say that, but it is much more difficult to work out what the regulatory attachment point is. The reason it is complex is that it is the Libra system, rather than a single point, that should be thought of. One of the main questions to work through is in relation to the coin and whether it is a regulated security. That also goes to the question of what the nature is of the claim a coin holder has over the Libra reserve, whether it is electronic money or a crypto-asset outside of the regulated system. All of that concerns Libra as a store of wealth.

However, the more important questions are about Libra as a means of transacting. All of this is speculation and potentially for the future, but looking at the heart of the Libra system, with the validators within the association, the exchanges, the dealers and the coin itself, common sense and the Committee on Payments and Market Infrastructures and International Organization of Securities Commissions (CPMI-IOSCO) definition both suggest that it is a payment system. However, it is a different question to ask what that means in law in the various jurisdictions.

At the edge there are also other parts of the system which already exist today. Those would likely remain outside the regulatory perimeter, although that could be debated. Those issues need to be debated urgently in order to try and agree a shared position.

Francesco Mazzaferro

The Chair noted that the US could look at Libra and consider that US society has been producing the technology and the big IT winners come from there, but, alternatively, it could note that it produces the dollar, which is the most important currency in the world, and does not want to have a private competitor. The Chair asked for Dino Falaschetti's view.

Dino Falaschetti

Dino Falaschetti confirmed that the issue is being studied very carefully in the Treasury Department. After 2008, a lot of frameworks were created to try and stem systemic risk, and even to preclude it. 2008 was not a surprise. Raghuram Rajan gave a talk at Jackson Hole in 2005 and was criticised at the time. In 2004, the Minneapolis Fed, one of the strongest research institutes in the federal reserve system, had spoken of 'too big to fail.' The President's Council of Economic Advisors in 2005, chaired by Ben Bernanke, wrote a report on the importance of financial services to not only the real economy but for households more generally. It pointed to systemic risks in the housing crisis. This was not just economics; this was at the White House. That was not an easy thing for the White House to say at the time. Ben Bernanke then went to the Fed and presided over the great recession.

Researchers and rule makers do a lot of good work but should be soberer in terms of what is known. For many briefs on systemic risks it seems that 'systemic risk' is appended after anything. In Washington, anything new is a systemic risk until proven otherwise.

Francesco Mazzaferro

The Chair asked about the micro/macro aspect of the risk weight question. There are a number of countries where the view is that there is a necessity to set a regulatory minimum from a macro side, for an instrument that is also micro.

Sam Woods

Sam Woods replied that a risk-weight-only system of the kind there was in the UK before the crisis is a thoroughly dangerous system both because the risk weights can be wrong – either for political reasons in standardised formulae, or for incentive or indeed analytical problems where those risk weights are modelled – and because even if the risk weights are right there can be a massively leveraged banking system. The basic construct that has been developed, albeit with slightly different variances in different jurisdictions, of having the two measures of leverage and risk weight, is absolutely essential.

More narrowly, there is a live debate in the UK and elsewhere about mortgage risk weights. There is a 15% floor in Finland and a 25% floor in Sweden. In the UK, modelled mortgage risk weights have dropped from 15.1% to 9.7% over about the last eight years. All of the reasons why that has occurred are eminently explicable, effectively in terms of house price increases, lowering the loss given default, and a small amount of PD as well. Notwithstanding that, it is good ask whether there is a level below at which it is just not sensible. Even if that capital is captured in the pillar 2 requirements, it can be asked whether there is some level below which pillar 1 requirements should not drop. That should be looked at further.

Francesco Mazzaferro

The Chair noted that that is not a new risk in some respects. It concerns the normal business of banks. The Chair asked Dino Falaschetti whether the regulator or the financial stability person should think about risk weights or have some distance.

Dino Falaschetti

Dino Falaschetti accepts that the question of where to set risk weights is difficult. Though he is an economist, he is sceptical about trade as well. The preference is for a leverage ratio. In the last Congress, the House Financial Services Committee created a bill which would have provided regulatory relief for a sufficiently high leverage ratio, and there was a lot of research into what would be a reasonable leverage ratio. There was really solid research-backed work coming out indicating that 30% or

20% does not curtail lending too much. Ultimately, when the politics played out, it went from 30% to 20% and then ended up at 10%. Dino Falaschetti asked Sam Woods for his opinion of a framework like that.

Sam Woods

Sam Woods confirmed that that process was followed with great interest in the UK. The idea of the potential for a simpler regime, particularly for smaller firms, in the off-ramp mechanism is interesting. There is interest in some of the risk weighting elements, though in a couple of cases there is a degree of complexity which is harder for smaller firms. He does not approve of leverage only, because it makes two firms that have very different levels of risk look the same with respect to their capital metrics, which creates strange incentives.

From a European perspective the number sounds quite good for regulators, but not for bankers. Using UK banks as an example, the combined effect of the leverage stress test hurdle and the nature of the stress test means that banks need to run at about 20-times levered. That is where the debate is settling in the UK. That is a significant degree more permissive than for the USA.

Francesco Mazzaferro

The Chair was interested in Dino Falaschetti's comment about defining anything new and not yet seen as systemic. The Chair asked how a systemic risk is defined, and at what time a risk is taken to be systemic.

Dino Falaschetti

Dino Falaschetti explained that there are a number of transmission channels. Many people talk about contagion, correlation and connectedness. As a student of Bob Lucas, and a micro-based macro type of person, it is more sensible to look at the fundamentals of what is common amongst all of those risks.

Francesco Mazzaferro

The Chair noted that there has recently been an enormous amount of geopolitical announcements and strange things happening in the world, some of which are not spoken about. By listening to radio from around the world, it is possible to hear about issues such as the very complex situation between Japan and Korea, which Europe never speaks about but which is very significant in Asia. There is a major problem between Pakistan and India. Benjamin Netanyahu's announcement that Israel could annex the territories is significant and a shock. The Chair queried how the market has managed to not explode after all of these events. It appears as if there are organised experiments every two or three weeks with something formidably new that it has never been expected could happen, but the financial markets remain resilient. The Chair asked how that should be interpreted.

Sam Woods

Sam Woods noted that the Chair did not mention Brexit. To some extent, those present are paid to be prepared for downside scenarios, and that is how to proceed. In relation to Brexit, the approach taken from almost three years ago was to get the financial system ready for no deal. That is what the Bank of England spends most of its time doing on this issue, and as best it can it has covered that. It is possible that the market has placed some confidence in aspects of that. He is unable to provide an answer for the broader picture

Dino Falaschetti

Dino Falaschetti stated that the date is 9/11. On that day, anything that was left on the ground was considered to be a bomb. The worry is that that is the perspective held in the wake of the financial crisis, and the deep research that is necessary to figure out whether there is a true systemic risk that needs to be halted immediately, or if this is superficial, is not being done. Better can be done on those margins.

Francesco Mazzaferro

The Chair wondered whether it is possible that the world is not exploding because the work by public institutions is good.

Sam Woods

Sam Woods suggested that people would perceive delusion in someone replying yes, and excessive pessimism in someone replying no, and so answered that it may be the reason.

Dino Falaschetti

Dino Falaschetti replied that with experience at the White House, the Financial Services Committee and the OFR it is clear the work is incredibly hard.

Francesco Mazzaferro

The Chair thanked the panellists. ■

Views of a global bank CEO

Bruce R. Thompson - Vice Chairman and President, EU and Switzerland, Bank of America - **David Wright** - President, EUROFI

David Wright

I have the pleasure, again, of having an exchange of views with Bruce Thompson, the Vice-Chair and President, European Union and Switzerland, of Bank of America. Welcome, Bruce. Thank you for being with us. Thank you for your support of Eurofi. The first subject we are going to talk about is Brexit. How do you see things? You have made regulatory changes to the way that you organise your business in Europe. Is that working out?

Bruce R. Thompson

Thank you again for having me, David. I realised we first spoke about Brexit in Sofia in April of 2018, and we were worried if we would have our bank set up in time for Brexit to happen. I guess we can say we are ahead of the schedule, with where we are today. Clearly, not unlike other financial institutions, the impact of Brexit and how we operate has been significant. I will just give a few quick facts.

The first is we took our UK bank and merged it into a bank in Ireland to create our European bank, so all of our traditional banking services are run out of that European bank in Dublin. The merger happened in December of 2018, so we have been almost a year running.

During the second quarter our European bank had one of the best months in its history, so the progress for the bank has been good. The people who needed to move have moved, and exercises are taking place such as the supervisory review and evaluation (SREP) and comprehensive assessments. Our bankers are able to go to clients and say that, regardless of what happens from a Brexit perspective, we will be able to serve your needs. Similarly, there have been many uncertainties with individuals – their jobs, their residences, and so on. As the merger is done and cannot be reversed, our colleagues are in place and know where they are going to be going forward.

The investment firm started a little bit later, with the licence attained in Q4 of 2018. The entity started trading in February 2019. There is around $6 billion of capital committed to that area, and we started with roughly 100 people in France, and ramped up to just under 400 people at present. In a post-Brexit environment, it will be at about 450 people. That process has gone very well. Roughly 90% of clients have been onboarded into that entity and are ready to go in a Brexit environment. The one thing that everyone, from a financial institution perspective, is working through is that despite having all of the clients onboarded, clients are splitting their trading activity between the legacy entities in the UK and all of the European entities. However, on balance we feel very good about where they are. Like everyone else, they have done everything possible to be ready from a preparation perspective. With the 31 October date coming up, playbooks are being dusted off again from the end of March and early April, and the outcome awaited.

David Wright

Looking at it from a slightly broader perspective, do you see this uncertainty in the market? Nobody knows where we are going to be in one week's time, let alone three weeks' time. This uncertainty must be worrying for global financial institutions such as yours.

Bruce R. Thompson

Yes. What is interesting, David, is you would think there would be more concern out there, but if you look at absolute valuation levels in the markets, if you look at where credit spreads are, by almost any metric the financial markets, knock on wood, feel very good at this point.

Factoring in Brexit and slowing economic growth into different issues such as threats of tariffs and trade wars, there is a worry that the cumulative effect can seep into the real economies. As a financial institution with a significant credit book, we are trying to make sure that we appropriately understand the impact, as these factors lead to changes in real economies and we are looking at how they manage associated risks.

David Wright

Looking at Europe, and I will use my usual trick here and make you the temporary commissioner of financial services for the next five years, what is your advice to the incoming commissioner, Vice-President Dombrovskis, who is going to continue with his role here? What is the real thing that would ramp up the growth rate in Europe?

Bruce R. Thompson

I am not going to get into the social issues, but I will say a couple of points.

The one topic that does need much focus is the Capital Markets Union (CMU) project. Much work has been done on the project. We believe that it is very important in a post-Brexit world. Looking at the European markets, roughly a third of the activity will come out of the EU when the UK exits, which is significant. Considering policies spilling into economies, post-Brexit the companies that borrow capital will be relying on roughly 75% of that capital from financial institutions, relative to 25% from the capital markets. In the US, that relationship basically flips to where around 75% is from the capital markets, which gives the banks the ability to recycle capital and to do things to support the economies at a much quicker rate.

In the US, investment grade borrowers raised just under $80 billion in four days which was the most capital that has ever been raised in a week, let alone four days (last week was the first week back post-Labor Day). In the context of a 12% capital ratio, that in effect is $10 billion of capital that has been recycled in the banking system that can then be reinvested to do things to help the economy. Particularly in a post-Brexit environment, the development and certainty of CMU are particularly important.

The other subject we all speak about is the need to make sure that there is harmonisation in the overall regulation that we go through. Historically, everything that we did across Europe tended to be hubbed in London, and in our case, we have two new legal entities in addition to what is in London: one in Dublin, which is the European bank, one in Paris, which is the European investment firm. The complexity that goes along with that has obviously gone up I would argue more than threefold as we do that. We want to make sure we are doing all the things that the regulatory community wants us to do. To the extent that there can be more harmonisation and more consistency about that, that should bode well for everybody.

David Wright

Press on, Commission. Press on, Europe, with Capital Markets Union. I could not agree more with you. When you look in your seat of great importance at risk across the world, what worries you the most? Is it the trade risk, the low-interest rate environment in certain major jurisdictions? Is it cyber-security? Is it the slowing of the US economy? What keeps you up at night?

Bruce R. Thompson

If you go back to anything that ultimately flows into how the companies and the individuals we bank are affected in terms of their credit profile, we are clearly focused on understanding the slowing economies, and understanding the impact that tariffs and the like can have. There is a broader issue with tariffs and the like, and there has been an increase in populism that goes along with that and understanding how that can flow into the core economies.

The other item you touched on, that it would be naïve not to highlight, is cyber-security. It is one of the issues we across our company spend a great deal of time on, and just to give context to the importance, we will spend somewhere between $700 and $800 million in 2019 purely on cyber-security and making sure that our systems are protected. From a cliff-edge or an event perspective, cyber is very important. We have seen the negative impact it can have on a financial institution when they do not get it right.

David Wright

Just a final word, because you obviously are a major bank from the Unites States with interests all over the world. Some people are saying the US economy is slowing, and some people are more optimistic. Where are you on the balance sheet?

Bruce R. Thompson

Our CEO, a week or so ago, said that the only thing we have to fear of a recession is the talk of a recession. This is reflective of what is being seen in the US economy at this point. There is no question that the growth rate has slowed down a bit, but in the second quarter it was still 2.1%. Looking at the recent data that came out in July, 130,000 jobs have been added. Year-over-year personal income in the US is up over 3% and unemployment remains below 4%. Looking at the strength of the core consumer in the US, on average they have more in their checking account this year than they had the previous year. Their credit card debt is lower this year than it was last year. With the appreciation of home prices, for those who own property they have more equity in their house this year than they did last year.

At this point, there is a good feeling about the US economy and where the consumer is. At the same time vigilance must be maintained, because clearly the activity and the noise on the global stage is real, and it is something we spend a lot of time with, but so far so good.

David Wright

Thank you so much, Bruce. We had better check in in Zagreb next year and Berlin. I am looking forward to that, I hope you are too.

Bruce R. Thompson

Thank you very much. ■

What ambitions for the EU banking sector and related policy priorities?

Andrea Enria - Chair of the Supervisory Board, SSM, ECB - **Alessandro Rivera** - Director General of the Treasury, Ministry of Economy and Finance, Italy - **Carlos San Basilio** - Secretary General of the Treasury and International Financing, Ministry of Economy and Business, Spain - **Xavier Musca** - Deputy Chief Executive Officer, Crédit Agricole S.A. - **Felix Hufeld** - President, BaFin

The Chair introduced the broad discussion on ambitions for the EU banking sector and related policy priorities that reflect a situation which no European can be satisfied with. Profitability is an issue, there are legacy issues of all kinds and there is an obvious profitability gap to US competitors.

1. The profitability malady: an overview from an EU supervisor

1.1. Banks are much more resilient, but their profitability remains disappointing

A Central Bank official gave a snapshot of the European banking sector. The post-crisis repair process is almost complete, and banks are in a satisfactory place on credit and liquidity. Capital requirements and buffers are now fairly similar across the euro area, UK and US banks. The boxes are ticked.

Asset quality in internal models and risk weighted assets is close to the end of the process. The European Central Bank's (ECB) targeted review of internal models (TRIM) process will soon be complete. Policies on non-performing loans (NPLs) are in place and significant progress has been achieved in cleaning up banks' balance sheets. There is still an issue of execution and completion of the process in banks where issues are still relevant. European Banking Authority (EBA) policies on internal models are close to implementation. The Basel package is coming.

The sector is more robust and resilient, but the major issue is that it is now widely considered almost un-investable. Low current and expected profitability is reflected in low market valuation price and books often well below one. This profitability malady is a problem for supervisors because they like banks to generate capital organically and to be able to raise capital in the market if needs be. Banks are not in a comfortable place now.

1.2. The remedy does not lie in watering down key prudential regulatory reforms

The banking sector and the industry argue that the remedies to this situation lie with public policies. They propose putting pressure on central bank regulators to focus on higher interest rates and ideally lower regulation and lower capital regulation, especially a relaxation in the implementation of the Basel standard. This is not the way forward. It is not the appropriate policy response to these problems. It is important to complete the post-crisis adjustment and make clear that the process is finished. A clear signal is crucial. There is a perception sometimes, also from investors, that in Europe the bar for capital is going higher and higher. This must be clearly shown to be the last bit. On Basel, an effort was made to repair internal models and maintain a risk-sensitive approach to supervision. It is vital to finish the job. Almost all the Basel standards come from EBA analysis or from findings that have been confirmed by the ECB's on-site analysis.

These points have been made in these forums in the past. The output floor has never been a strong point and has never convinced that it is a good way forward. More reliance was placed on the bottom-up repair done at the ECB and the EBA for internal models, while acknowledging that it was part of an international deal. Negotiation started with a window on the output floor of between 70% and 90% and ended at 72.5%. That was as much as could be achieved in the international negotiations. It is now crucial to get this done.

1.3. Banks should concentrate efforts on cost efficiency, refocusing business models and digitalisation to restore profitability

If deregulation is not the right response to the low profitability issue, the question is what the policy focus should be. Banks control levers that need to be used. The ECB's work shows that cost efficiency, business model viability, strategic steering and investment in new technologies are features of banks that have recovered profitability. Banks raise the point that compliance costs and the Banking Union machinery can be heavy handed and demanding. There is a need to listen and respond positively if that can be lowered.

1.4. Restarting the securitisation market on a more viable basis should remain a high priority for public policies in the euro area in the EU

Another area of focus is securitisation. Five years ago, the discussion was around securitisation as the low hanging fruit of the Capital Markets Union (CMU). It is sad that the market still does not have a tool for a liquid and standardised securitisation market. This would help banks to have leaner balance sheets and to deploy capital for better purposes. Complex securitisation products still exist. Restarting the securitisation market on a more viable basis should remain a high priority for public policies in the euro area in the EU.

1.5. Authorities should deploy a multi-pronged strategy to address the structural issues that are preventing excess capacity in the sector from being addressed and hampering efforts to move towards a truly integrated, single domestic market in the Banking Union

The structural problems that are impeding banks from recovering profitability must be acknowledged. These can be classified under two headings. The first is excess capacity and lack of consolidation, and the second is backward steps in financial integration and the lack of a truly domestic single jurisdiction for European banks in the Banking Union. Public policy should focus on these structural issues as a matter of urgency. The ink is barely dry on the recent legislative package and legislative constraints will not go away quickly.

Exit from the market should be made smoother and easier. This is an issue that qualifies the European post-crisis experience in a negative way compared to the US. The US had more exits from the market and more consolidation immediately after the crisis, which helped to mop up excess capacity much faster than Europe could. The Bank Recovery and Resolution Directive (BRRD) would have brought Europe closer to these objectives. It must be acknowledged that even relatively small banks still do not have good enough technology to pull the plug and exit the market in a smooth way. Common tools are needed. There are various approaches, ranging from voluntary liquidation to corporate-like liquidation, to administrative liquidation, to administrative liquidation with liquidation aid. It is messy.

The second point is to review the obstacles to consolidation, especially to cross border consolidation and integration to find a better way of allowing banks to pool capital and liquidity across the Banking Union. The work on the European deposit insurance scheme (EDIS) under the euro working group is anticipated. It is important to make progress, but it will be difficult. Progress must also be made with the current legislative environment. An interesting proposal was made by Jacques de Larosière and François Villeroy de Galhau to rely more on intragroup guarantees. These avenues should be explored. Recovery and resolution plans could give greater strength to these tools and ensure that they provide sufficient safeguards to both home and host authorities and to have greater progress in these areas.

The Chair finds the options interesting. Compressed risk premia and a severe low interest environment have existed for some time. It is not known how long it will last but the industry is increasingly feeling the impact.

2. The root causes of the profitability malady

There are both temporary and permanent factors behind this drag on profitability.

2.1. The conjunctural causes: lasting very low interest rates and low growth deteriorate the profitability of the banking sector in Europe

Low interest rates reduce euro-zone banks' intermediation margins and the return on their excess reserves, leading to low bank profitability.

An official advised that this is another perfect storm. Several elements are putting pressure on the banking industry. One is the impact of interest rates on margins, which will exist for some time. Latest signals from both the ECB and the FED suggest that low policy rates are here to stay for the foreseeable future. This highlights the difficulties for monetary policy in having an impact on inflation and the traditional channels of monetary policy. Monetary policy cannot solve structural economic issues. Increasing growth in the euro area will have to come from other instruments and fiscal policy is the obvious choice, particularly for countries that benefit from room for manoeuvre. The current decelerating macro environment also worsens banks' prospects for making revenue. Structural factors impact profitability. The regulatory burden is associated with additional requirements for solvency.

An industry representative advised that a recent investor roadshow delivered the message that progress is being made and should continue, along with cost reduction and digitalisation. Supervisor recommendations are followed because they come from the supervisor and match those from shareholders. European banks are committed and are obliged to go this route as there is no other route.

Despite that, the message is that banks are not investible due to extended periods of very low interest rates. Commenting on monetary policy goes far beyond what bankers can do. That is the reality. It must be coped with and it would be foolish to imagine that revenues can increase massively in this environment.

An official stressed that the current unconventional monetary policy has allowed banks without a viable business model to stay in the market. In addition, this lack of exit means that non-viable banks can be aggressive in their pricing and make life more complicated for other banks.

2.2. Structural factors

2.2.1. Banks face mounting competition from new FinTech providers

A public decision-maker raised external factors such as digitalisation. Banks' P&L show strong pressure on specific business lines that are influenced by new FinTech providers. This will only increase in the future. The challenge is whether the banking industry, which is well suited to benefit from this technological solution and innovation, can benefit from it or be a victim of innovation. So far, banks have weathered the fintech environment reasonably well. With more investment and creativity, they should end up benefitting from it.

2.2.2. Ring-fencing policies fragment markets, impede consolidation and impact European banks' profitability

When comparing European banks with their American peers which benefit from a single financial market, EU banks do not benefit from the expected opportunities that a single banking market and effective Banking Union could deliver for market participants. Some progress was made but there is more to do.

An official stated that analysis must go deeper into the structural issues to set out an appropriate policy response. Banks are too small and have too many branches because there is fragmentation across the jurisdiction. The structural reasons for this outcome are closely interlinked. There is no effective and smooth crisis management in Europe. This creates a lack of trust between supervisors and therefore ring-fencing policies. The EU resolution framework is indeed incomplete. There are notably two different layers of banks and frameworks for crisis management. One is dedicated to 30 banks of public interest that need to be resolved if likely to fail. The second layer is for the others except the 30, which are left with liquidation. That is unrealistic and must be addressed. This discussion has been long and requires innovative solutions or lateral thinking, otherwise it becomes like the chicken and egg and leads nowhere.

An industry representative advised that profitability issues cannot be overcome without the political will in Europe to address the lack of consolidation or excess banking capacities in Europe. Banking Union is a tremendous success and there is a strong supervisor and a respected resolution authority. Yet the capacity to invest in another country has not changed on the ground, even within the eurozone. The SSM cannot be reproached for that as they have made efforts. More should be done as there is little progress.

While cross borders can generate synergy revenues and partly resolve access capacity problems, they do not reduce the cost base significantly due to the heterogeneity of retail markets in Europe. However, market fragmentation is adverse as it obliges banks to locate capital and liquidity in different eurozone countries, which is suboptimal in the management of the balance sheet.

2.2.3. Insufficient development of European financial markets contributes to EU banks' low profits

An official agreed with the factors behind low profitability outlined in the presentation. The relatively low development of capital markets is an issue as they are a potential source of revenue for banks and can at least partially offset decreased revenues from slowing economic growth or negative interest rates.

The answer cannot be to backtrack on regulatory decisions that have been achieved, while acknowledging that a more stringent approach has been adopted for these decisions than in the US, such as minimum requirement for own funds and eligible liabilities (MREL) requirements that exceed the global arrangement.

3. Solutions for improving bank profitability

3.1. Settling the home-host dilemma is the right way-forward

An effective Banking Union requires going beyond the 'risk reduction, risk sharing' debate and to address the root causes of ring-fencing policies.

3.1.1. Addressing the root causes of ring-fencing policies

An official noted that it is vital to define the Banking Union reboot, which goes beyond EDIS. It goes into significant issues around fragmentation. Recent legislation has not helped in this respect and has probably gone in the other direction. The home-host balance is indeed not favourable for consolidation across the eurozone. Consequently, addressing fragmentation requires the home-host balance to be reassessed. Moreover, the Banking Union's first two pillars must also be assessed. There is room to improve and have a more efficient and well organised exit strategy for banks.

A clear roadmap is essential and must be delivered at the end of the year or early next year, including significant and enforceable targets. Deposit insurance is one, market fragmentation is another and a clear exit strategy should be the third. The fourth would be risk reduction, where a great deal has been done. Most of the targets set a few years ago have been achieved but there is more to do.

A Central Bank official noted that the issues of fragmentation and requirements that force banks to keep capital and liquidity segmented in different jurisdictions have been raised. Insufficient progress has been made, which jeopardises the movement of capital and liquidity.

An official responded that regulators can improve the situation. Having the Banking Union as a single marketplace for banks in at least the euro area would be a game changer. This has been a struggle for the last few years. In the early stages of the Banking Union and in the first attempt, there was a clear roadmap with three pillars and three key ambitious targets. Then came the pressure of the crisis and the need for urgent delivery. There was success on single supervision and single resolution, which only a few years before would have seemed impossible. There was a failure not to deliver on EDIS, which would give depositors, investors, managers and shareholders across the euro area certainty that the guarantees are the same regardless of the location of the bank they put their money into. But EDIS is not the only missing part of an effective Banking Union. A single marketplace must be dealt with as should other issues like the bank sovereign 'doom loop', which is only partly addressed by the single deposit system for Europe.

3.1.2. Addressing ring fencing policies would also encourage cross-border consolidation

The EU legislative framework does not recognise trans-national groups at the consolidated level but only as a sum of separate subsidiaries ('national or solo approach') due to member states' insufficient trust in the Banking Union's institutions. Ring-fencing practices such as increased capital buffers or Pillar 2 requirements for subsidiaries, application at the local level of specific capital, liquidity and MREL requirements are an obstacle to the emergence of truly transnational banking groups within the Banking Union as they hinder effective allocation of capital and liquidity within banking groups and reduce economies of scale.

An industry representative gave the example of a company's subsidiary in another country, where both countries are in the eurozone. There are MREL requirements for the subsidiary, but a waiver is not possible. It is possible for the parent's subsidiaries in the same country but not possible because of regulation on the foreign subsidiary. The political will is that each country is still considered totally independent, even though they are members of the

eurozone under the same reliable supervision and managed by the same resolution authority in the event of crisis.

There is a lack of will to resolve this and put all euro area bank subsidiaries on the same footing. Such measures would not resolve the problem but would encourage cross border. The consolidation process is less attractive if a cross border acquisition traps liquidity and capital in other countries.

3.2. Completing the Banking Union and addressing the sovereign bank nexus are also required

3.2.1. Achieving an agreement on EDIS

An official stated that the first layer on consolidation is large. The Banking Union's first and second pillars exist but the third one, EDIS, is missing. It is like the chicken and the egg. More risk reduction is needed for EDIS to become a reality, but that risk reduction is only made possible by establishing Banking Union. The SRM, as the second pillar of the Banking Union, exists in a form that does not seem to be useful, due to the lack of a harmonised liquidation regime.

This is a risky discussion as there is a danger that markets perceive policymakers as concentrating on ring fencing rather than breaking down fences. If market perception is that consolidation will not happen, cross-border activity will remain expensive because expectation plays a key role.

A Central Bank official noted that without the third leg of the Banking Union, there is an argument that the bill lands on the national table if something goes wrong. This cannot be let go. There have been positive experiences and cases where banks were allowed to pay extraordinary dividends to the parent with the parent's commitment to intervene with subscriptions of additional tier one, tier two or capital in the subsidiary if something goes wrong. These techniques should be further developed to address these issues.

The Chair noted that much has been done to deleverage NPLs, but not enough to move towards EDIS.

3.2.2. Addressing the sovereign-bank nexus and harmonising EU liquidation procedures

A new proposal on the regulatory framework and the implementation of the next round of Basel is imminent. This review should acknowledge the prudential advantages of diversification of sovereign bonds holdings. If concentration charges can be considered, so can diversification advantages. It meets European specificities that aim for a single jurisdiction, recognising the issue of asymmetric shocks in different eurozone countries.

M&A is not a target for others per se and is beneficial in facilitating concentration. Regulators and policymakers should not target M&A so that market operators are free to choose between organic growth and other tools. But removing excessive costs must be an objective of policymakers and regulators.

Leaving banks with national liquidation regimes is inconsistent with a well-functioning Banking Union. Something beyond liquidation is needed and the Federal Deposit Insurance Corporation's (FDIC) crisis management provides an example to European public decisionmakers for addressing small banking crises.

3.3. A question of political awareness and method

The Chair noted the lack of political will on consolidation and asked what could be done to promote it if the political will is available. An industry representative paid tribute to the SSM for doing what is possible within its mandate's limits to reinforce the eurozone's strengths and the fluidity of capital among member states. The question is the present limits set by regulation. There is an issue of priority and a question of political awareness and method. Eurozone savings are not circulating normally from the north to the south, from countries with excess savings, such as Germany or the Netherlands, to those with a need of investment financings such as Portugal or Greece. Saving surpluses are not recycled within the eurozone but outside it. This is not corrected by a capital union nor by a redistribution and transfer mechanism as there is no federal budget at the eurozone or EU level.

Few banks are present simultaneously in many eurozone countries, which reflects the eurozone's weakness. Those banks cannot channel savings from one part of the eurozone to another. The key political question is whether the eurozone is ready to accept this financial fragmentation. Answer it and the technical details can be discussed. If the political priorities are not at the top of the eurozone's agenda, the same debate will happen again without any solution. It is a concern that that point has been reached.

The second message is not about measures, but procedures. Banks are heavily regulated. They have clients and they have shareholders. How policy is aimed at banks should be tested and discussed with investors because losing their confidence will not make things easier, but worse.

A public decision maker started from a pessimistic assumption of how the Banking Union's functioning can be improved with a mandate of four and a half years if political debates do not progress. Positive surprises are hoped for, but it is vital to improve the functioning of the existing infrastructure and that is where to focus attention. Intragroup guarantees will be key to working within the current setting.

Investors sometimes consider the ECB an obstacle. Bankers' body language shows that they do not think the ECB puts its money where its mouth is. A first objective would be to convince markets that the ECB is not an obstacle to consolidation. It would be enough to focus on these points during a limited mandate.

3.4. The lack of success on securitisation is disappointing and cannot be a solution at this stage

An industry representative advised that securitisation's lack of success is disappointing. First, the passed legislation is stricter than the precedent. The hope that securitisation will be a solution is doubtful. Second, targeted longer-term refinancing operations (TLTRO) and lasting very low interest rates make securitisation less attractive because TLTRO supposes that loans are kept on the balance sheet. That is unfortunately not a solution. Securitisation exists in countries with more developed financial markets, such as the US, where it is massive and publicly managed by Fannie Mae and Freddie Mac. Europe does not have that. The difficulty for the EU is not a lack of support from supervisors, nor is the solution to relax the banks' efforts. The banks will do their utmost. It is not good banking if the price to book is lower than one, but if all the European banks' price to book are below one, it is not because bankers are not efficient. There is a collective problem.

3.5. The Basel IV reform would penalise the competitiveness of the EU banking sector

An industry representative stated that the level of capital in European banks is adequate. That raises the question of why the EBA says that global systemically important banks (G-SIBs) should raise 28%, which is

more than significant. It is an adverse environment which always asks for more capital. The prospect of more capital to be invested is not interesting for investors. The price to book is lower than one for all these reasons and there are difficulties in arguing that.

As reassurance, no one talks about backtracking regulation. No one says that supervisors' and regulators' past actions were inappropriate, but the EBA's message is that the solution to the problem is to not distribute dividends. Investors do not like that. Maybe the EBA is misunderstood but that is what is passed on.

A Central Bank official commented on the EBA report on the impact of the Basel agreement. Much of the adjustment requested by the Basel package is underway thanks to the EBA action for repairing internal models and the impact that the TRIM is having on banks. The final effect of the Basel package on the banks will be much lower. The EBA report looks at the complete Basel implementation without considering any deviation from Basel that European legislators have already decided to take and which they will not revert to. There is also an issue of distribution. Repairing internal models aims to ensure a right, reliable distribution of capital and so this model and approach must be pursued.

3.6. Revamping the CMU agenda

An official noted that developing capital markets is important for profitability because it provides additional revenues. Revamping the CMU agenda is important and is being explored by a group of experts. The Commission will present ideas. Remaining as ambitious as possible is key. The CMU is often perceived as technically complex, but less controversial politically than the Banking Union. The CMU is complex both from technical and political perspectives. Issues like insolvency legislation include property rights, which is a highly politically sensitive issue and is why justice ministries have difficulties in finding agreements.

The Chair noted that having savers' money circulate freely within the EU is important. The policy question is around the structures that the EU would have to offer to make that work. Expressing the wish is one thing, offering policy structures to make it work is something else.

One free wish for the new EU Commission would be to complete the Banking Union. The impact on European banking market profitability will be marginal but it must be done for policy reasons. The big game changer which could happen if the political will exist, is to put it at the top of the agenda the CMU project. The most impactful lever would be unlocking EU pension savings as a homegrown strengthening of the buy side, where the EU is weak. Not to downgrade the importance of Banking Union, but there is almost an obsession with completing it but this will not be a game changer. A CMU would be. Unfortunately, it is a huge challenge both technically and politically, but not tackling it is not an option. ■

Enhancing the role of asset management in the financing of the EU economy

Patrick Thomson - Chief Executive Officer, EMEA, J.P. Morgan Asset Management - **David Wright** - President, EUROFI

David Wright

Ladies and gentlemen, I would like to begin our exchange of views with Patrick Thomson who is the Chief Executive Officer, EMEA, for J.P. Morgan Asset Management. He has been in the firm from 1995, and has a vast experience of the asset management industry in Europe. We are going to talk about the role of the asset management industry in Europe, how it is evolving, and particularly how he would like the industry regulatory environment to change as we move forward.

Patrick Thomson

David, thank you for the introduction. It is a delight to be here. In summary, when we think about what asset management does and what the industry actually does, it does a couple of very important things. One, it helps savers meet their own goals in retirement, or their own personal goals. Two, it provides capital to companies. And so when you think of that in a European context I would say that actually under the UCITS framework the asset management sector has been very successful in meeting the goals of its customers, which of course is what we are here to do. I think the predictability and the consistency of the UCITS framework has really helped asset managers and their customers understand the role that asset managers play in providing capital to companies and to infrastructures for a societal benefit, but we also of course give a return to our customers, which allows them to grow their capital over time and keep the purchasing power of the capital.

In summary, I think the European asset management industry and the way it is regulated can generally been regarded as very successful, and I submit as evidence of that the fact that pension funds all around the world in Chile, in Singapore and in other parts of Asia now adopt the UCITS framework which, in essence, is a success.

David Wright

But do we have a genuinely competitive and integrated European market for asset management? One often hears about fragmentation related for example to marketing rules, is that a major issue?

Patrick Thomson

I would say that generally speaking and from the perspective of one of the largest cross-border providers of mutual funds in Europe, the EU fund framework is a huge competitive advantage when you look at other markets, compared for example to Asia, which is a very fragmented market. Each market has its own regulations about products and services in Asia, so relative to that I would actually say Europe has got a significant competitive advantage.

That having been said, there are clearly areas where rules could be improved in Europe. There are some challenges in terms of the way that we have to describe our products, if you think of the PRIIPs regulation that clearly does not meet customer needs and requirements. That is a real challenge. Generally speaking regulation has good intentions, and the way that the regulation is created is usually through consultation with the industry and then rules are made. However in some cases, some of those rules have unintended consequences, and I would submit PRIIPs as possibly one example, whereby you are given information which is very complex to digest.

David Wright

Besides tackling the unintended consequences of PRIIPs, what else is on your wish-list for the incoming Commission regarding EU regulation?

Patrick Thomson

The one ask I would have for the incoming Commission is to build on the success of UCITS, which was built up over 30 years. It is a very stable, consistent,

understandable and pragmatic set of rules. They are not perfect, no rule is, but they allow people both inside and outside the EU to have confidence that when they put their capital in the hands of an asset manager that manages UCITS products, that capital will meet the goals that are stated by the asset manager in a sensible and safe way, so that the investor is actually protected.

The UCITS experience also indicates that consistency and predictability over time help to build investor confidence. Our advice would be not to tinker too much with existing regulations that work well. The same goes for MiFID II and AIFMD which is under review.

David Wright

I agree UCITS is a major achievement and this example should be followed in other areas such as pensions. What more could be done to capitalize on the success of UCITS?

Patrick Thomson

The one request I would have to the Commission is to continue to listen to the industry. When the industry actually makes a point around something like PRIIPs then it is worth listening to that.

Another example might be delegation of portfolio management. Delegation of fund management services, which is where your portfolio managers might sit in a different geography to the client or to where the fund is registered, is a fundamental principle in the supply chain of asset management. This has nothing to do with Brexit or third-country regulation. If investors want an exposure to Japan or to the US, then the people managing those assets need to be as close as possible to that market. That notion of delegation is incredibly important for the continued success of the asset management industry.

David Wright

Do you see any major changes happening in the European market with Brexit or other on-going evolutions?

Patrick Thomson

What will happen with Brexit is very difficult to anticipate, but I would say that the asset management industry is prepared. More generally, the industry continues to see Europe as a very successful source of both capital and investment. One example is infrastructure. Europe has been over the last few years a fantastic place both in terms of a place to invest in infrastructure projects and of regulation and organisation of the market, which are very sensible.

Also, we are increasingly seeing European citizens interested in investing in infrastructure themselves. That is a result particularly of the very low levels of yields that we are currently in. What is happening to government bonds at the moment is quite remarkable. Fifteen 10-year government bond yields are now negative, and over twenty others have negative yielding assets somewhere along the curve.

If you think about that, and you combine that with the very low levels of returns on deposits for European savers, that presents a tremendous challenge to the asset management community to be able to generate income or capital growth on those assets, which is why the asset management industry has begun to look at different asset classes. Infrastructure is a perfect example of this because it is a very predictable, inflation protected, sensible investment that actually delivers a societal benefit to European citizens, increasing productivity and efficiency of the European economy. I think those different factors combine to make Europe continue to be a very successful place to invest.

David Wright

Patrick, at the European and global levels there is much talk about fund liquidity risks and possible run risks associated with mutual funds and ETFs. Is this a major concern?

Patrick Thomson

Different factors need to be considered. One is that we are possibly coming to the end of a nine or ten year period of economic expansion, which means that asset prices have risen a great deal. This is a very cyclical industry. A contributory factor is central bank action; the world is awash with money through quantitative easing, so of course liquidity is incredibly important to our clients.

Another issue is that we are potentially entering a long phase of low interest rates that may be more worrying than liquidity. This may be similar to what Japan has experienced over the last 10 years, where there is now talk of "low-for-longer" and "low-for-ever", as was mentioned in a previous session of the Forum. We may just be at the starting point of this in the euro area, so monetary policy response and the implication of that policy response is actually a very grave concern for long-term investors.

In this context, I think it is very important that regulators do not overprescribe on liquidity. Let us remember that over 30 years since their creation UCITS funds have weathered various crises, which is a very good validation of the way the UCITS regulation has been built over time. What is very important is that regulators and asset managers work together on this topic, and that asset managers demonstrate that they understand liquidity and its implications both in stable and difficult market conditions.

One could argue that the most liquid investment would be short-dated treasuries, government bonds, or potentially bank deposits. However, bank deposits do not give you the return that you need in order to meet your retirement provision, so you have to take a balanced view on both risk as an investor and also liquidity. There should be parts of a portfolio – a pension fund, for example – that can very well be invested in illiquid assets that provide a superior return over time.

You mentioned ETFs. We want to be able to provide our clients with as much choice as we can, which means that rules in this area should not be over-prescriptive either.

David Wright

Another representative of an asset management company mentioned in a previous session that there has been a completely unambiguous move in the industry for five years towards thinking about sustainable investment and green finance. Do you agree with that?

Patrick Thomson

Yes. This is the one of the most exciting evolutions in the European market. It is not a fad; it is here to stay. You only need to look at what happened this summer with the civil action and unrest around climate change in many of the major capital cities to know that this is absolutely foremost in the minds of voters, and voters, of

course, are our clients. People increasingly want to know what we are doing with their money for retirement, whether it is invested in companies in a sustainable way, if the way that these companies generate returns is sustainable… We need to be able to respond to that. I would further make the point that customers are moving faster than the industry and the regulators are. And I think Europe is in an extraordinary position to take a leading role in determining – not unlike it did with UCITS – a sensible set of policies that the industry can then use to derive products that meet these customer needs.

I am very excited about that opportunity, because I think Asia and the US are a long way behind. Europe has a leadership position in terms of the description or taxonomy of this type of investing, which covers many different fields in many different areas. Having a consistent description about what sustainable investing actually is, is essential. Asia and the US have large pools of capital, so that also represents a huge opportunity for capital to come into Europe and for European policymakers to take the lead on describing the nomenclature and the way that we should think about investing sustainably.

David Wright

When we talk about ESG everybody talks a lot about the E (environment), but they do not talk too much about the S (social) and the G (governance) aspects. Have you got teams of people looking at the social and governance policies of these institutions, or is it all environment?

Patrick Thomson

We look at it relatively holistically, but I think you have hit on a really interesting issue, which is why I think people are now veering more towards the description of sustainable finance. If you talk to US investors about the 'S,' let alone 'G' aspects you are going to get quite an adverse reaction generally, although some of them are now beginning to accept the notion of the impact on the environment and the degree of sustainability around the economic footprint of businesses. Many also consider that this is not the role of investors but of governments. Being very precise and careful around these descriptions will help build a degree of consensus around what these sorts of solutions should look like.

Sustainability is a huge opportunity and a huge goal, which we really do see as a significant advantage. The one ask I would have however around ESG is again not to be overly prescriptive in terms of excluding various activities, investment methods, processes and opportunities, just to reach some sort of purist interpretation of what E, S and G might mean. For example, there are different standards of governance around the world, and so one has to be careful.

David Wright

Finally, Patrick, how important is technology for the fund industry? Can major changes be expected on that front?

Patrick Thomson

Technology is an important factor. There are different applications of technology, but as an investment manager we are particularly excited about what technology can do in terms of helping us deliver better products faster, quicker and cheaper to clients. I think there is also an important role for technology in simplifying the delivery of products to consumers and in the provision of information in digestible formats. We see this in different markets, where more and more customers use their banking apps for example. The banking app we have in the US is one of the most popular financial apps. It is consulted by customers five, six or seven times a day. You get a high degree of confidence and interaction through this, and if we can do the same in the investing sphere, getting people to look on a mobile app at how their savings for their retirement are doing and how well it is working for them, you get better familiarity with investment. That will build confidence and ultimately lead to better investor education and more informed investors, which is a good thing for Europe overall.

The whole continuum of services needs to be considered including robo-advice Technology is disrupting our business but also providing improvements to consumers. You only need to look at what is happening in China and look at the extent of the digital footprint around savings products there to see the power of that. It would be a great outcome for the European Commission to help support that.

David Wright

Patrick, a great pleasure to see you here. Thank very much for your insight.

Patrick Thomson

My pleasure. ■

Developing securities markets

Adena Friedman - President and Chief Executive Officer, Nasdaq
David Wright - President, EUROFI

David Wright

Good afternoon, everybody. I have the great pleasure of welcoming Adena Friedman, who is the President and Chief Executive Officer of Nasdaq. We are delighted that you can be here.

We are going to talk about developing securities markets in Europe. We are now on the cusp of a new European political cycle of five years. How do we dynamise our capital and equity markets?

Adena Friedman

Thank you very much. It really is a pleasure to be here. It is probably good to remind the audience that Nasdaq is a wonderful market in the US but we also own and operate the markets in Denmark, Sweden, Finland, Iceland and the Baltics.

The role of capital markets is really to create jobs and economic opportunity for individuals and all the citizens of our countries, so it is very important to focus on the incentives needed as well as on the obligations that we put on companies, investors and intermediaries to make sure that you have a vibrant but well-protected system. In Sweden, Finland and Denmark, in particular, we have a market called First North, which is the small and medium-sized enterprise (SME) market. It has been an incredibly successful market in recent years and is mainly a retail market. We have had 200 initial public offerings (IPOs) in the last five years onto First North from across the Nordic region and we are starting to attract companies from other parts of the region as well.

What makes it work and how are we getting retail investors to come to this market? The first factor is that there is a strong equity and risk-taking culture in the Nordics that I think is somewhat unique in Europe and is very helpful for the development of the market.

But there are many incentives also. One of the newer incentives that have been created in the last seven years, and one which is definitely a catalyst of the success of First North, is the ISK savings account in Sweden. It is a very tax efficient savings account for retail investors, which allows them to put money into an account that has to be invested in public equities. These equities can be issued in Sweden but also in Europe. The annual tax is only 1-2% on total assets, which is marked every year. About two million accounts have been opened in Sweden in the last seven years. If you look at the trading activity and market cap of the SMEs in First North, it is almost all retail, so the ISK has definitely been a catalyst for investment in equities.

Moreover you need to develop the right market structure, so that you have sufficient capital coming into the market and also to create tight spreads, deeper liquidity and, therefore, a lower cost of equity capital for companies, which then incentivises them to go there to seek capital as opposed to the private markets. With that, we have a market-maker sponsor programme that allows a trading firm to sponsor the companies onto the exchange. They have a certain spread obligation but they also get some benefits as well. All of this creates an ecosystem that has become a great engine of growth for the region. We are really proud of it.

David Wright

Are there any issues with the availability of research for the small cap market?

Adena Friedman

Thanks for bringing that up. The one thing that we are finding challenging about MiFID II is that the

research regime has changed for SMEs as much as it has changed for larger-cap companies. There is a declining amount of research happening in Europe in general on the back of the MiFID II obligations on unbundling, but it is really hitting SMEs the hardest. There are not that many institutional investors in these companies and they will not explicitly pay for research on SMEs, so many brokers have just stopped producing it, because they need incentives to do so.

What we have done on our side is to enter into a contract with Morningstar, who now provides research across all of the companies in the market. It is a generic, machine-learning-type analysis of companies, but at least it allows retail investors to get a basic level of knowledge. This is what we can do to help support research on SMEs but it would be better to have some exceptions in MiFID II rules around unbundling for SME research.

David Wright

Do you think the model of the Nordic markets could be replicated around the EU to dynamise capital markets and what would be the main ingredients?

Adena Friedman

I really do think it can be replicated but it is not something that happens overnight or even in a single political cycle. It is a matter of setting up some basic parameters over time.

First, not overdoing the disclosure obligations on small companies. These need to be lower than those on the main market, as is the case on First North.

The second element is creating incentives for individuals to invest in equities. I have seen statistics showing that the Nordics have 50% more equity ownership by retail than the rest of Europe. As I have mentioned previously, this is due to a combination of factors including cultural elements (a strong social network and a risk-taking culture), a high level of innovation among Nordic companies and also the ISK savings accounts, which has been a huge catalyst of growth in equities. This explains also why so many companies want to go to the equity market.

The last issue that I hear about a great deal, but which is a much harder problem to tackle, is insolvency rules. If you compare Europe and the US, not all is good in the US, but there are elements of the US system that encourage risk-taking and entrepreneurship. One of these is the ability to try something, fail and try again, which is a foundation of the US economy. Therefore I do believe that insolvency laws is something that Europe should really examine in greater depth.

David Wright

I agree with you, we have not advanced very much on this over the last 20 years. One other element that you mentioned when we prepared this conversation is the importance of a centralised repository of information for the market, such as the Electronic Data Gathering, Analysis and Retrieval (EDGAR) system in the US. Should implementing a similar system be considered in the EU?

Adena Friedman

EDGAR is a central repository that the US Securities and Exchange Commission (SEC) operates, into which companies have to submit every quarterly statement and every public announcement that is of material nature. It has become a huge central repository of financial information and disclosures from companies, which I believe is one of the key success factors of the US market. What happens with all the information in one place is that, first of all, the formats are the same and the language is the same. Also, technology companies can more easily come in and build algorithms that scrape information from these filings, and then make that information accessible to investors. Of course, investors can go find it themselves, but technology allows the creation of reports better adapted to investor needs.

In Europe, creating one place for every company to submit their information, using a common language and format such as International Financial Reporting Standards (IFRS) would simplify the access of investors to information about companies and the comparison of these companies. This information could also more easily go to each of the regulators. I am very supportive of this. It does not require sophisticated technology either.

David Wright

We are also seeing in Europe – as well as in the US – a big increase in private equity. For small firms, raising capital through the public markets is quite expensive today compared to private equity. Should we be concerned about this?

Adena Friedman

I would be the first to admit that the US market is not as vibrant as it could be. There are not as many small companies that go public in the US anymore. When we compare the small-cap market on Nasdaq and the First North market in Europe, First North works better. It has tighter spreads and deeper liquidity, and it has many more companies that come into the market at an earlier stage. More can be done to improve the market in the US, but a major factor is the amount of private money available. There are extremely low borrowing rates and ready access to vast amounts of private capital, particularly for technology and innovative companies. This puts public markets at a fundamental disadvantage.

If you are a small or even a mid-sized company and you are trying to raise capital to grow your business, are you going to take money from a long-term investor that does not require a huge amount of disclosure and allows you to grow and expand and, possibly, lose money for a long time, or are you going to raise money on the public market, where you may not be able to predict your financials easily and have a shorter-term investor horizon and a huge amount of disclosure obligations? I think you are going to pick the former.

We have work to do in the US to make the public markets more attractive. We have similar conversations in the US as in Europe around graduating companies more progressively to stringent disclosure obligations, which requires changing some of the proxy rules and other measures to make it less intimidating for smaller companies to go public.

David Wright

Do you think that type of graduation is enough in the current low or even negative interest rate environment?

Adena Friedman

Probably not. However despite the current monetary context, there are positive signs in the US market. It is worth noting that, last year, Nasdaq had 184 IPOs. This year, we have had more than 120 so far, so we are on track to beat last year's figure. More companies are going public because of the cycle. The public-equity markets are also very attractive at the moment, giving companies the same level of valuation they might get in the private market, even if they are pretty discerning. We are also seeing companies going public at a smaller size outside of tech.

However, we still have a long way to go to create the right balance between private capital coming from venture capital (VC) and private equity and public markets in supporting company growth and entrepreneurship.

David Wright

In the US, you also have a massive pension 401(k) market of roughly $20 trillion. Much of that finds its way into the equity markets. Europe does not have that, or much less. Would creating pan-European pension funds be an important driver on the demand side for growing the capital market?

Adena Friedman

I believe that the 401(k) market has been a huge driver of retail activity into the public markets in the US. Defined-contribution and defined-benefit plans are both as important and in the US we have both. The advantage of the European system is that you have giant public pension systems that can invest in their own market. The issue however is that they do tend to not invest in small companies, which require too many resources. However, you can incentivise public pensions to be more oriented towards domestic equity markets through tax incentives and other measures. Even if you had a small percentage of public pension money going into the SME market, it would represent a massive inflow of money for SMEs.

Some public and even private pensions also allow investors to segment a certain percentage of the money that they are entitled to invest themselves. This can be done within the existing system.

David Wright

I would now like you to imagine that you are the European Commissioner for Financial Services about to take office. What would be your priorities for developing capital markets in Europe?

Adena Friedman

There are three main issues that seem essential to me. First, is the development of an equity culture in the different EU countries and what the EU can do to influence individual nations to do this, which is quite challenging. This first requires creating the right incentives, because people do tend to respond to them. This is about focusing on savings accounts, on individual investment into equities and on motivating pension funds. Then you can tackle the harder issues such as insolvency rules in individual countries. The Commission can only write papers and comment on what works and what does not in this latter area.

The second aspect that I would focus on is market structure, and we do think that there is a great scope for improvement in equity market rules in Europe. MiFID II had good intent but the execution has been less than perfect. We have seen no increase in lit volume on the exchanges and just a repurposing of dark trading into the systemic internalisers (SIs), which does not benefit anyone. The spreads are not getting tighter, there is no additional liquidity going into the markets and this is just making them more complicated.

A third aspect is that we still do not have the level of disclosures on a post-trade basis that we think is necessary to incentivise retail investors to come into the market. We are supporters of a post-trade consolidated tape that includes every trade – SIs and dark pools as well as lit venues – so that a basic disclosure of the last trade that happened can be created. It would also provide a consolidated view to investors and an experience closer to that of a single European market.

David Wright

You could do a pretty good job here, Adena. Thank you very much for being with us. I found this very instructive and I hope these ideas and the experience of what is happening in the Nordic markets can be taken on board when the European Commission launches work on what we can call Capital Markets Union II. Thank you very much for being with us. ■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INDEX OF SPEAKERS

EUROPEAN PUBLIC AUTHORITIES

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Klaus Kumpfmüller
Executive Director

Autorité de Contrôle Prudentiel et de Résolution
Patrick Montagner
First Deputy General Secretary

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Tom Mutton
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Gerry Cross
Director of Financial Regulation - Policy and Risk

Commission de Surveillance du Secteur Financier
Marco Zwick
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Commissione Nazionale per le Società e la Borsa
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Director General, Payments and Settlement Systems
Joachim Wuermeling
Member of the Executive Board

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Head of Efficient Capital Markets Division and Trade Decisions Supervisor

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Deputy Director-General, DG CONNECT
Martin Merlin
Director, Bank and Insurance, DG FISMA
Mario Nava
Director, Horizontal Policies, DG FISMA
Philip Owen
Head of Unit, DG CLIMA

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European Investment Bank
Alain Godard
Director General, Risk Management
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Vice-President

European Investment Fund
Roger Havenith
Deputy Chief Executive

European Parliament
Sirpa Pietikäinen
MEP, ECON Committee
Paul Tang
MEP, ECON Committee

European Securities and Markets Authority
Steven Maijoor
Chair
Verena Ross
Executive Director

European Stability Mechanism
Klaus Regling
Managing Director

Federal Financial Supervisory Authority, Germany
Frank Grund
Chief Executive Director of Insurance and Pension Funds Supervision

Federal Financial Supervisory Authority, Germany
Felix Hufeld
President

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

Federal Ministry of Finance, Germany
Levin Holle
Director General, Financial Markets Policy
Jörg Kukies
State Secretary

Financial Conduct Authority
Lee Foulger
Head of International Department

Financial Services and Markets Authority, Belgium
Jean-Paul Servais
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Deputy State Secretary on Financial Policy

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Madis Müller
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POLL RESULTS

These polls were conducted during the Helsinki event on the Eurofi mobile website

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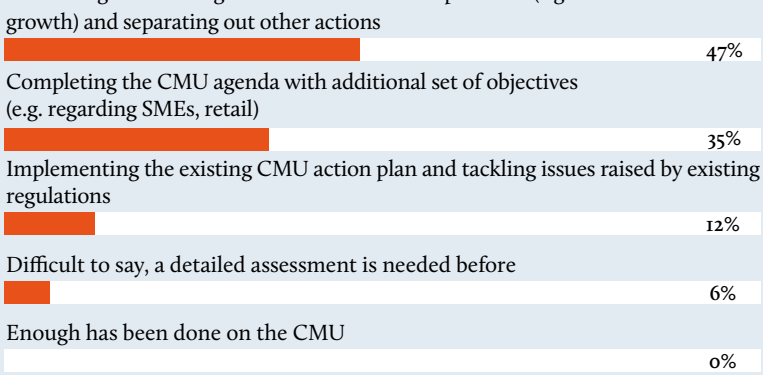
Key priority for the incoming Commission in the financial services sector?

CMU 2.0

Way forward for CMU in 5 coming years?



CMU 2.0

Key priorities for CMU going forward?

EURO

How to strengthen the international role of the euro?

RETAIL INVESTMENT

Main priorities for increasing retail investment?

EU-UK

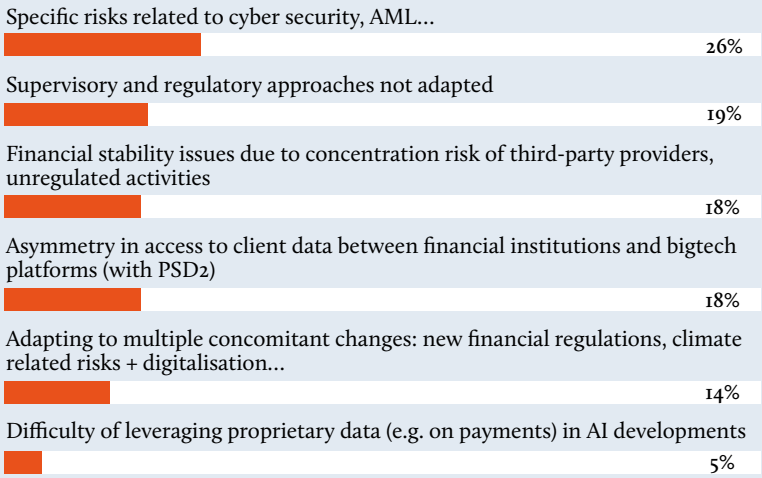
Evolution of the European financial system structure post-Brexit?

SUSTAINABILITY

Main components of an 'optimal' EU sustainability policy?

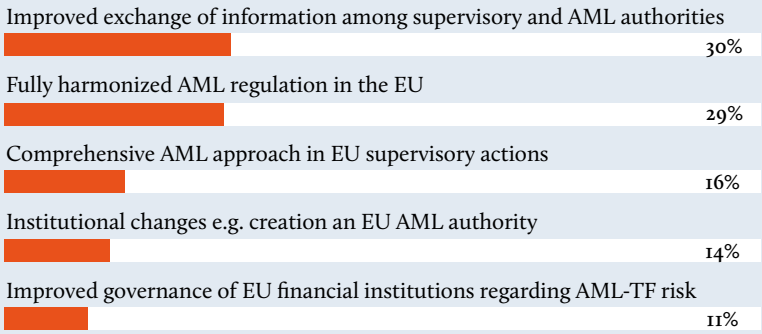
DIGITALISATION

Main challenges posed by digitalisation to the EU financial sector?



AML-TF

Priorities for more effectively tackling suspicious financial flows?



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About EUROFI

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The European think tank dedicated to financial services

- **A platform for exchanges between industry players operating in the financial services sector 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 or consumer standpoint.

We organise our work mainly around two yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow us to structure effective debates and offer extensive input. The result of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proven over time to be an effective way of moving the regulatory debate forward in an objective and open manner.

Our organisation and membership

Eurofi works on a membership basis and comprises a diverse range of more than 70 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, different service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

Our events and meetings

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends.

These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society. More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (USA, Japan, China...) and international organisations (IMF, BIS, FSB, IOSCO, IAIS...). 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 impacting 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 industry 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 each conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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